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Board of Governors of the Federal Reserve System
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Washington, DC 20551
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[Electronic Request Form]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

September 4, 2020

Re: *Freedom of Information Act Request No. F-2020-00228*

This is in response to your email message dated May 23, 2020, and received by the Board's Information Disclosure Section on May 26. Pursuant to the Freedom of Information Act ("FOIA"), 5 U.S.C. § 552, you seek:

> A copy of the Questions For the Record (QFR) and agency QFR responses to Congress responding to QFRs during calendar years 2017, 2018, 2019 and 2020 to date, for the Federal Reserve Board.

Staff searched Board records and located information responsive to your request. The Board's Information Disclosure Section will provide you with this information under separate cover. Your request, therefore, is granted in full.[1]

Very truly yours,

Michele Taylor Fennell
Assistant Secretary of the Board

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[1] If you have any questions regarding the processing of your request, you may contact the Board's FOIA Public Liaison, Ms. Candace Ambrose, at 202-452-3684 for assistance.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 25, 2017

The Honorable Ben Sasse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 7 and 8 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. On April 7, 2017, I provided a response to question 1. Additionally, on March 24, 2017, I provided responses to questions 2 through 6. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on February 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Sasse:

7. I'd like to discuss the likely possibility that the United States will face reduced trade in the near future.

a. How would a 45% tariff on Chinese goods impact the U.S. economy?
b. How would a 20% tariff on Mexican goods impact the U.S. economy?

A higher tariff on either Chinese goods or Mexican goods would tend to shift demand both towards U.S.-produced goods but also to imports originating elsewhere. Although U.S. business may benefit from increased domestic demand, these firms would likely have to pay more for imported intermediate inputs, increasing these firms' production costs. An additional effect would be to raise prices for goods consumed by U.S. households. The targeted country's demand for U.S. exports would decline not only because a U.S. tariff would reduce the targeted country's own income, but also because the targeted country may retaliate by increasing its tariffs on U.S. goods.

In particular with regards to Mexico, the negative effects of higher tariffs on the Mexican economy could result in additional indirect spillovers to the U.S. economy, given the close relationship between the two countries.

c. What are the economic consequences of failing to ratify TPP for the U.S. economy?

Specific trade decisions are the province of Congress and the Administration. The argument made by proponents of Trans-Pacific Partnership (TPP) and other trade agreements is that open trade and capital flows provide many benefits for businesses and firms – including larger and deeper markets for products and a wider selection of inputs for production. Consumers also benefit in terms of greater variety of goods and more competitive prices. However, increased trade can cause dislocations, including the loss of jobs in some industries. Policymakers and economists alike are increasingly cognizant of the need to design policies to support workers and families so that the benefits of globalization can be more widely and evenly shared.

d. President Trump has said that he will either renegotiate NAFTA or withdraw the U.S. from NAFTA completely. Mexico has stated that it would withdraw from NAFTA if renegotiations go poorly. Assume for the moment that renegotiations will fail and set aside if President Trump has authority to unilaterally withdraw from NAFTA. How would the dissolution of NAFTA impact the U.S. economy?

Most of the academic literature studying the effects of the North American Free Trade Agreement (NAFTA) has found modest positive effects for the United States. Although some firms and workers have faced challenges, on balance U.S. firms and workers have benefited from expanded supply chains and access to new markets. Likewise, U.S. consumers have benefited from a greater choice of goods at lower costs. Of course, some workers have suffered from the sectoral dislocations caused by increased trade, and economists in the past may have underestimated these negative effects. This is why increased trade should be accompanied by policies to aid those workers, providing training and other services to help them find good new jobs.

Trade is not a zero-sum game. In addition to the modest positive effects on the United States, NAFTA has helped the Mexican economy to modernize and integrate with the global trading system. The United States benefits from the prosperity and stability of our close neighbor.

e. Mexico has reported been exploring ways to reduce imported corn from the United States, including by opening up trade with Brazil or Argentina. If Mexico could successfully reduce U.S. corn imports by 50%, how would this impact the corn market in the United States?

Mexico is the third-largest market for U.S. agricultural exports and the largest market for U.S. exports of corn, with U.S. corn exports to Mexico valued at $2.6 billion in 2016. Each year, the United States exports about 14 percent of its corn crop. A sizable reduction in Mexican demand for U.S. corn would force U.S. farmers to find other markets for their corn exports. Doing so could be difficult, especially in the short run, as other trading relationships would have to be developed or expanded. In addition, corn exports may become less profitable, after accounting for the increased shipping costs to reach farther away destinations. However, those same considerations raise questions over the ease with which Mexico could reduce its U.S. corn imports by as much as 50%.

f. How would a trade war with China impact the U.S. economy?
g. How would a trade war with Mexico impact the U.S. economy?

China is an important U.S. trading partner. The Chinese economy is also an important source of demand for commodities and other products from the United States and other countries. What happens to China matters for the U.S. and global economies. Similarly, Mexico is an important U.S. trading partner; the U.S. and Mexican economies are closely integrated, with supply chains for many manufactured products crossing the U.S.-Mexican border. At the same time, it is important for trade and financial relations to be arranged so that countries operate on a level playing field.

In general, increased trade barriers would tend to induce some U.S. firms and consumers to switch expenditures away from foreign goods and toward U.S. produced goods. However, this benefit may be offset by U.S. producers having to adapt to higher costs for intermediate inputs. In addition, there may be reduced demand for U.S. exports, if other countries retaliate by imposing increased restrictions or tariffs on U.S. goods. Another consideration is that reduced trade and competition could lead to slower productivity growth in the U.S. economy.

8. I'd like to ask you about the Chinese economy.

a. Is China engaging in currency manipulation in order to undervalue its currency?

The G-20 countries, which include China, have pledged not to target their exchange rates for competitive purposes. China's authorities have stated the objective of moving toward an increasingly market-determined foreign exchange value of the renminbi. In recent years, amid downward pressure on the Chinese currency from capital outflows, Chinese authorities have been intervening not to depreciate their currency, but rather to keep it from depreciating too rapidly.

b. How will the Chinese economy be impacted by the Trump Administration's stepping away from TPP?

As you know, China was not part of the TPP, so they will not be affected directly. However, the U.S. withdrawal from the TPP may create an opportunity for China to exert a greater influence over global trade through alternative trade agreements such as the Regional Comprehensive Economic Partnership (RCEP), which includes many of the countries that were involved in the TPP negotiations.

c. What are the most troublesome ways in which China still does not operate as a market economy?

China's transition to a market economy remains incomplete in several important respects. The government continues to play a significant role in resource allocation, albeit a much smaller one than in the past, by providing state-owned enterprises (SOEs) with access to cheap land, natural resources, and credit directed through its largely state-owned banking system. Although the authorities have been addressing these issues, further reforms, especially of China's SOEs, are needed to provide a level playing field with the private sector. In addition, foreign firms face particular problems competing in China's market, including through preconditions for investing in China, delays in getting licenses, and insufficient protections against infringement of intellectual property rights.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 7, 2017

The Honorable Ben Sasse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 1 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. On March 24, 2017, I provided responses to questions 2 through 6. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on February 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Sasse:

1. I'd like you to elaborate on your statement to Senator Reed during your Senate Banking testimony that "cybersecurity is a major, major risk that financial firms face."

a. How could a large scale cyberattack on our financial system impact the U.S. economy and international economy?

The global financial system has a heightened level of exposure to cyber risk due to the high degree of information technology intensive activities and the increasing interconnection between firms across the financial services sector. In addition, the presence of active, persistent, and sometimes sophisticated adversaries means that malicious cyber attacks are often difficult to identify or fully eradicate, may propagate rapidly through the system, and have potentially systemic consequences.

Given the highly interconnected nature of the financial sector and its dependencies on critical service providers, all participants in the financial system face cyber threats. The potential scenarios and resulting impact are diverse in nature and scale. In some cases, attackers may seek to undermine public confidence and impact an institution's and/or country's reputation. In other cases, a cyber attack on a financial institution or a group of financial institutions could impact liquidity, thereby causing insolvency issues at the affected firms which could lead to systemic consequences.

b. What is the most likely cyber-threat to our financial system?

In general, cyber threats against financial institutions are becoming more frequent, sophisticated, and widespread. The rise in frequency and sophistication of cyber attacks can be attributed to numerous factors including nation-states that breach systems to seek intelligence or intellectual property, hacktivists making political statements through systems disruptions, and criminals seeking to breach systems for monetary gain. While Internet-based denial-of-service attacks intended to disrupt or impede financial market activities are among the most frequent attacks on U.S. financial institutions, potential attacks that alter or destroy financial institution data are more likely to threaten U.S. financial stability.

c. When does the Federal Reserve expect to issue a proposed rule relating to cybersecurity?

The Federal Reserve, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency issued an advance notice of proposed rulemaking (ANPR) on October 20, 2016, inviting comment on a set of potential enhanced cybersecurity risk management and resilience standards that would apply to large and interconnected entities under their supervision. The agencies received substantial feedback from industry on the ANPR through the public comment period that ended on February 17, 2017. In general, the feedback emphasized the burden on firms of trying to comply with multiple cybersecurity frameworks and encouraged the agencies to adhere to a common approach to cybersecurity developed in collaboration with industry that leverages the work done by organizations such as the National Institute of Standards and

Technology. The Federal Reserve is considering options for better integration with existing efforts and has not committed to a timeframe for any future notice of proposed rulemaking.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

March 24, 2017

The Honorable Ben Sasse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2 through 6 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Sasse:</u>

2. I'd like to continue our discussion about deficits and the debt. During your Senate Banking Testimony, you told Senator Corker that "fiscal sustainability has been a long-standing problem, and...the U.S. fiscal course, as our population ages and health care costs increase, is already not sustainable."

a. In correspondence with me last year, you told me that "fiscal policymakers should soon put in place a credible plan for reducing deficits to sustainable levels over time." What level of deficits and debt would the Federal Reserve consider sustainable over the long-run?

A sustainable level of federal debt is when the ratio of debt to nominal gross domestic product (GDP) remains essentially constant or is decreasing over the longer run. Sustainability can potentially be achieved at different levels of the debt-to-GDP ratio. For example, the Congressional Budget Office (CBO) recently illustrated the fiscal policy changes necessary in two different scenarios to put the federal debt on a sustainable path over the next 30 years: one in which the debt-to-GDP ratio would remain constant at its current level of about 75 percent and another where the debt-to GDP ratio would be brought down to its 50-year average of around 40 percent.

In regards to the deficit, a good rule-of-thumb is that the "primary" budget deficit--which is defined as federal non-interest spending minus tax revenues--needs to be around zero, on average, for the debt-to-GDP ratio to remain constant over the longer run. A declining debt-to-GDP ratio usually requires primary budget surpluses--that is, tax revenues must be greater than non-interest spending--on average.

b. What metrics would the Federal Reserve consult in order evaluate the impact of the U.S.'s debt and deficit levels? What levels must these metrics reach in order for the U.S. debt and deficit to be sustainable?

The Federal Reserve uses monthly data produced by the Department of the Treasury to evaluate the current state of the budget deficit and the debt. We use the periodic federal budget and debt projections provided by the CBO to inform our view of the expected future paths of federal deficits and debt. As I described earlier, a sustainable fiscal policy is one in which projected budget deficits are at low enough levels such that the debt-to-GDP ratio is projected to remain constant or to be decreasing.

c. Assuming current policy and current demographic trends, how will population aging impact the U.S. fiscal situation over the next ten years?

As described in the CBO's most recent budget outlook, population aging contributes importantly to the projected growth in federal spending for retirement and health care programs over the next ten years. Growth in these federal spending programs is expected to outpace growth in tax revenues, which is reflected in the CBO's projection of rising budget deficits over the next decade.

d. Assuming current policy and current demographic trends, how large does the Federal Reserve expect the shortfall to be between retiring workers and new entrants into the workforce, over the next ten years?

Most economic analysts expect that labor force growth will be slower over the next 10 years than it has been, on average, over the past several decades. This outlook reflects the well-known demographic trends of both a faster pace of workers retiring and a slower pace of new entrants. I do not think that our views on how these trends will evolve in the future--which are quite uncertain--differ materially from the projections of others, such as the CBO.

e. What policy changes could Congress consider to address the impact of population aging on our fiscal situation?

In general, simple arithmetic indicates that the policy changes will need to include restraining federal spending or increasing tax revenues or some combination of both. All other things being the same, policy changes that are more likely to help promote economic growth would ease the fiscal challenges somewhat, although it is quite unlikely that our economy could grow its way out of the long-run fiscal situation. Ultimately it is the responsibility of the Congress and the Administration to decide on the appropriate policy changes to put the fiscal situation on a sustainable path in the long run.

f. How would the Federal Reserve evaluate the economic impact of an unfunded $1 trillion infrastructure spending package, especially in light of the Federal Reserve's concerns about fiscal sustainability?

Federal spending for public infrastructure can potentially increase productivity and the size of the economy, although the magnitude and timing of these potential gains would depend on the composition of the infrastructure spending. Moreover, as the CBO has reported, the overall gains to the economy and the effects on the budget would depend importantly on whether the increased infrastructure was financed by borrowing or by changes in other government spending or revenues.

3. I'd like you to elaborate on your discussion with Senator Cotton during your Senate Banking testimony regarding depressed wage growth in particular fields.

a. You stated that the U.S. has seen "much faster wage growth for higher skilled individuals and much slower wage growth for those who are less skilled." Are there any fields where less skilled workers have seen more robust wage growth?

b. What conditions must be present in the U.S. economy for lower skilled wages to increase?

c. Typically, the barrier to entry for entering a high-skilled profession is high. Do you know of any high-skilled professions that lower-skilled workers have had an easier time transitioning into? If so, what conditions allow for this occur?

d. What higher-skilled professions are currently facing a labor shortage?

The widening of the U.S. income distribution over the past several decades has been evident in the wage outcomes for people of different skill and educational levels. For example, on average over the past decade (according to data from the Current Population Survey), wages of people with a high-school education but no college have just kept up with inflation, while wages of people with a college degree have exceeded inflation by about ½ percent per year. Similarly, wage gains for occupations typically classified as high-skill (managers, professionals, and technicians) have far outpaced wage gains for low-skill occupations (food preparation and serving, cleaning, and personal care services).

This pattern changed somewhat over the past year or so, as we have seen relatively large gains for the lower-skill, lower-education portion of the workforce. For example, median usual weekly earnings were almost identical for workers with college degrees, some college, and high school graduates in 2016 (all between 2.2 and 2.4 percent, not adjusting for inflation). This pattern is also visible in the wages for different industries; the leisure and hospitality sector, for example, is dominated by lower-paid workers who for the past decade have had the lowest wage gains of any major industry group, but wages in this sector rose well above average in 2016. A portion of the explanation for the differing results last year is probably that a number of states increased their minimum wages in 2016. But another portion of the explanation may be that the strengthening labor market, with ongoing solid rates of job creation and declining unemployment, has reached a point that it is benefiting these lower-skill workers more visibly. I am hopeful that continued gains in the labor market will further benefit workers throughout the income distribution.

Despite this recent wage news, it remains the case that signs of labor shortages appear most prevalent in higher-skilled occupations. Data point to shortages primarily in management, business and financial services occupation, or in professional and related services occupations. Other anecdotal evidence points to labor shortages for some types of manufacturing and construction work, and in health care.

As I noted, a strong labor market seems to be helping generate higher wages throughout the income distribution. Effective Federal Reserve policy can therefore contribute to further such progress, but I would emphasize that the primary forces leading to different economic outcomes for workers of different skill levels are beyond the realm of monetary policy. Most especially, I see education as a critical factor in enabling individuals to succeed in a labor market that increasingly rewards higher skills. And there are many aspects to improved education, from the quality of our primary and secondary schools, to the ability of high-school graduates to afford college without incurring excessive debt, to improved job training opportunities for people of any age. Improved education, through any of these channels, is surely an important part of a strategy to help more Americans become qualified for these higher-skilled jobs.

4. I'd like to discuss the U-6 real unemployment rate.

a. What is the Federal Reserve's estimation of the longer-run normal level U-6 rate?

b. Has the Federal Reserve's estimation of this longer-run normal U-6 rate decreased since the 2008 financial crisis? If so, why?

Federal Open Market Committee participants do not submit an estimate of the longer-run normal level of the U-6 measure of labor underutilization. (This measure augments the official unemployment rate by also including the "marginally attached" -- individuals who would like to work, are available to work, and have sought employment within the past 12 months but not the past four weeks – and those who are working part time, but say they would like to be working full time.) As with other such measures, the U-6 rose substantially during the recession and has been coming down since then. However, the U-6 measure still remains a little above its pre-recession level, and the difference between the U-6 measure and the official unemployment rate has widened by about 1 percentage point since that time. Some economists think that the higher level of U-6 could reflect structural changes in the economy, for example, because employers in some growing service sectors may have a relatively high propensity to use part-time labor. But the somewhat elevated level of U-6 also may indicate some remaining labor market slack that is not captured by the official unemployment rate.

5. I'd like to discuss the U.S. agricultural markets.

a. How would an interest rate hike impact the agricultural sector, given current economic conditions? How will the Federal Reserve take this into account when evaluating current economic conditions?

b. According to the United States Trade Representative, Nebraska goods exports totaled $7.9 billion in 2014. This number is a 238% increase from export levels in 2004. A recent report released by the Department of Agriculture titled, "USDA Agricultural Projections to 2026" predicts that over the next 10 years the U.S. dollar will remain stronger than any year since 2006. According to the report, "A stronger U.S. dollar will increase the relative price of U.S. exports, thereby constraining export growth." Does the Federal Reserve share this opinion about a stronger dollar and the impact on export levels?

The Federal Reserve considers all segments of the U.S. economy during the regular course of monetary policy deliberations. Our monetary policy mandate, given to us in law by the Congress, is to pursue price stability and maximum sustainable employment. The concepts that constitute the so-called dual mandate apply across the full economy. That is appropriate because our policy tools likewise have their effects across the full economy; they cannot be targeted to specific sectors.

Turning to the agricultural sector, conditions there have softened in recent years. Many factors influence profitability in the agricultural sector, but a prolonged downturn in the prices of agricultural commodities has been the primary driver of the weakness in the farm economy over the past few years; in turn, the prices of many agricultural commodities are heavily influenced by global supply and demand conditions, not just domestic conditions. The nominal value of U.S. agricultural exports has declined modestly since 2014, on the tide of lower commodity prices and a stronger dollar. A modest increase in interest rates will affect economic and financial conditions in the agricultural sector through multiple different channels. For one thing, a modest increase in interest rates will often--as in the present circumstances--be accompanied by a strengthening overall economy, and so, generally speaking, will be accompanied by sustained domestic demand for the output of the agriculture sector. A modest increase in interest rates may also result in a possible increase in borrowing costs. However, interest expenses account for a relatively small portion of production costs in the U.S. farm sector and farm loan delinquencies remain historically low. As economic and financial conditions evolve, the Federal Reserve will continue to carefully monitor developments in the agricultural sector.

6. I'd like you to elaborate on your statement regarding automation to Senator Heitkamp during your Senate Banking testimony that "there are dramatic accounts of changes that are on the horizon that could have profound effects on the labor market."

a. What industries are most vulnerable to automation?

b. What industries will see the most growth because of automation?

c. Does the Federal Reserve expect automation to permanently increase unemployment for lower skilled workers? Or will the impacts of automation primarily be transitional, as new entrants into the workforce adapt to new technologies?

The jobs that are most susceptible to automation appear to be those that involve routine tasks, either physical or cognitive. Many tasks in the manufacturing sector fall into this category, as machines or robots are able to carry out physical tasks. This is also the case for some services, where automation can substitute for routine cognitive tasks; prominent examples include banking, where ATMs have substituted for tellers, or sales workers who have been displaced by internet shopping. Conversely, tasks that require non-routine skills appear least vulnerable to automation, and they may expand as other jobs are automated. These non-routine tasks cut across the skill distribution, and include laborers and personal care providers along with higher-skilled workers such as managers and software developers. Of course, as technology changes, it may be that more types of occupations become susceptible to at least partial automation. As a result, demand and workers will shift to new occupations, some of which may not even exist today.

Even though the likelihood of a job being automated cuts to some extent across the skill distribution, on balance, changes in technology appear to have reduced demand for lower-skilled workers and have contributed to the increased inequality of incomes that have been in train for several decades. Moreover, as a recent report from the Council of Economic Advisers[1] highlighted, reduced demand for lower-skilled workers also can help explain the ongoing decline in labor force participation of men 25-54 years old, which has been most concentrated among those with a high-school degree or less.

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[1] https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160620_cea_primeage_male_lfp.pdf.

Knowing whether these trends will continue is of course difficult, and there is debate among economists about the pace of automation and its likely effects. But as I said in the response to question 3, I see education as critically important for ensuring that new entrants to the labor force are prepared for a work environment dominated by new technologies.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
February 14, 2017

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Sasse:

1. I'd like you to elaborate on your statement to Senator Reed during your Senate Banking testimony that "cybersecurity is a major, major risk that financial firms face."
    a. How could a large scale cyberattack on our financial system impact the U.S. economy and international economy?
    b. What is the most likely cyber-threat to our financial system?
    c. When does the Federal Reserve expect to issue a proposed rule relating to cybersecurity?

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    a. In correspondence with me last year, you told me that "fiscal policymakers should soon put in place a credible plan for reducing deficits to sustainable levels over time." What level of deficits and debt would the Federal Reserve consider sustainable over the long-run?
    b. What metrics would the Federal Reserve consult in order evaluate the impact of the U.S.'s debt and deficit levels? What levels must these metrics reach in order for the U.S. debt and deficit to be sustainable?
    c. Assuming current policy and current demographic trends, how will population aging impact the U.S. fiscal situation over the next ten years?
    d. Assuming current policy and current demographic trends, how large does the Federal Reserve expect the shortfall to be between retiring workers and new entrants into the workforce, over the next ten years?
    e. What policy changes could Congress consider to address the impact of population aging on our fiscal situation?
    f. How would the Federal Reserve evaluate the economic impact of an unfunded $1 trillion infrastructure spending package, especially in light of the Federal Reserve's concerns about fiscal sustainability?

3. I'd like you to elaborate on your discussion with Senator Cotton during your Senate Banking testimony regarding depressed wage growth in particular fields.
    a. You stated that the U.S. has seen "much faster wage growth for higher skilled individuals and much slower wage growth for those who are less skilled." Are there any fields where less skilled workers have seen more robust wage growth?
    b. What conditions must be present in the U.S. economy for lower skilled wages to increase?
    c. Typically, the barrier to entry for entering a high-skilled profession is high. Do you know of any high-skilled professions that lower-skilled workers have had an easier time transitioning into? If so, what conditions allow for this occur?
    d. What higher-skilled professions are currently facing a labor shortage?

4. I'd like to discuss the U-6 real unemployment rate.
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    b. Has the Federal Reserve's estimation of this longer-run normal U-6 rate decreased since the 2008 financial crisis? If so, why?

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    a. What industries are most vulnerable to automation?
    b. What industries will see the most growth because of automation?
    c. Does the Federal Reserve expect automation to permanently increase unemployment for lower skilled workers? Or will the impacts of automation primarily be transitional, as new entrants into the workforce adapt to new technologies?

7. I'd like to discuss the likely possibility that the United States will face reduced trade in the near future.
    a. How would a 45% tariff on Chinese goods impact the U.S. economy?
    b. How would a 20% tariff on Mexican goods impact the U.S. economy?
    c. What are the economic consequences of failing to ratify TPP for the U.S. economy?
    d. President Trump has said that he will either renegotiate NAFTA or withdraw the U.S. from NAFTA completely. Mexico has stated that it would withdraw from NAFTA if renegotiations go poorly. Assume for the moment that renegotiations will fail and set aside if President Trump has authority to unilaterally withdraw from NAFTA. How would the dissolution of NAFTA impact the U.S. economy?
    e. Mexico has reported been exploring ways to reduce imported corn from the United States, including by opening up trade with Brazil or Argentina. If Mexico could successfully reduce U.S. corn imports by 50%, how would this impact the corn market in the United States?
    f. How would a trade war with China impact the U.S. economy?
    g. How would a trade war with Mexico impact the U.S. economy?

8. I'd like to ask you about the Chinese economy.
    a. Is China engaging in currency manipulation in order to undervalue its currency?
    b. How will the Chinese economy be impacted by the Trump Administration's stepping away from TPP?
    c. What are the most troublesome ways in which China still does not operate as a market economy?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 15, 2017

The Honorable David Perdue
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 2 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. On April 25, 2017, I provided a response to question 3. Additionally, on April 5, 2017, I provided a response to question 1.

This constitutes completion of my responses to all of your written questions submitted. Please let me know if I can be of further assistance.

Sincerely,
Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Perdue:</u>

2. Madame Chair, I am grateful for all the hard work that you and your colleagues at the Federal Reserve have undertaken. However, I am concerned about the rising levels of global debt. Since 2007, governments alone have added over $25 trillion in debt, with the advanced economics contributing to 75% of the increase. The combined global household, corporate, and government debt has exceeded $200 trillion.

a. At $200 trillion in global debt, global debt is leveraged at nearly 3 times as much as the global economy. Do you have concerns that the world is overleveraged?

b. Where do you see the systemic risks in the global economy?

i. Chinese corporate debt?

ii. Greek debt default?

iii. Capital flight from emerging markets as the Fed and Bank of England raise rates?

iv. Japanese governmental debt?

Rising debt levels are a concern to the extent that borrowers could face difficulty servicing that debt if their incomes decline or the interest rates that they pay increase. Debt servicing can also potentially crowd out other spending, thereby placing a drag on the economy.

Since the global financial crisis, debt has grown in many countries. Much of that growth reflects increases in sovereign debt that were accumulated as governments supported their economies during the crisis, recession, and slow recovery. Such higher debt levels are a source of concern, both because they may signal diminished creditworthiness and because they may constrain governments in responding to future economic shocks. However, in most cases, debt remains on a sustainable path as evidenced by the very low level of sovereign bond yields. In some countries, however, sovereign debt and bond yields are at more worrisome levels, and more concerted efforts at debt reduction are needed.

In addition to sovereign debt, corporate debt levels have also increased in a number of countries, especially emerging market economies. By many assessments, the risks associated with high leverage do not appear to be widespread across countries and sectors. In addition, rising interest rates in advanced economies by themselves should not be problematic for emerging market borrowers if they are associated with stronger global economic activity. However, a sudden reversal in sentiment that leads to a revaluation of risk-return tradeoffs and a rapid reversal in capital flows can certainly have adverse consequences, especially for highly-leveraged emerging market firms. This is a risk that we continue to monitor, although U.S. investors' direct exposures to the emerging market corporate sector remain fairly limited.

U.S. investors' direct exposures to China's corporate debt are also low, but China is a significant part of the global economy, and its corporate debt has risen rapidly in recent years. China's corporate debt is currently estimated to be about 170 percent of gross domestic product (GDP), which is high for an emerging market economy. That poses a potential vulnerability for the

Chinese economy, particularly to the extent that this debt has financed low-return investments. A mitigating factor is that policymakers have substantial resources and tools to address the issue, especially because the banks and most of the entities borrowing are state-owned.

Greece still faces daunting financial and economic challenges, including its very high and growing level of public debt. European authorities acknowledge that Greek public debt sustainability remains a serious concern, and that a resolution will require further difficult steps – including additional Greek reforms and additional debt relief from Greece's creditors. It is encouraging that Greek and European authorities have reached preliminary agreement on a package of economic reforms that Greece must implement to receive another disbursement of official financing.

Japan's government debt is equal to about 200 percent of GDP, the highest among the G-7 economies. Ratings agencies have cited that high debt level in downgrading the rating of Japanese government bonds over the past few years. The burden of that debt is currently reduced by the extremely low interest rates that the government pays, with 10-year Japanese government bond yields around zero. Domestic Japanese investors, including banks and insurance companies, are willing to hold most of this debt at those low interest rates. Eventual rises in Japanese bond yields would increase the burden of that debt, but if the yield rises are driven by improving economic growth and rising prices, tax revenues would rise as well. Eventually, action will be needed to reduce the debt.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 25, 2017

The Honorable David Perdue
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 3 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. On April 5, 2017, I provided a response to question 1. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 14, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Perdue</u>:

3. Madame Chair, I want to focus on the issue of currency revaluations. With the election of President Trump and a likelihood of tax reform and an infrastructure package, the market is already building in higher inflation prospects into the value of the dollar. Now, we have discussions of a border-adjustment tax that some wish to implement.

a. Do you believe that the authors of the Border Adjustment Tax are correct, that the imposition of a 20% tax on imports would result in an immediate 20-25% appreciation of the Dollar or do you believe the effect of a border tax on the currency market is harder to both calculate and anticipate?

There is now substantial literature on the potential effects of the border adjustment tax. While there is a logic for why the dollar might fully adjust to offset the effects on U.S. trade and import prices, it is unclear whether that would happen in practice. Based on experience looking at foreign exchange markets and the many factors that can affect them, there is considerable uncertainty about how exchange rates would evolve following the imposition of a border adjustment tax.

b. What is the effect of an overnight 20% appreciation of the Dollar on the global economy, especially the emerging markets?

The economic effects of exchange rate movements will depend in part on the factors behind those movements. For example, if dollar appreciation were caused by a stronger outlook for U.S. economic growth, then one might expect a relatively favorable impact on the global economy. All else equal, however, dollar appreciation makes U.S. goods more expensive abroad and foreign goods cheaper in the United States. Over time this should have several effects. First, it should restrain U.S. exports and boost U.S. imports, reducing U.S. aggregate demand and economic activity. Second, it should put some downward pressure on import prices in the United States and eventually may put some upward pressure on prices of some consumer goods. The counterpart of dollar appreciation is the depreciation of foreign currencies. Currency depreciation would tend to boost the net exports of our trading partners, but that positive effect on their economies could be offset by negative impacts from a tightening of financial conditions, especially in emerging market economies, as capital inflows slow and some central banks are forced to tighten monetary policy to resist rising inflation. In addition, some emerging-market corporations that have debt denominated in dollars could face difficulties.

c. If the dollar appreciates as anticipated, would there be substantial risks to US pension funds and other US investors that hold foreign assets?

U.S. investors hold nearly $8 trillion in foreign-currency denominated financial assets and nearly $4 trillion in foreign-currency denominated foreign direct investment. Thus a 20 percent appreciation of the dollar, were it to occur, could generate significant wealth losses. These foreign-currency assets are held by a variety of U.S. investors, including households in the form of mutual fund investments, as well as by pension funds, insurance companies, and other financial intermediaries. For pension funds specifically, foreign-currency assets are a relatively small portion of their $19 trillion in total financial assets. However, for U.S. investors more generally, a decline in wealth would be expected to have some effect in reducing spending. Again, it is worth noting, there is much uncertainty about these potential outcomes.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 5, 2017

The Honorable David Perdue
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 1 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Perdue:</u>

1. Madame Chair, currently among all the financial institutions under the Federal Reserve's supervision:

a. How much are all the member institutions combined holding in Total Risk-Based Capital?

The Federal Reserve is the consolidated supervisor of all U.S. bank holding companies and savings and loan holding companies (U.S. depository institution holding companies), as well as the supervisor for state member banks. The Federal Reserve Board's (Board) capital rules, which include the requirement to hold a minimum amount of total (risk-based) capital, apply to all state member banks and to certain bank holding companies and savings and loan holding companies.[1] The aggregate amount of total capital held by U.S. depository institution holding companies that are subject to the Board's capital rules at the consolidated level is approximately $2.007 trillion as of December 31, 2016.[2] The aggregate amount of total capital held by state member banks is approximately $272.3 billion as of December 31, 2016.[3]

b. How much of it is comprised of Common Equity Tier 1?

Approximately $1.554 trillion (77 percent of aggregate total capital) held by U.S. depository institution holding companies described above is in the form of common equity tier 1 (CET1) capital.[4] Approximately $247.4 billion (91 percent of the aggregate total capital) held by state member banks is in the form of CET1 capital.

c. Are there comparable figures that you can disclose from 2007?

U.S. bank holding companies reported an aggregate amount of approximately $1.017 trillion in total capital as of December 31, 2007.[5] The CET1 capital measure was not in effect as of

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[1] Total capital is defined in the Board's capital rules under 12 CFR 217.20.

[2] This figure reflects the aggregate value of the total capital as reported by U.S. holding companies subject to consolidated capital requirements, including bank holding companies, savings and loan holding companies, and intermediate holding companies of foreign banking organizations, on Schedule HC-R of the Consolidated Financial Statements for Holding Companies report (FR Y-9C).

[3] This figure reflects the aggregate value of the total capital as reported by state member banks on Schedule RC-R of the Call Report (Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices (FFIEC 031) and Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only (FFIEC 041)).

[4] CET1 capital is defined in the Board's capital rules under 12 CFR 217.20(b).

[5] This figure reflects the aggregate value of the total capital as reported by U.S. bank holding companies that were subject to consolidated capital requirements on Schedule HC-R of the Consolidated Financial Statements for Holding Companies report (FR Y-9C), as of December 31, 2007. The Board's revised regulatory capital framework, adopted in 2013, amended the definition of total capital. Note that Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) transferred to the Board the supervisory functions of the Office of Thrift Supervision related to savings and loan holding companies beginning on July 21, 2011. Thus, 2007 data do not reflect capital requirements for these firms. In addition, intermediate holding companies of foreign banking organizations were formed pursuant to the Board's Regulation YY, which implements the

year-end 2007. However, we estimate that, as of December 31, 2007, approximately $523.8 billion (52 percent of the total capital) held by U.S. bank holding companies was in a form that would qualify as CET1 capital under the current capital rules of the Board.[6] State member banks reported an aggregate amount of approximately $148.3 billion in total capital as of December 31, 2007.[7] Using the same methodology as used for U.S. bank holding companies, we estimate that, as of December 31, 2007, approximately $114.6 billion (77 percent of the total capital) held by state member banks was in a form that would qualify as CET1 capital under the current capital rules of the Board.

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enhanced prudential standards mandated by the Dodd-Frank Act. Thus, 2007 data similarly do not reflect capital requirements for these firms.

[6] This methodology used to create this estimate is consistent with that used by the Federal Reserve in 2012 to estimate the impact of changes to the regulatory capital rule. That methodology was made publicly available on November 14, 2012, as part of remarks made to the Senate Committee on Banking, Housing, and Urban Affairs by Michael Gibson, Director of the Division of Banking Supervision and Regulation at the Board. Those remarks and the methodology used by the Federal Reserve (see Attachment A) are available here: https://www.federalreserve.gov/newsevents/testimony/gibson20121114a.htm.

[7] This figure reflects the aggregate value of the total capital as reported by state member banks on Schedule RC-R of the Call Report (Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices (FFIEC 031) and Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only (FFIEC 041)). The Board's revised regulatory capital framework, issued in 2013, amended the definition of what qualifies as total capital.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
February 14, 2017

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Perdue:</u>

Question #1:
Madame Chair, currently among all the financial institutions under the Federal Reserve's supervision:

- How much are all the member institutions combined holding in Total Risk-Based Capital?
- How much of it is comprised of Common Equity Tier 1?
- Are there comparable figures that you can disclose from 2007?

Question # 2:
Madame Chair, I am grateful for all the hard work that you and your colleagues at the Federal Reserve have undertaken. However, I am concerned about the rising levels of global debt. Since 2007, governments alone have added over $25 trillion in debt, with the advanced economics contributing to 75% of the increase. The combined global household, corporate, and government debt has exceeded $200 trillion.

a. At $200 trillion in global debt, global debt is leveraged at nearly 3 times as much as the global economy. Do you have concerns that the world is overleveraged?
b. Where do you see the systemic risks in the global economy?
    i. Chinese corporate debt?
    ii. Greek debt default?
    iii. Capital flight from emerging markets as the Fed and Bank of England raise rates?
    iv. Japanese governmental debt?

Question #3:
Madame Chair, I want to focus on the issue of currency revaluations. With the election of President Trump and a likelihood of tax reform and an infrastructure package, the market is already building in higher inflation prospects into the value of the dollar. Now, we have discussions of a border-adjustment tax that some wish to implement.

c. Do you believe that the authors of the Border Adjustment Tax are correct, that the imposition of a 20% tax on imports would result in an immediate 20-25% appreciation of the Dollar or do you believe the effect of a border tax on the currency market is harder to both calculate and anticipate?
d. What is the effect of an overnight 20% appreciation of the Dollar on the global economy, especially the emerging markets?
    i. If the dollar appreciates as anticipated, would there be substantial risks to US pension funds and other US investors that hold foreign assets?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 10, 2017

The Honorable Dean Heller
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2 and 3 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. On April 25, 2017, I provided a response to question 1. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Heller:</u>

2. Is the Federal Reserve currently complying with the President's January 23, 2017, Memorandum to freeze the hiring of Federal civilian employees?

The Federal Reserve Board (Board) and the Federal Reserve Banks have aligned ourselves with the administration's short-term directive at this time and are evaluating the April 30, 2017 Office of Management and Budget guidance that replaced the hiring freeze. The Federal Reserve has long believed that it must operate in a manner that efficiently and effectively implements the responsibilities with which we are charged.

3. Will the Federal Reserve voluntarily comply with the President's January 30, 2017, Executive Order on reducing regulations and controlling regulatory costs?

The Board attempts to minimize regulatory burdens in its rulemakings consistent with the effective implementation of our statutory responsibilities. As part of the rulemaking process, we specifically seek comment from the public on the burdens and benefits of our proposed approach as well as on alternative approaches. In adopting a final rule, we seek to adopt a regulatory alternative that faithfully implements the statutory provisions while minimizing regulatory burdens.

We also routinely examine the efficacy of our regulatory framework and consider modifications to it where the costs of a particular regulation outweigh its benefits. For example, we recently reviewed our stress testing rules, and as a result of that review, removed the qualitative portion of the test as it had applied to more than 20 firms, relieving them of substantial compliance burdens.

We will continue to carefully consider the costs of our existing and future regulations and make changes when imbalances arise.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 25, 2017

The Honorable Dean Heller
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 1 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Heller:</u>

1. With Governor Tarullo's imminent departure, will the Federal Reserve be issuing any significant regulatory actions before the Vice Chair for Supervision position is filled?

As you know, among the duties assigned by Congress to the Federal Reserve Board (Board) is responsibility for promoting a safe, sound, and stable financial system that supports the growth and stability of the U.S. economy. The Board as a whole is charged with this important duty and is held accountable by Congress and the taxpayer for carrying out this responsibility continuously and under all circumstances. In order to better be able to carry out its responsibilities, the Board would welcome action by the President and the Senate to appoint and confirm a Vice Chairman for Supervision as well as to fill the other vacancies on the Board.

To update you on our internal leadership, as you may know, Governor Jay Powell is now Chairman of the Federal Reserve Board's Committee on Supervision and Regulation. As a long-time member of the committee and a Governor steeped with financial services experience, I believe Governor Powell will serve as an excellent chairman. As I have indicated in testimony, upon confirmation, the new Vice Chairman for Supervision will assume the chairmanship of this committee.

As I also noted in my testimony, our near-term calendar of final regulatory actions is relatively light and involves primarily routine matters that are either burden-reducing, required by law, or non-controversial. I do not foresee any major final regulatory actions in the near term and any proposals that the Board suggests are likely to provide a significant opportunity for public comment as well as for new members of the Board to help determine the appropriate outcome.

The Federal Reserve remains dedicated to continually reviewing and improving our supervisory practices to ensure that they are effective, without imposing unnecessary costs and burdens. We look forward to working with you on these matters and appreciate your interest.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
February 14, 2017

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Heller:</u>

QFR #1: Question – With Governor Tarullo's imminent departure, will the Federal Reserve be issuing any significant regulatory actions before the Vice Chair for Supervision position is filled?

QFR #2: Question – Is the Federal Reserve currently complying with the President's January 23, 2017, Memorandum to freeze the hiring of Federal civilian employees?

QFR #3: Question – Will the Federal Reserve voluntarily comply with the President's January 30, 2017, Executive Order on reducing regulations and controlling regulatory costs?

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, DC 20510-6075

February 22, 2017

The Honorable Janet Yellen
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Chair Yellen:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs at our hearing on February 14, 2017 entitled "*The Semiannual Monetary Policy Report to the Congress.*" In order to complete the hearing record, we would appreciate your answers to the enclosed as soon as possible. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a MS Word or .pdf attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo

Mike Crapo
Chairman

MC/dr

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

March 8, 2017

The Honorable Jack Reed
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Reed:</u>

1. You have said the United States is at or near full employment. You have also said that fiscal policy changes are not necessary to reach full employment under current economic conditions. There are, however, many long-term unemployed individuals in my home state of Rhode Island, and around the country, who would take issue with the statement that we are at full employment. They would also argue that our unemployment system did not adequately adjust, as they continue to struggle in the wake of the Great Recession. How would you recommend that I answer my constituents whose experience leads them to question whether we are truly at full employment? What safeguards need to be put in place now to protect against job loss in the next economic downturn?

The statement that the U.S. economy is at or near full employment pertains to the national economy. Within that overall national situation, there will be important variation by geographic location, industry, and skill set. As you correctly observe, it remains the case that not every willing worker in every location can currently find a job that she or he is qualified to fill. The policies (including monetary policy) that affect aggregate demand at the national level will generally not be well suited to address these sorts of more-localized and more-specialized situations, as real and as painful as they are for those experiencing them.

To address the real and important aspects of unemployment that remain today, a more-detailed set of interventions will probably be more appropriate and effective. These interventions may be designed at the federal, state or local level, and may involve government actions at that level, private actions, or partnerships involving both the public and private sectors. In one of my earliest speeches as Chair of the Federal Reserve in October 2014, for example, I highlighted some potential "building blocks" for greater economic opportunity; these included strengthening the educational and other resources available for lower-income children, making college more affordable, and building wealth and job creation through strengthening Americans' ability to start and grow businesses.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
February 14, 2017

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Reed:

Q: You have said the United States is at or near full employment. You have also said that fiscal policy changes are not necessary to reach full employment under current economic conditions. There are, however, many long-term unemployed individuals in my home state of Rhode Island, and around the country, who would take issue with the statement that we are at full employment. They would also argue that our unemployment system did not adequately adjust, as they continue to struggle in the wake of the Great Recession. How would you recommend that I answer my constituents whose experience leads them to question whether we are truly at full employment? What safeguards need to be put in place now to protect against job loss in the next economic downturn?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 9, 2017

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 5 that you submitted following the February 14, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On April 14, 2017, I provided responses to questions 1 through 3. Additionally, on March 29, 2017, I provided responses to questions 4 and 6. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Rounds</u>:

5. I'm concerned that a number of factors abroad could be threatening our nation's economic recovery. The stalemate between Greece and its international creditors over the past week has been troublesome. And elsewhere around the world, major economies like China are grappling with trouble in their own real estate markets as well as with ballooning debt.

Can you discuss the downside risks to the US economy given continued slowdown in China's economy and Europe's debt crisis? Do you think China and Europe could become more of a problem for the US economy?

In our highly globalized economic and financial system, no economy can be fully insulated from developments outside its borders. Over the past several years, a series of foreign shocks have buffeted the U.S. economy – including the euro-area debt crisis, uncertainty about Chinese economic policy, and the sizable run-up in the dollar and sharp decline in oil prices. These developments have directly impacted the U.S. economy through their effects on trade and inflation and indirectly through confidence and financial channels.

At present, the effects of these past headwinds appear to be waning. Oil prices have stopped falling, thereby easing pressure on energy companies and oil-reliant economies, concerns about financial stability in Europe and China have eased somewhat, and economies abroad have been recovering. These are hopeful signs for the U.S. economy. However, several foreign risks remain a concern, including those that you raise about China and Europe.

Chinese economic growth has been on a general slowing trend over the past few years as a result of demographic changes and the moderation in growth typical of maturing economies. There are concerns, however, that the rapid credit growth in China in recent years may have increased financial risks, and a materialization of those risks could trigger a much sharper slowdown in the economy. Specific concerns include mounting non-performing corporate debts; a growing reliance on short-term sources of funding in the financial system; rapid growth in house prices; and the possibility that expectations of currency depreciation could cause an acceleration of capital outflows. Should the Chinese economy decelerate abruptly and severely, there would clearly be an impact on the global economy. China is an important market for the exports of other Asian economies as well as for commodity exporters, and these economies would be hit particularly hard. U.S. export growth also would be restrained, both directly, as China has accounted for a significant portion of U.S. export growth since 2007, and indirectly, as other markets for U.S. exports are hindered.

While we are attuned to these risks, we do not view a Chinese financial crisis and sharp slowdown in GDP growth as the most likely scenario. Growth remains relatively solid. Chinese authorities have recently taken measures to curb the rapid rise in house prices and slow the growth of lending. Market participants seem more comfortable with the Chinese authorities' current approach to their currency. And the government has sufficient resources to provide important support to the financial sector in case of distress.

Regarding your concern about Greece, and Europe more generally, European economics have shown considerable improvement over the past few years. The economic recovery appears to be gaining momentum and unemployment rates have been falling. Moreover, the European Central Bank has taken a number of actions to help backstop sovereign debt, and the region has made substantial progress toward banking union. Thus, other European countries are better insulated from the situation in Greece than they were in 2010 when the debt crisis broke out.

However, Greece still faces daunting financial and economic challenges, including its very high and growing level of public debt, the resolution of which will require further difficult steps – including additional Greek reforms and additional debt relief from Greece's creditors. Developments in Greece continue to have the potential for disruptions that could spill over and affect the European economic outlook and global financial markets. It is encouraging that Greek and European authorities have reached a preliminary agreement on a package of economic reforms that Greece must implement to receive another disbursement of official financing.

Europe faces other challenges as well, such as negotiating the United Kingdom's withdrawal from the European Union (EU), following through on the EU's structural reform agenda, and continuing to make progress on economic recovery and lowering unemployment. We will continue to monitor the European economy, as we consider how foreign developments may affect the achievement of our domestic objectives of price stability and maximum employment.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 14, 2017

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1 through 3 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. On March 29, 2017, I provided responses to questions 4 and 6. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Rounds</u>:

1. Small banks and community financial institutions are the cornerstones of cities and towns across the country, but they play an especially important part in the economy of my state, South Dakota. While South Dakotans are proud of the role that smaller financial institutions have, the rules and regulations promulgated by the federal government since the financial crisis are making it harder for smaller institutions to compete.

The Economist recently pointed out that more rules and regulations were heaped on our financial institutions between 2010 and 2014 than the total number of all financial regulations that existed in 1980. And a study by the Minneapolis Federal Reserve found that adding two extra staffers to the compliance department of a small bank would make the difference for one third of all small banks between operating at a profit and operating at a loss.

Recently I introduced legislation called the TAILOR Act to help ease regulatory overreach for our nation's small banks and community financial institutions. Is our regulatory framework for small banks and community financial institutions appropriate for the current macroeconomic environment? What further adjustments are needed by Congress?

The Federal Reserve recognizes that the costs of regulation can be a significant challenge for small banks. Accordingly, it seeks to tailor prudential standards and supervisory guidance to community banks based on their risk, size and complexity and to minimize unnecessary burdens whenever possible. Moreover, as discussed in the March 2017 Economic Growth and Regulatory Paperwork Reduction Act Joint Report to Congress, the Federal Reserve has taken a number of actions independently and jointly with the other regulatory agencies to address issues raised during the review that should reduce regulatory burden for community banks. These include leveraging technology to conduct as much of the examination work off-site as possible, significantly cutting the information collected from small banks on the Call Report, and improving examination planning efforts to better tailor examination work so that well-run, low risk banks receive significantly less supervisory scrutiny. In addition, the agencies are initiating efforts to ease the conditions under which an appraisal is required to support a commercial loan and to develop a simplified regulatory capital regime for community banks.

To help further ease regulatory burdens for small banks, Congress could consider exempting community banks from two sets of Dodd-Frank Wall Street Reform and Consumer Protection Act requirements: the Volcker rule and the incentive compensation limits in section 956. The risks addressed by these statutory provisions are far more significant at larger institutions than they are at community banks. In the event that a community bank engages in practices in either of these areas that raise heightened concerns, we believe that the banking agencies would be able to address them as part of the normal safety-and-soundness supervisory process.

2. Congress has significant responsibilities with respect to cybersecurity, and I'm honored to chair the new Armed Services Subcommittee on Cybersecurity. With its advanced rulemaking notice on cybersecurity in October, the Federal Reserve rightly recognized that our financial infrastructure is a significant target for our nation's adversaries.

Can you comment on the threats that our financial sector faces and the vulnerabilities that exist in the system?

In general, cyber threats against financial institutions are becoming more frequent, sophisticated, and widespread. The rise in frequency and sophistication of cyber attacks can be attributed to numerous factors including nation-states that breach systems to seek intelligence or intellectual property, hacktivists making political statements through systems disruptions, or bad actors seeking to breach systems for monetary gain.

Despite the increasing level of attack sophistication, it is more apparent that a significant portion of successful breaches could have been avoided by adhering to basic information security tenets, sound technology governance and network administration practices.

Do you have the regulatory authority you need to keep this important part of our economy safe, or is additional action needed on the part of Congress?

The Federal Reserve's general safety and soundness authority is the primary source of its information technology requirements, including those for cybersecurity. In addition, the Federal Reserve, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency have authority under the Bank Service Company Act to examine the services that third-parties provide to financial institutions that are supervised under each of the agency's regulatory authorities. At the present time, the Federal Reserve is not seeking additional regulatory authority in this area.

3. The Federal Reserve recently issued a final rule in regards to its Comprehensive Capital Analysis and Review and stress testing rules. In September, Federal Reserve Board Governor Daniel Tarullo gave a speech on the next steps in stress testing.

Governor Tarullo's speech covered numerous areas of stress testing, but one particular aspect stood out: the stress capital buffer. Governor Tarullo noted that the Fed "will be considering adoption of a 'stress capital buffer...'" From his remarks, it appears that the stress capital buffer, which would include an additional risk-based capital requirement, would be substituted for the capital conservation buffer.

Could you give us your take on the stress capital buffer? And is the Federal Reserve still considering its adoption?

At this time, the Federal Reserve Board (Board) does not have plans to propose any significant rules. However, the Board continues to consider ways to more closely integrate CCAR and the Board's regulatory capital rules. Before making any changes to the Board's rules, we would provide notice of any proposed changes and invite public comment on them.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

March 29, 2017

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 4 and 6 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Rounds:</u>

4. President Trump's recent executive actions took a strong stance on financial regulatory reform, and Congress has started to revisit and in some cases rescind financial regulations proposed by the previous Administration.

Given these developments, do you think that the Federal Financial Institutions Examination Council, including the Federal Reserve, should take up review of the Dodd-Frank Act and recommend to Congress what rules should be rolled back in light of the President's recent executive orders?

The President issued an executive order on February 3, 2017, that articulates his Administration's core principles of financial regulation. The executive order also instructs the Secretary of the Treasury to consult with the heads of the member agencies of the Financial Stability Oversight Council and report to the President within 120 days on (i) the extent to which existing laws and regulations promote the core principles; and (ii) any laws or regulations that inhibit federal regulation of the U.S. financial system in a manner consistent with the core principles.

I intend to participate in this Treasury-led review of U.S. financial law and regulation, which will include all the federal agency members of the Federal Financial Institutions Examination Council and likely will include review of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

6. The Federal Funds rate has been at an extremely low, nearly-zero level for quite some time since the financial crisis. On February 1, the Federal Open Market Committee (FOMC) decided to keep the target range for the federal funds rate at a half to three quarters of one percent. The FOMC's press release cited improving conditions in the economy including a strengthening labor market, solid job gains and increasing inflation. Where would the Fed like to see additional improvements in the economy before raising the target rate?

At the Federal Reserve, we are squarely focused on achieving our congressionally mandated goals of maximum employment and price stability. These goals guide our decisions regarding the appropriate level of the federal funds rate.

At our most recent meeting, on March 14-15, the Federal Open Market Committee (FOMC) did raise the target range for the federal funds rate by 1/4 percentage point, to 3/4 to 1 percent. That decision was based in part on incoming data indicating that the labor market had continued to strengthen and that inflation had moved closer to the FOMC's 2 percent objective. In addition, our decision in March reflected our expectation that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will reach 2 percent on a sustained basis.

The same factors that drove our decision in March will be key for our future deliberations about the appropriate path for the federal funds rate. In particular, if the U.S. economy continues to evolve broadly as the FOMC anticipates--economic activity expanding at a moderate pace, labor market conditions strengthening somewhat further, and inflation reaching 2 percent on a sustained basis--additional increases in the federal funds rate are likely this year. Indeed, the median assessment of FOMC participants at our March meeting was that an additional 1/2 percentage point cumulative increase in the federal funds rate would likely be appropriate over the remainder of this year, which would bring the year-end target range for that rate to 1-1/4 to 1-1/2 percent.

Nonetheless, as my FOMC colleagues and I have said many times, monetary policy cannot be and is not on a preset course. The FOMC stands ready to adjust its assessment of the appropriate path for the federal funds rate if unantieipated developments materially change the economic outlook.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

March 27, 2017

The Honorable Jon Tester
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1 and 2 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Tester:</u>

Debt/Deficit:

1. Chair Yellen, I want to start this morning by talking about our nation's debt and deficit. Now, it's my belief that our nation's debt and deficit continues to be unsustainable. I think we refuse to actually take a long hard look at our federal budget to see what simply doesn't make sense anymore and at the same time we continue to hand out unpaid for tax credits like candy.

Now just recently my friends on the other side of the isle have proposed repealing the affordable care act, which will reduce revenues by $350 billion over the next decade. On top of that, they have proposed a tax plan that would reduce federal revenue more than two trillion dollars.

a. So I guess my first question is, what sort of effect will that kind of new debt have on our economy?

The current level of federal debt is equal to more than 75 percent of nominal gross domestic product (GDP), which is far higher than the average debt-to-GDP ratio of about 40 percent over the past 50 years. Moreover, the Congressional Budget Office (CBO) projects that federal budget deficits and federal debt will be increasing, relative to the size of the economy, over the next decade and in the longer run.[1] Additional federal borrowing would accelerate those unsustainable trends. The CBO appropriately describes several reasons why high and rising federal government debt could have serious negative consequences for the economy over time. First, because federal borrowing eventually reduces total saving in the economy, the nation's capital stock would ultimately be smaller than it would be if debt was lower; as a result, productivity and overall economic growth would be slower. Second, fiscal policymakers would have less flexibility to use tax and spending policies to respond to unexpected negative shocks to the economy. Third, the likelihood of a fiscal crisis in the United States would tend to increase. However, there is no way to predict with any confidence whether and when such a crisis could occur; in particular, there is no identifiable level of federal government debt, relative to the size of the economy, indicating that this would be likely or imminent.

b. Do you believe our debt and deficit levels are unsustainable in the longer term?

I agree, as do most economists, with the assessment that the federal government budget is on an unsustainable path, given current fiscal policies. As I noted earlier, the CBO projects that federal budget deficits and federal debt will be increasing, relative to the size of the economy, over the next decade and in the longer run, which is unsustainable. In the CBO's projections, growth in federal spending--particularly for mandatory entitlement programs and interest payments on federal debt--outpaces growth in revenues in the coming years. The increases in entitlement programs, such as Social Security and programs providing health care, are mainly attributable to

[1] Congressional Budget Office, "The Budget and Economic Outlook: 2017 to 2027," January 2017, and "The 2016 Long-Term Budget Outlook," July 2016.

the aging of the population and rising health care costs per person. For fiscal sustainability to be achieved, whatever level of spending is chosen, revenues must be sufficient to sustain that spending in the long run.

c. Does in inhibit our labor market?

As I mentioned earlier, increasing federal borrowing reduces total saving in the economy over time, ultimately leading to the nation's capital stock being smaller than it would be if debt was lower. As a result, productivity and overall economic growth would be slower. As described by the CBO, lower productivity growth would slow the pace of gains in labor compensation, which would tend to provide individuals less incentive to work.[2]

d. During the course of several meetings with President Trump's nominees, folks kept telling me that they believe we can grow economy so much that it will offset $2 trillion in tax cuts. Do you believe this is possible?

In general, I think most economists tend to agree that the historical evidence suggests that most tax cuts do not usually pay for themselves.[3] Even though well-designed tax changes could increase household incentives to work and save, along with potentially enhancing business incentives to hire and invest, the positive effects of these changes on overall economic growth appear to usually not be large enough to offset the direct budgetary effects of a tax cut. Ultimately, the challenge for fiscal policymakers is that the tax policies chosen must generate revenue sufficient to sustain the level of government spending that is also chosen.

Economy:

2. Chair Yellen, are there particular areas in the labor market that give you concern? Are there specific sectors you see strong growth in vs. others that are struggling?

The solid gains in payroll employment that we have seen over the past several years have generally been fairly widespread across different sectors of the labor market. However, manufacturing employment has been relatively flat more recently, reflecting in part the effects of the higher foreign exchange value of the dollar, weak foreign economic growth, and tepid domestic demand for capital investment. Particularly as economic activity continues to strengthen, both domestically and abroad, the prospects for the U.S. manufacturing sector should improve. Indeed, the manufacturing employment has picked up in recent months as factory output has accelerated somewhat.

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[2] Congressional Budget Office, "The 2016 Long-Term Budget Outlook," July 2016.

[3] For example, see the Tax Foundation, "Do Tax Cuts Pay for Themselves?" at https://taxfoundation.org/do-tax-cuts-pay-themselves; and the Tax Policy Center, "Do Tax Cuts Pay for Themselves?" at http://www.taxpolicycenter.org/briefing-book/do-tax-cuts-pay-themselves.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 5, 2017

The Honorable Jon Tester
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 3 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. On March 27, 2017, I provided responses to questions 1 and 2. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Tester:

Community Banks:

3. Chair Yellen, I strongly believe that our community banks serve the folks that keep state's like mine running. And I think everyone up here knows that our community banks weren't involved in developing and selling exotic and risky financial products, and they didn't stray from the products that have served them and their customers for generations. I think it's time that we provide our community banks with some regulatory relief. I don't believe they caused the financial crisis and they shouldn't have to pay for it either.

Over the last several years, I've seen dozens of mergers and acquisitions of community banks across Montana and its very concerning to me. If community banks continue to consolidate, the real losers will be folks living in rural America, states where a majority of our institutions are community banks, and I'm not so sure anyone will fill the void once their gone.

a. Can you give me a sense of what the Federal Reserve did in 2016 to ensure that we are protecting consumers, but at the same time differentiating regulations between community banks, regional banks, and global banks?

In 2016, the Federal Reserve took a number of steps to reduce regulatory burden on community banks. For example, in response to bankers' concerns about the burden imposed on small banks when large numbers of examiners participate in on-site examinations, the Federal Reserve issued guidance to encourage examiners to review loan files off-site for examinations of banks with less than $50 billion in total assets, if requested by the bank. Together with the other banking regulators, the Federal Reserve also reduced the regulatory filing requirements for banks with less than $1 billion in consolidated assets by eliminating about 40 percent of the items in the required quarterly financial reporting form known as the Call Report. In addition, the Federal Reserve enhanced its examination planning process to use updated statistical models to tier community banks by risk level. These enhancements allow examiners to better target their work and should result in less examination time being spent reviewing well-managed, lower risk community banks. For regional banks with assets between $10 and $50 billion, the Federal Reserve continued to refine its expectations for company-run annual stress tests required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). This included providing banks with additional flexibility with respect to required assumptions that must be included in the stress test and extending the length of time allowed to perform and report on the results of the tests. These actions are examples of how the Federal Reserve seeks to tailor its supervisory programs to reflect the lower systemic risks presented by community and regional banks.

The March 2017 Joint Report to Congress on the results from the second Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) review highlights many of the actions that the Federal Reserve is undertaking to further reduce regulatory burden on community banks, including simplifying regulatory capital requirements, addressing challenges in obtaining appraisals, and further reducing items collected on the Call Report.

With respect to protecting consumers in their banking activities, the Federal Reserve System conducts specialized examinations to ensure compliance with consumer protection laws and regulations in the institutions under its purview.[1] During 2016, the Federal Reserve Banks completed 209 consumer compliance examinations and 206 examinations for the Community Reinvestment Act (CRA) of state member banks. The Federal Reserve is mindful of the importance to balance efforts to tailor our supervisory approach in consumer compliance with our responsibility to ensure that banks are transparent and fair in their dealings with consumers, regardless of the size or type of institution involved.

Toward this end, the Federal Reserve has adopted the following procedures to conduct risk-focused consumer compliance supervision, implementing this program in January 2014. Examination intensity is based on the individual bank's risk profile and effectiveness of its compliance controls. In addition, more up-front work is completed off-site. This has improved the efficiency and effectiveness of our examinations and reduced regulatory burden for many community banks. In addition, we have lengthened time between consumer compliance examinations for community banks with lower risk profiles. Banks with satisfactory consumer compliance ratings are now examined every 48 to 60 months if they have assets under $350 million (up from every 24 months). And banks with satisfactory ratings and assets between $350 million and $1 billion are examined every 36 months instead of every 24 months.

The Federal Reserve also works to support institutions in their consumer compliance efforts through guidance and outreach to clarify supervisory expectations. For example, the banking agencies have revised the CRA Q&As twice in the past five years. The agencies are also working together to update interagency examination procedures and other process improvements. With respect to fair lending examinations, the agencies issued revised Interagency Fair Lending Examination Procedures that provide more detailed information regarding current fair lending risk factors that can aid a bank in its analysis of fair lending risks and to prepare for fair lending exams. We have also increased our communications with banks during the exam process and engaged in a variety of outreach activities, such as regular participation in conferences sponsored by both industry and advocacy groups with the goal to highlight fair lending risks so that institutions can take steps to effectively manage compliance.

b. Is the Federal Reserve concerned about the consolidation we continue to see throughout the industry?

The Federal Reserve recognizes the vital role community banks play in local economies and closely monitors consolidation trends at community banks. While several factors have

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[1] For consumer financial protection, the Federal Reserve has examination and enforcement authority for federal consumer financial laws and regulations for insured depository institutions with $10 billion or less that are state member banks and not affiliates of covered institutions, as well as for conducting CRA examinations for all state member banks regardless of size. The Federal Reserve Board also has examination and enforcement authority for certain federal consumer financial laws and regulations for insured depository institutions that are state member banks with over $10 billion in assets, while the Consumer Financial Protection Bureau has examination and enforcement authority for many federal consumer financial laws and regulations for insured depository institutions with over $10 billion in assets and their affiliates (covered institutions), as mandated by the Dodd-Frank Act.

contributed to the decline in the number of community banks, some have attributed a significant part of the decline to regulatory compliance costs. Recognizing that regulatory compliance costs may be a contributing factor to consolidation, the Federal Reserve seeks to ensure that its regulations are balanced and provide safety and soundness benefits that are relatively proportional to the resulting compliance costs. In addition, the Federal Reserve tailors its prudential standards and examination procedures to banks based on their risk profile, size and complexity. Doing so allows the Federal Reserve to achieve its goal of promoting a strong banking system and preventing or mitigating against the risk of bank failures while minimizing regulatory compliance costs to community banks.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
February 14, 2017

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Tester:</u>

Debt/Deficit: Chair Yellen, I want to start this morning by talking about our nation's debt and deficit. Now, it's my belief that our nation's debt and deficit continues to be unsustainable. I think we refuse to actually take a long hard look at our federal budget to see what simply doesn't make sense anymore and at the same time we continue to hand out unpaid for tax credits like candy.

Now just recently my friends on the other side of the isle have proposed repealing the affordable care act, which will reduce revenues by $350 billion over the next decade. On top of that, they have proposed a tax plan that would reduce federal revenue more than two trillion dollars.

- So I guess my first question is, what sort of effect will that kind of new debt have on our economy?
- Do you believe our debt and deficit levels are unsustainable in the longer term?
- Does in inhibit our labor market?
- During the course of several meetings with President Trump's nominees, folks kept telling me that they believe we can grow economy so much that it will offset $2 trillion in tax cuts. Do you believe this is possible?

Economy:

- Chair Yellen, are there particular areas in the labor market that give you concern? Are there specific sectors you see strong growth in vs. others that are struggling?

Community Banks: Chair Yellen, I strongly believe that our community banks serve the folks that keep state's like mine running. And I think everyone up here knows that our community banks weren't involved in developing and selling exotic and risky financial products, and they didn't stray from the products that have served them and their customers for generations. I think it's time that we provide our community banks with some regulatory relief. I don't believe they caused the financial crisis and they shouldn't have to pay for it either.

Over the last several years, I've seen dozens of mergers and acquisitions of community banks across Montana and its very concerning to me. If community banks continue to consolidate, the real losers will be folks living in rural America, states where a majority of our institutions are community banks, and I'm not so sure anyone will fill the void once their gone.

- Can you give me a sense of what the Federal Reserve did in 2016 to ensure that we are protecting consumers, but at the same time differentiating regulations between community banks, regional banks, and global banks?
- Is the Federal Reserve concerned about the consolidation we continue to see throughout the industry?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 28, 2017

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 4 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. On April 7, 2017, I provided responses to questions 2, 3 and 5. Additionally, on March 24, 2017, I provided a response to question 1. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Tillis:

4. Chair Yellen, can you let me know Governor Tarullo's precise responsibilities at the Fed, how you work with Governor Tarullo in his execution of those responsibilities, and can you commit to me that you will work with whomever President Trump nominates to serve as the Vice Chair for Supervision at the Fed?

As you know, among the duties assigned by Congress to the Federal Reserve Board (Board) is responsibility for promoting a safe, sound, and stable financial system that supports the growth and stability of the U.S. economy. The Board as a whole is charged with this important duty and is held accountable by Congress and the taxpayer for carrying out this responsibility continuously and under all circumstances. In order to better be able to carry out its responsibilities, the Board would welcome action by the President and the Senate to appoint and confirm a Vice Chairman for Supervision as well as to fill the other vacancies on the Board.

To update you on our internal leadership, as you may know, Governor Jay Powell is now Chairman of the Federal Reserve Board's Committee on Supervision and Regulation. As a long-time member of the committee and a Governor steeped with financial services experience, I believe Governor Powell will serve as an excellent chairman. As I have indicated in testimony, upon confirmation, the new Vice Chairman for Supervision will assume the chairmanship of this committee.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 7, 2017

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2 through 3 and 5 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. On March 24, 2017, I provided a response to question 1. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Tillis:</u>

2. Chair Yellen, the Federal Financial Institutions Examination Council is supposed to coordinate the work of different regulators, but I am hearing that in practice this is not happening. Do you believe we need separate layers of examination at the holding company level by the Fed and OCC? What added value is there for having both the Fed and OCC examine a bank – is one incapable of doing the job? Does the Fed not trust the OCC to conduct examinations or the OCC's expertise? Do you believe that there is regulatory cooperation taking place as it should?

The Federal Reserve has statutory responsibility for supervising bank and savings and loan holding companies on both a consolidated and parent-company-only basis. Holding company supervision complements the examination work completed by the other banking agencies, including the Office of the Comptroller of the Currency, but its focus is different than that of bank supervision. Specifically, holding company supervision aims to ensure that the parent serves as a source of strength to its depository institutions and that nonbank activities conducted by the holding company, many of which are supervised solely by the Federal Reserve and can be quite substantial for some complex holding companies, do not adversely affect the safety and soundness of insured depositories. Lastly, holding company supervision assesses the overall consolidated financial and managerial condition of the consolidated organization, including all subsidiary banks, nonbanks and the parent company.

In fulfilling its holding company supervision responsibilities, the Federal Reserve cooperates and coordinates closely with the federal and state supervisors of insured depositories and nonbank entities and relies substantially on the work and expertise of these agencies in evaluating the condition of any banks or nonbanks they directly supervise. The principle of coordinating with the other regulatory agencies is required by statute and is a well-established tenet of the Federal Reserve's supervisory process. For example, section 604 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, now codified in the Bank Holding Company Act, requires that the Federal Reserve rely to the fullest extent possible on the work of other regulators. The Federal Reserve reinforced this requirement by issuing *SR 12-17, Consolidated Supervision Framework for Large Financial Institutions*, and *SR 16-4, Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $50 Billion.* Both of these supervisory directives require Federal Reserve examiners to work with the primary regulators of insured depositories to avoid duplication of effort and minimize regulatory burden.

These directives and other Federal Reserve guidance also tailor expectations for examiners depending on an organization's size, complexity, and degree of systemic risk. For smaller bank holding companies, where consolidated assets are composed principally of the assets of the subsidiary bank, nonbank activities are minimal, and parent company leverage is low, the Federal Reserve limits its work and relies substantially on the primary regulator's examination of the insured depository to assess the condition of the holding company. As holding companies become larger and more complex, and nonbank activities become more important to the organization, inspection work correspondingly expands. However, regardless of the size, complexity and risk of the holding company, the Federal Reserve endeavors to avoid duplication by relying on primary regulators whenever possible, meeting regularly with them to ensure we are not duplicating efforts, and using their examination work to reach a consolidated supervisory view.

3. Chair Yellen, you have been asked in the past whether there are liquidity problems in the bond market – can you tell me whether or not there is a present or imminent problem? I think it is important to get the diagnosis right, so I want to understand whether you think there is a liquidity problem in the bond market, and that if you are merely monitoring the situation, whether or not that indicates a cause for concern in terms of what lies ahead.

In corporate bond markets, estimated bid-ask spreads have declined and estimated price impacts are lower than in the early 2000s, indicating that, if anything, liquidity may have improved despite the reduction in dealer holdings of these securities.[1] Demand from buy-side market participants has been very high, which has likely helped to support market liquidity. Partly as a result of this high demand, corporate debt issuance has been quite robust, which in turn can help to explain some of the decline in turnover as some of these investors may be more likely to buy and then hold the securities for some time.

However, while acknowledging that some key measures do not show a decline in liquidity, we must recognize that our ability to measure market liquidity is imperfect. We have less data on dealer-to-customer trading in Treasury markets than in the interdealer market, and, given the nature of the corporate bond market, estimates of liquidity are based on transactions rather than on direct observations of quotes to buy or sell these bonds. We have heard the concerns from market participants that they may not be able to buy or sell large quantities of securities in a timely fashion. The Federal Reserve is taking these concerns about market liquidity seriously. We are committed to analyzing liquidity conditions across a wide array of financial markets as market liquidity is important for the conduct of monetary policy, the health of the financial system and financial stability. Federal Reserve staff regularly assess and monitor liquidity conditions on an ongoing basis for all of the reasons cited.

Federal Reserve Board staff have also been involved in several projects on market liquidity both internally and with other U.S. government agencies. Internally, staff have studied and are continuing to study whether there has been a decline in secondary market liquidity in the fixed income markets. Although we have not found strong evidence of a significant deterioration in day-to-day liquidity, it is possible that changes in the structure of markets have made liquidity less resilient. This is more difficult to analyze because it involves the study of relatively infrequent events. Among the factors we have looked at, algorithmic traders have become more prevalent in the Treasury market, and the share of bond holdings held by open-end mutual funds, some of which provide significant liquidity transformation, has grown significantly in the post-crisis period. Internal work has explored the importance of these factors, and it has also focused on changes in the broker dealer business model and on the potential impact of regulatory changes on market liquidity. We note that staff at the Federal Reserve Bank of New York have

[1] See Bruce Mizrach, "Analysis of Corporate Bond Liquidity," Financial Industry Regulatory Authority (FINRA), Office of the Chief Economist Research Note, December 2015.

also done a number of studies on market liquidity and have recently published some of this work online.[2]

Federal Reserve staff have also played a key role in the interagency work on the events of October 15, 2014, when fixed income markets experienced a sudden and extreme increase in market volatility.[3] Staff also continue to engage actively with the U.S. Treasury, the Commodity Futures Trading Commission, and the Securities and Exchange Commission (SEC) on work examining longer term changes in fixed income market structure and their potential impact on market liquidity.

5. Chair Yellen, aside from the Joint Agency Frequently Asked Questions document circulated with supervisory letter SR-16-19, has the Federal Reserve conducted any research into the impact that the Current Expected Credit Loss (CECL) standard will have on capital reserves, credit availability, and the potential for a reduction in credit during times of economic stress? If so, please detail. If not, why not?

a. While CECL is designed to help prevent the credit bubbles such as the one that fueled events surrounding the 2008 financial crisis, many have expressed concerns given the need for a financial institution to account for losses on the life of a loan at the time of origination and thus the capital reserves held against those losses—that in times of economic stress, financial institutions may reduce lending exacerbating the economic stress. What has the Federal Reserve done to address this concern and has the Federal Reserve discussed this with the other federal financial regulators?

The Financial Accounting Standards Board (FASB) issued the final Current Expected Credit Loss (CECL) standard on June 16, 2016, with the earliest mandatorily effective date of January 1, 2020, for calendar year-end SEC registrants. We followed the FASB's CECL standard during its development and will continue to do so through implementation. One of the stated intents of the CECL standard is to align the accounting with the economics of lending by requiring banks and other lending institutions to record the full amount of credit losses that are expected over the life of a loan on a more timely basis. There was a general belief that the existing accounting framework resulted in loan loss allowances that were "too little, too late" and that the accounting framework should be changed to address this weakness. This goal is accomplished in part by requiring that the allowance reflects losses a firm expects to experience over the remaining life of their loans instead of unduly delaying recognition until the point where losses have already been incurred. The CECL standard also requires incorporation of a reasonable and supportable forecast of future conditions allowing firms to incorporate on a more timely basis early indicators of deterioration in credit quality such as loosening underwriting standards.

Since the FASB's final issuance of the CECL standard, we have established various groups to conduct research on the impact of the CECL standard on loan loss provisioning, regulatory capital, and the availability of credit through the economic cycle. We are in the earlier phases of

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[2] http://libertystreeteconomics.newyorkfed.org/2016/02/continuing-the-conversation-on-liquidity.html#.Vs3HdXIUWmR.

[3] http://www.federalreserve.gov/newsevents/press/other/20150713a.htm.

our research given that FASB issued the CECL standard in June 2016. We are working closely with other U.S. federal financial institution regulators to monitor the implementation of the CECL standard and its micro-prudential and macro-prudential impacts. We meet on a regular basis to ensure consistent resolution of key issues and timely communication to the industry.

b. The annual Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Stress Tests (DFAST) require a covered financial institution to project potential losses under each scenario for eight quarters into the future. Starting in 2018, this eight quarter projection will begin to run into January 2020, the date at which CECL would begin implementation. While CCAR does not currently require calculations based upon future changes to the accounting rules, there is uncertainty about whether the Federal Reserve will require institutions to essentially run two sets of calculations for each scenario, one under the Allowance for Loan and Lease Losses (ALLL) and one under CCAR. How does the Federal Reserve plan to implement CECL into CCAR in 2018? Will covered financial institutions need to prepare two sets of calculations based on differing accounting standards for each scenario? Please describe in detail how the Federal Reserve intends to address this matter.

On January 6, 2017, we provided instructions to firms to exclude the effect of the CECL standard in 2018 Dodd-Frank Act Stress Tests/Comprehensive Capital Analysis Review (DFAST/CCAR). In past CCAR submissions, bank holding companies were instructed not to reflect the adoption of new accounting standards in their projections unless a firm had already adopted the accounting standard for financial reporting purposes. For 2018 DFAST/CCAR, consistent with previous guidance, we instructed firms to exclude the effect of the CECL standard.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

March 24, 2017

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 1 that you submitted following the February 14, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Tillis:</u>

1. Chair Yellen, in your testimony you stated that: you expect inflation to "gradually [rise] to 2 percent;" "toward 2 percent;" "return to 2 percent;" etc. Can you expound on whether 2 percent inflation represents a target objective or is a ceiling?

The Federal Open Market Committee (FOMC) sets monetary policy to achieve its statutory goals of maximum employment and price stability set forth in the Federal Reserve Act. As indicated in its Statement on Longer-Run Goals and Monetary Policy Strategy, which the Committee first agreed to in January 2012 and reaffirms each year, the FOMC judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures (PCE), is most consistent over the longer run with the Federal Reserve's statutory mandate for price stability. The Committee's 2 percent inflation objective is not a ceiling. Indeed, the Committee indicates in the Statement of Longer Run Goals that it would be concerned if inflation were running persistently above or below 2 percent, and that its inflation goal is symmetric. Communicating this symmetric inflation goal clearly to the public is important because it helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant economic disturbances.

In communications with the public over the past year--the statement issued after FOMC meetings, the minutes of those meetings, the Chair's quarterly post meeting press conferences, and the Monetary Policy Report and testimony--the Federal Reserve has indicated that it expected headline inflation to rise over time to the Committee's 2 percent objective. In the event, 12-month PCE price inflation rose to nearly 2 percent in January, up from less than 1 percent last summer. That rise was largely driven by energy prices, which have been increasing recently after earlier declines. Core inflation, which excludes volatile energy and food prices and tends to be a better indicator of future inflation, has been little changed in recent months at about 1-3/4 percent. The Committee expects core inflation to move up and overall inflation to stabilize around 2 percent over the next couple of years, in line with its longer-run objective. The economic projections submitted by individual FOMC participants before the March 2017 FOMC meeting are consistent with this view, with projections for headline and core inflation in 2019 ranging from 1.8 percent to 2.2 percent, with a median projection of 2.0 percent.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 28, 2017

The Honorable Barry Loudermilk
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the written question that you submitted following the February 15, 2017[1], hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on March 21, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Loudermilk:</u>

1. As you know, Congress has conducted oversight into reports of more than 50 cyber breaches that took place at the Federal Reserve between 2011 and 2015.[1] I understand that the Federal Reserve's cybersecurity efforts to protect sensitive data, including consumers' personally identifiable information (PII), are ongoing.

a. What are the most pressing cybersecurity challenges that the Federal Reserve is currently working to address?

The Federal Reserve Board (the Board) is keenly aware of the risks and threats within cyberspace. The Board follows the National Institute of Standards and Technology (NIST) Risk Management Framework as required by the Federal Information Security Modernization Act to manage its information security including cyber risks. Current areas of focus include ensuring sensitive information, such as personally identifiable information (PII), is being protected and handled appropriately, and protecting against advanced hacking techniques from nation states and other advanced actors, insider threats, and Distributed Denial of Service (DDOS) attacks. To address these challenges, the Board has implemented and continues to enhance our Data Loss Protection (DLP) program. The Board is also enhancing information handling policies; implementing data encryption at rest technologies, including for databases containing PII; enhancing incident response processes; and continually improving Advanced Persistent Threat and DDOS protection and detection capabilities. In addition, the Board is in the process of implementing the Department of Homeland Security's Einstein suite of advanced intrusion detection capabilities.

The Board and the Reserve Banks, which also follow an information security program based on NIST standards adapted to their environment, use a comprehensive defense in-depth approach whereby multiple layers of security controls are implemented to protect sensitive information as well as vigilantly monitoring probes and attacks on an ongoing basis. It is important to acknowledge, however, that no defense is foolproof. Early detection of attacks is just as important as prevention through multiple layers of defense. Hence, we continually work to identify and remediate attacks before any damage occurs.

The Federal Reserve also recognizes the systemic risk posed by cyber threats to the financial system. The global financial services sector has a heightened level of exposure to cyber risk due to the high degree of information technology intensive activities and the increasing interconnection between firms in the sector. As such, cyber risk mitigation and cyber resiliency initiatives continue to be high priorities for the Federal Reserve. To strengthen risk management practices across the sector and reduce the impact of a cyber-related incident, the Federal Reserve works independently and in collaboration with other agencies, public/private partnerships, and international authorities, to introduce and participate in programs to share information and benchmark from best-practices that combat the increasingly frequent and sophisticated emerging cybersecurity threats.

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[1] Jason Lange & Dustin Volz, Fed Records Show Dozens of Cybersecurity Breaches, Reuters, Jun. 1, 2016, available at http://www.reuters.com/article/us-usa-fed-cyber-idUSKCN0YN4AM.

b. What steps is the Federal Reserve taking to strengthen its protection of PII and other sensitive information?

We are continually improving our information handling policies and processes. Protecting sensitive information throughout its lifecycle from creation to destruction is a vital component of our overall cybersecurity strategy. In addition to working aggressively to minimize access to sensitive information based on "least privilege necessary" and "need to know" criteria, we have implemented and are enforcing email classification and labelling, as well as require document labeling. Additionally, we continue to enhance our DLP program while also implementing encryption of databases containing PII as well as other sensitive/mission critical data consistent with the requirements of the Federal Cybersecurity Enhancement Act.

c. What steps is the Federal Reserve taking to protect against insider threats?

Information handling processes and data loss protection capabilities are fundamental building blocks in strengthening our ability to identify and respond to insider threats. We continue to expand the use of automated solutions to assist us in ensuring that only authorized individuals have access to information and to prevent the movement of information to unauthorized locations including limiting the use of mobile data storage devices. We are also increasingly utilizing operational analytics to identify and respond to threats.

Our insider threat protection strategy is consistent with our layered protections strategy and focuses on people, processes, and technology. Our ongoing training and awareness program reinforces the importance to our employees of the need to safeguard sensitive information entrusted to them and the importance of using systems and data for authorized purposes only. Security processes associated with insider threats are focused on limiting access to sensitive information based on the tenets of "least privilege necessary" and "need to know" criteria. We strive to continually improve our investments in security technologies to enable us to detect early signs of anomalous activities indicative of insider or other forms of cyber threats.

House Committee on Financial Services

Full Committee Hearing: "Monetary Policy and the State of the Economy"

February 15, 2017

Questions for the Record from Congressman Barry Loudermilk (GA-11)

The Honorable Janet Yellen, Chair, the Board of Governors of the Federal Reserve System

- As you know, Congress has conducted oversight into reports of more than 50 cyber beaches that took place at the Federal Reserve between 2011 and 2015.[1] I understand that the Federal Reserve's cybersecurity efforts to protect sensitive data, including consumers' personally identifiable information (PII), are ongoing.
    - What are the most pressing cybersecurity challenges that the Federal Reserve is currently working to address?
    - What steps is the Federal Reserve taking to strengthen its protection of PII and other sensitive information?
    - What steps is the Federal Reserve taking to protect against insider threats?

[1]Jason Lange & Dustin Volz, *Fed Records Show Dozens of Cybersecurity Breaches*, REUTERS, Jun. 1, 2016, *available at* http://www.reuters.com/article/us-usa-fed-cyber-idUSKCN0YN4AM.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 10, 2017

The Honorable Blaine Luetkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the written question that you submitted following the February 15, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on March 21, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Luetkemeyer:

1. As you know, Congress in statute and the Fed through regulation appropriately carved the business of insurance out of the Volcker Rule's restrictions. However, in the final rule, insurance companies which are also savings and loan holding companies because of a subsidiary thrift must meet unnecessarily burdensome compliance requirements that are based on total consolidated assets of the insurance company, rather than being limited to the size of financial subsidiaries that are subject to the Volcker Rule's prohibitions. This does not comport with congressional intent and the spirit of the Volcker Rule, which was not targeting, and specifically exempted, insurance company activity. Do you agree that insurance assets should be excluded from consolidated assets for purposes of Volcker compliance, since the business of insurance was carved out of the rule?

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the statutory provision known as the "Volcker Rule"), which added a new section 13 to the Bank Holding Company Act of 1956 (BHC Act), generally prohibits any banking entity from engaging in proprietary trading, and from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a covered fund, subject to certain exemptions. Under the terms of the statute, the Volcker Rule applies to any company that controls an insured depository institution, and any affiliate or subsidiary of any such entity. As a result, the Volcker Rule and the implementing rules issued by the Federal Reserve, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Commodity Futures Trading Commission (the "Agencies") apply to savings and loan holding companies and their affiliates and subsidiaries.

Section 13 of the BHC Act requires the Agencies to implement rules "to insure compliance with this section." The Federal Reserve Board's (Board) rules provide that each banking entity must establish a compliance program, with enhanced minimum standards applicable to institutions that meet certain additional criteria set forth in the rules. These enhanced minimum standards apply to banking entities with the most significant covered trading activities or those that meet a specified threshold of total consolidated assets. However, the Board's rules expressly provide that with regard to the compliance program established by a banking entity, the "terms, scope and detail of the compliance program shall be appropriate for the types, size, scope, and complexity of activities and business structure of the banking entity" (12 CFR 248.20(a)). Therefore, each institution subject to the enhanced minimum compliance program requirements, including a large savings and loan holding company with significant insurance-related assets, has flexibility under the rule to tailor its compliance program based on the nature of its activities.

Questions for the Record
Rep. Blaine Luetkemeyer (MO-03)
"Monetary Policy and the State of the Economy"
Committee on Financial Services
February 15, 2017

To Chair Yellen:

1. As you know, Congress in statute and the Fed through regulation appropriately carved the business of insurance out of the Volcker Rule's restrictions. However, in the final rule, insurance companies which are also savings and loan holding companies because of a subsidiary thrift must meet unnecessarily burdensome compliance requirements that are based on total consolidated assets of the insurance company, rather than being limited to the size of financial subsidiaries that are subject to the Volcker Rule's prohibitions. This does not comport with congressional intent and the spirit of the Volcker Rule, which was not targeting, and specifically exempted, insurance company activity. Do you agree that insurance assets should be excluded from consolidated assets for purposes of Volcker compliance, since the business of insurance was carved out of the rule?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 3, 2017

The Honorable Brad Sherman
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the written question that you submitted following the February 15, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on March 21, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Sherman:

1. The latest round of Basel capital rules established punitive risk weightings for mortgage servicing rights (MSR), which may have caused banks to rethink whether to own these assets. Ultimately, these punitive standards may impact American borrowers through higher rates or reduced access to mortgage credit.

What are your thoughts about strict conformity with the international Basel framework, and do you think it is appropriate to ensure that the U.S. rules are implemented or amended in a fashion that addresses possible harm to consumers and businesses, specifically on the MSR issue, and more generally where the framework puts U.S. banks and their lending activity at a competitive disadvantage?

The Board of Governors of the Federal Reserve System (Board), Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (federal banking agencies) have long limited the inclusion of mortgage servicing assets (MSAs) in regulatory capital in light of the high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions. These regulatory capital limitations help protect banks from sudden fluctuations in the value of MSAs and from the inability to quickly divest these assets at their full estimated value during periods of financial stress. In the July 2016 *Report to the Congress on the Effect of Capital Rules on Mortgage Servicing Assets*, the federal banking agencies together with the National Credit Union Administration noted that MSA valuations are inherently subjective and uncertain because the valuations rely on assessments of future economic variables.

As a member of the Basel Committee on Banking Supervision (BCBS), the Board works with other BCBS members to develop minimum international regulatory capital standards that promote consistency across the largest banking organizations in BCBS member jurisdictions and avoid a race-to-the-bottom in international prudential regulation. Before adopting any changes to its regulations, the Board invites public comment and considers any unique features of the U.S. economy and financial sector. After inviting public comment on a revised capital treatment of MSAs that was based on work conducted by the Board and other members of the BCBS, in 2013 the Board and the Office of the Comptroller of the Currency adopted a final rule that modified the capital treatment of MSAs to better address the risks associated with these assets.

The Board recognizes community banks' concerns with respect to the burden and complexity of the U.S. regulatory capital framework. The Board, along with the other federal banking agencies, recently committed to address such concerns in their report on the review of the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA report), which emphasized the "goal of reducing regulatory burden on community banks while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system." As described in the EGRPRA report, the federal banking agencies are jointly developing a proposal to simplify certain aspects of the regulatory capital framework, including the treatment of MSAs.

Congressman Brad Sherman

Question for the Record

Financial Services Committee Hearing "Monetary Policy and the State of the Economy"

February 15, 2017

Question for The Honorable Janet Yellen, Chair of the Board of Governors of the Federal Reserve System:

The latest round of Basel capital rules established punitive risk weightings for mortgage servicing rights (MSR), which may have caused banks to rethink whether to own these assets. Ultimately, these punitive standards may impact American borrowers through higher rates or reduced access to mortgage credit.

What are your thoughts about strict conformity with the international Basel framework, and do you think it is appropriate to ensure that the U.S. rules are implemented or amended in a fashion that addresses possible harm to consumers and businesses, specifically on the MSR issue, and more generally where the framework puts U.S. banks and their lending activity at a competitive disadvantage?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 20, 2017

The Honorable French Hill
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the written question that you submitted following the February 15, 2017[1], hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 15, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Hill:</u>

1. In response to Mr. Williams question regarding what is currently stopping the Federal Reserve from winding down its balance sheet, you stated that the federal funds rate range was now between 50 and 75 basis points and that you wanted "a bit more buffer" in order to reach normalization so that the Fed could then begin to contract the size of its balance sheet.

What range constitutes "a bit more buffer"? In other words, specifically at what range does the federal funds rate need to reach for the Fed to start running off its balance sheet?

As noted in recent Federal Open Market Committee (FOMC) statements, the Committee has indicated that it expects to continue its current policy of reinvestments until the process of normalizing the level of the federal funds rate is well underway. However, the Committee has not established a formal linkage between a particular level of the federal funds rate and a change in its reinvestment policy.

The FOMC conducts monetary policy to promote its longer-term objectives of maximum employment and stable prices. Consistent with this overarching principle, the FOMC will reach a judgment about reinvestments and the balance sheet based on its assessment of the economic outlook and the prospects for continued progress toward its longer run objectives. This process will include an evaluation of the anticipated trajectory for the economy as well as the risks to the economic outlook.

As noted in the minutes of the March 2017 FOMC meeting, provided that the economy continued to perform about as expected, most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year.

Rep. French Hill
"Monetary Policy and the State of the Economy"
February 15, 2017

Questions for the Record
Representative French Hill
to
Janet Yellen
Chair of the Board of Governors of Federal Reserve System

In response to Mr. Williams question regarding what is currently stopping the Federal Reserve from winding down its balance sheet, you stated that the federal funds rate range was now between 50 and 75 basis points and that you wanted "a bit more buffer" in order to reach normalization so that the Fed could then begin to contract the size of its balance sheet.

Question: What range constitutes "a bit more buffer"? In other words, specifically at what range does the federal funds rate need to reach for the Fed to start running off its balance sheet?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 5, 2017

The Honorable Gwen Moore
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 2 that you submitted following the February 15, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on March 21, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Moore:</u>

2. Dodd-Frank created greater transparency and stability by directed more trades through market utilities, including for derivative trades. Title VIII (8) established a framework to assessing systemic risk associated with these utilities and granted the Fed, CFTC, and SEC enhanced regulatory authority over these utilities.

a. Do you agree that if Title VIII of Dodd-Frank were removed, as is contemplated in the CHOICE Act, the potential for systemically significant market events might increase due to the resulting absence of enhanced supervision of CCPs, as well as the absence of emergency liquidity facilities and risk-free accounts for customer margin?

Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) creates an enhanced framework for the supervision of financial market utilities (FMUs), including central counterparties that have been designated as systemically important by the Financial Stability Oversight Council. This enhanced supervision framework allows the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the Board of Governors of the Federal Reserve System (Board) to prescribe enhanced risk management standards for FMUs and provides mechanisms for information-sharing and coordination among the supervisory agencies. Title VIII provides the Board with the ability to obtain a certain level of insight across all designated FMUs through examination participation and notification of material rule changes and also provides the Board with certain limited enforcement authority.

Effective risk management of FMUs enhances the stability of the financial system, more broadly. It is important that FMUs be overseen consistently, and in a manner that focuses on the safety of the system as a whole and not just its individual components. The role given to the Board under Title VIII allows for such a systemic view of FMUs and assists the supervisory agencies in promoting consistency across the various designated FMUs.

The SEC, CFTC, and Board have each adopted regulations that have materially raised the expectations to which systemically important FMUs are held and that have improved FMUs' credit and liquidity risk management frameworks and enhanced their operational resilience. Further, the CFTC, SEC, and Board's respective requirements for FMUs designated under Title VIII require these firms to manage their risks by relying on private-sector resources only, without any assumption of reliance on public funds during times of market stress.

Title VIII permits the Board to authorize a Federal Reserve Bank to establish an account for and provide services to a designated FMU. Conducting money settlements using central bank money, where available, is consistent with strong risk management practices. It is likely that that the provision of accounts and services to certain designated FMUs has reduced risk in the system by minimizing credit and liquidity risk associated with holding margin payments and contingent liquidity resources in commercial bank accounts.

Title VIII also permits the Board to authorize a Federal Reserve Bank to provide discount and borrowing privileges to a designated FMU only in unusual or exigent circumstances, upon an affirmative vote of a majority of the Board of Governors then serving, after consultation with the Secretary of the Treasury, and upon a showing by the FMU that it is unable to secure adequate credit accommodations from other banks.

The variety of tools created by Title VIII have provided effective mechanisms for highlighting the importance of risk management to FMUs and for the agencies to oversee and coordinate the implementation of FMU risk-management policies and procedures. Collectively, these activities have resulted in a reduced likelihood of market stress, which may have systemic implications, and have enhanced the ability of FMUs and supervisory agencies to respond to those stresses should they occur. These results are consistent with the principle of reducing reliance on public funds in response to market stress or a financial crisis.

b. How might American consumers and workers be impacted by the return of greater systemic risk?

Over the past three decades, the financial system has evolved to rely more and more on FMUs that connect banks, broker-dealers, financial advisors, and other financial institutions, as well as in many cases farmers and businesses of all sizes as they try to reduce the risks associated with their core business activities. FMUs generally reduce the credit risk faced by the parties that rely on these entities as connection points to facilitate the exchange of cash and securities of all kinds, and also can materially reduce the amount of liquidity needed to complete such transactions.

As discussed above, Title VIII of the Dodd-Frank Act has strengthened the supervisory framework over FMUs as well as raised the expectations for the risk management standards for designated FMUs. If Title VIII were repealed and this structure removed, the likelihood for disruptions that might impact a wide set of financial institutions, small businesses, and farmers who rely on FMUs on a daily basis may increase. As seen after the financial crisis of 2008, such market stress and disruptions can propagate across the financial system and have real consequences for the economy, including households and businesses.

Questions for Record
Of
Representative Gwen Moore
"Humphrey-Hawkins" Hearing
House Financial Services Committee

2/15/2017

1. I have been an advocate of the Orderly Liquidation Facility (OLF) for its ability to streamline liquidation of G-SIFIs in certain circumstances.

   Do you believe that Wall Street requires a government determination to figure out if a firm is systemically significant?

   Do you believe that repealing the OLF would create uncertainty and contagion in the event of another crisis?

2. Dodd-Frank created greater transparency and stability by directed more trades through market utilities, including for derivative trades. Title VIII (8) established a framework to assessing systemic risk associated with these utilities and granted the Fed, CFTC, and SEC enhanced regulatory authority over these utilities.

   Do you agree that if Title VIII of Dodd-Frank were removed, as is contemplated in the CHOICE Act, the potential for systemically significant market events might increase due to the resulting absence of enhanced supervision of CCPs, as well as the absence of emergency liquidity facilities and risk-free accounts for customer margin?

   How might American consumers and workers be impacted by the return of greater systemic risk?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 19, 2017

The Honorable Randy Hultgren
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 3 through 5 that you submitted following the February 15, 2017,[1] hearing before the Committee on Financial Services. On May 1, 2017, I provided a response to question 1. Additionally, on April 28, 2017, I provided a response to question 2. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on March 21, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Hultgren:

3. This month, a report was published by Harvard University paper titled *The Financial Regulatory Reform Agenda in 2017* by Robin Greenwood, Samuel G. Hanson, Adi Sunderam, and former Federal Reserve Governor Jeremy C. Stein that makes some criticism of the Supplementary Leverage Ratio.[1] The paper states, "The problem with the current implementation of the SLR, however, is that it has been calibrated too aggressively. As a result, it has distorted risk choices, discouraging some banks from investing in the safest assets. These distortions have already had an adverse effect on the functioning of the Treasury market. We would urge that the SLR be dialed back, so that it serves only as a secondary backup to the risk-based capital regime, and is not among the primary regulatory constraints that banks face."

I was encouraged when I saw remarks from Governor Tarullo last December stating, "And as part of our efforts to tailor our regulations according to the business models of firms, we are considering ways to address the special issues posed for the large custody banks by certain elements of our regulatory framework."[2]

a. Does the Federal Reserve Board plan to tailor the Supplementary Leverage Ratio (SLR) to acknowledge that deposits at the Fed are low-risk off-balance sheet exposures? In other words, can we expect these deposits will be removed from the calculation of the SLR?

The total leverage exposure measure, which is the denominator of the Supplementary Leverage Ratio (SLR), includes all assets reported on the balance sheet and certain off-balance sheet items, regardless of the risk associated with individual exposures. The custody banks have raised concerns regarding the relatively high capital requirement that the enhanced SLR standard imposes on the large volume of deposits that they place with the Federal Reserve as they reinvest their clients' excess cash. The Federal Reserve has engaged in discussions with the firms on potential ways to address their concerns and welcomes continued engagement.

The custody banks have suggested several potential reforms of the enhanced SLR to address their concerns, including an exclusion of some or all central bank deposits from the denominator of the SLR and a recalibration of the enhanced SLR so that each of our most systemic banking firms would face an enhanced SLR that is proportional to its individual systemic footprint. The Federal Reserve Board (Board) is actively considering these suggestions and other suggestions from market participants about how to improve the cost-benefit balance of our leverage ratio requirements.

b. If so, will this be done via rulemaking? When will the Fed (and other banking regulators) propose a rule change?

[1] Greenwood, R., Hanson, S. G., Stein, J. C., & Sunderam, A. (2017). The Financial Regulatory Reform Agenda in 2017. *Harvard University*.

[2] Federal Reserve Board Governor Daniel K Tarullo. Federal Reserve Bank of Cleveland and Office of Financial Research Financial Stability Conference. December 2, 2016. Note: Governor Tarullo recently announced he will retire soon. https://www.federalreserve.gov/newsevents/speech/tarullo20161202a.htm.

The Board is actively considering ways to address the concerns raised by custody banks and other members of the public about the Federal Reserve's leverage ratio framework. Before making any changes to its rules, including those relating to the SLR, the Board would provide notice and invite public comment.

4. I want to follow-up on the answers you provided to my Questions for the Record regarding the treatment of segregated customer margin in the U.S. implementation of the Basel leverage ratios for your last appearance before the House Committee on Financial Services. You answered a fundamentally different question on the treatment of on-balance sheet cash in the denominator of leverage ratio calculation rather than address my question on the exposure reducing effect of segregated customer margin for off-balance sheet exposures.

You noted that the Supplementary Leverage Ratio ("SLR") "requires a banking organization to hold a minimum amount of capital against on balance sheet assets and off-balance sheet exposures, including with respect to segregated customer margin, regardless of the risk associated with the individual exposure." I was not disputing this application or the purpose of the SLR. This is not a question of "excluding select categories of on-balance sheet assets" as discussed in your response. Therefore, I would like to clarify the question.

a. Why is segregated customer margin for cleared derivatives not recognized as reducing the off-balance sheet exposure you mention? By its very nature, the customer margin received and segregated by a bank-affiliated clearing agent reduces the bank's exposure to guarantee the debt owed by its customers to the clearinghouse.

The SLR rule requires internationally active banking organizations to hold a minimum amount of capital against both on-balance sheet assets as determined under U.S. accounting standards and certain off-balance sheet exposures specified in the rule, regardless of the risk associated with the individual exposure.

A fundamental construction principle of the SLR – and other leverage ratios – is to impose the same capital requirement on each of a bank's exposures, regardless of the creditworthiness of the counterparty and regardless of the presence of credit risk mitigants such as collateral. Accordingly, the current SLR does not recognize customer margin despite its economic value in reducing a bank's credit risk. The Board continues to explore, however, alternative methods for measuring the potential future exposure of derivatives for purposes of the SLR and continues to assess the overall calibration of the enhanced SLR that it applies to the U.S. global systemically important banks (GSIBs).

5. I am also not certain you understood the intention of my second question concerning the U.S. implementation of the Basel leverage ratios. You responded to my question suggesting that fewer bank-affiliated clearing firms will continue this line of business by stating, "the swap margin rule, issued in October 2015, incentivized firms to clear through central counterparties."

I am not disputing that clearing via central counterparties is increasingly required and/or "incentivized" by various regulations. As increased clearing takes hold, I am concerned that agents tasked with fulfilling the very rule you mention – those who act as

intermediaries between the firms now "incentivized to clear" and the central counterparty – will find it increasingly unappealing to continue this service.

a. How will the new clearing requirements coming into effect be impacted as consolidation among those who guarantee customer clearing obligations with the central counterparty (sometimes bank-affiliated clearing members) exit the business or reduce such services available to customers? These are customers who now more than ever need access to central clearing.

Achieving the full intended benefits of the move of standardized derivatives to central clearing does require that we have a substantial set of dealers that are willing and able to intermediate derivatives between end users and the central counterparties. Although a few dealers have exited or substantially reduced their client clearing businesses over the past few years – for a variety of different reasons – a substantial number of dealers remain active in client clearing. The Board will continue to monitor developments in this area and will coordinate with other policy makers to maximize the net systemic risk benefits from the move of standardized derivatives to central clearing.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 1, 2017

The Honorable Randy Hultgren
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 1 that you submitted following the February 15, 2017,[1] hearing before the Committee on Financial Services. On April 28, 2017, I provided a response to question 2. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on March 21, 2017.

__**Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Hultgren:**__

1. The Financial Crimes Enforcement Network ("FinCEN") recently exempted banks from its new Customer Due Diligence Rule for accounts established to finance insurance premiums, where loan proceeds are remitted directly by the bank to an insurer. FinCEN agreed with the industry "that these types of accounts present a low risk of laundering" and represent a "poor vehicle" for money laundering.

Despite FinCEN's finding of negligible Anti-Money Laundering ("AML") risk, the Federal Reserve Board has been requiring banks to apply another AML measure, customer identification programs ("CIP"), to premium financing accounts. This may put bank-affiliated lenders at a competitive disadvantage with non-bank companies, which are not obligated to apply such programs, and could be driving bank-affiliated premium insurance business out of the market. This would in turn make it more difficult for small businesses and others that rely on this kind of lending.

a. Will the Federal Reserve confirm that it will work with FinCEN and the bank-owned premium finance industry to also exclude it from CIP requirements, making use of exemptive authority as needed? Absent such confirmation, please explain the rationale, if any, for not using these agencies' exemptive authority or other authority to exclude bank-owned premium finance lenders from CIP requirements.

b. If the Federal Reserve sees risk in certain sectors of the premium finance industry, are there specific types of premium finance, for example with respect to property and casualty insurance that might be fully or partly exempted?

Yes, the Board of Governors of the Federal Reserve System (Board) will work with Treasury's Financial Crimes Enforcement Network (FinCEN), the other Federal Banking Agencies (FBAs),[1] and bank-affiliated premium finance lenders to consider requests to exempt bank-affiliated premium finance lenders and insurance premium finance accounts from the interagency Customer Identification Program (CIP) rule.[2]

FinCEN's Customer Due Diligence (CDD) rule was adopted in 2016[3] and generally requires a covered financial institution, which includes FBA-supervised banks, to identify and verify the beneficial owner of legal entity accountholders.[4] The CDD rule explicitly exempts covered financial institutions from this requirement with respect to accounts that "[f]inance insurance premiums and for which payments are remitted directly by the financial institution to the insurance provider or broker."[5] The CDD rule does not exempt insurance premium finance accounts from the CIP rule and other anti-money laundering requirements.

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[1] The FBAs include the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Association.

[2] "Banks" for the purposes of this response is consistent with the definition at 31 CFR 1020.100(b).

[3] 81 FR 29397 (May 11, 2016).

[4] 31 CFR 1010.230(a) and 1020.210(b)(5)(ii).

[5] 31 CFR § 1010.230(h)(1)(iii).

In contrast to the CDD rule, the CIP rule was jointly adopted by Treasury, the Board, and other FBAs in 2003. The CIP rule in coordination with guidance requires banks and their domestic subsidiaries, other than functionally regulated subsidiaries, to establish risk-based procedures for verifying the identity of their customers when opening an account withiu the meaning of the regulation.[6] The CIP requirements apply to extensions of credit, including insurance premium finance accounts.[7] The specific minimum requirements in the CIP rule allow the bank to establish a reasonable belief that it knows each customer's identity and can be satisfied by obtaining basic information before opening the account, such as the customer's name, date of birth for individuals, address, and an identification number.

The CIP rule provides that the Board and other FBAs may exempt any FBA-supervised bank or type of account from CIP requirements with the concurrence of the Secretary of the Treasury (Secretary).[8] The CIP rule also provides the Secretary with sole authority to exempt banks and accounts that are not supervised by an FBA from CIP requirements. To exercise this authority, the FBA and the Secretary must consider whether the exemption is consistent with the purposes of the Bank Secrecy Act and with safe and sound banking. The FBA and the Secretary may also consider "other appropriate factors."

Banks of all charter types may offer insurance premium finance accounts. The Board will therefore work with the other FBAs and Treasury not only to determine whether to exempt bank-affiliated premium finance lenders and insurance premium finance accounts from CIP requirements, but also to establish a process for coordinating reviews of CIP exemption requests.

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[6] The CIP requirements for banks are specified at 31 CFR §1020.220.

[7] 31 CFR 1020.100(a)(1) (defining "account" to include "a credit account, or other extension of credit").

[8] 31 CFR 1020.220(b). The CIP rule's exemption authority implements a provision of the Bank Secrecy Act that allows a Federal functional regulator, with the concurrence of the Secretary, to "exempt any financial institution or type of account from [CIP] requirements . . . in accordance with such standards and procedures as the Secretary may prescribe." 31 U.S.C. § 5318(l)(5). The CIP rule also provides exemption authority to the Securities and Exchange Commission and the Commodity Futures Trading Commission, with the concurrence of the Secretary, to exempt broker-dealers, mutual funds, futures commission merchants and introducing brokers in commodities from CIP requirements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 28, 2017

The Honorable Randy Hultgren
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 2 that you submitted following the February 15, 2017[1], hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on March 21, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Hultgren:</u>

2. An April 2016 GAO report found that the Fed "should revise the resolution plan rule's annual filing requirements to provide sufficient time not only for the regulators to complete their plan reviews and provide feedback but also for companies to address and incorporate regulators' feedback in subsequent plan filings." It suggests extending the annual filing cycle to every 2 years.

a. Does the Fed plan to adjust its living wills filing cycle to be in line with the GAO's recommendation? If so, when?

b. If not, why does the Fed disagree with the recommendations of the Government Accountability Office?

The Federal Reserve supports the Government Accountability Office's (GAO) recommendation to lengthen the current one-year resolution plan filing cycle and is consulting with the Federal Deposit Insurance Corporation (FDIC) on potential revisions to the regulation requiring annual resolution plan submissions. The Federal Reserve also has taken a number of actions since the GAO report to extend filing deadlines and reduce reporting requirements of resolution plan filers. In April 2016, the Federal Reserve and the FDIC (agencies) permitted domestic global systemically important banks to provide a progress report in October 2016 on their efforts to address shortcoming and deficiencies identified by the agencies in lieu of a full resolution plan due in July 2016. In June 2016, the agencies permitted 84 firms with limited U.S. operations to file resolution plans with significantly reduced informational content for three years. In August 2016, the agencies extended the deadline from year-end 2016 to year-end 2017 for the resolution plan submissions of certain smaller firms and non-bank organizations. In March 2017, the agencies granted certain large foreign banking organizations a one-year extension to incorporate guidance provided by the agencies for their next plans.

Financial Services Committee Hearing entitled, "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System"
February 15, 2017

Questions for the Record from Congressman Hultgren (R-IL)

The Honorable Janet Yellen, Chair of the Board of Governors of the Federal Reserve System

Question One
The Financial Crimes Enforcement Network ("FinCEN") recently exempted banks from its new Customer Due Diligence Rule for accounts established to finance insurance premiums, where loan proceeds are remitted directly by the bank to an insurer. FinCEN agreed with the industry "that these types of accounts present a low risk of laundering" and represent a "poor vehicle" for money laundering.

Despite FinCEN's finding of negligible Anti-Money Laundering ("AML") risk, the Federal Reserve Board has been requiring banks to apply another AML measure, customer identification programs ("CIP"), to premium financing accounts. This may put bank-affiliated lenders at a competitive disadvantage with non-bank companies, which are not obligated to apply such programs, and could be driving bank-affiliated premium insurance business out of the market. This would in turn make it more difficult for small businesses and others that rely on this kind of lending.

A. Will the Federal Reserve confirm that it will work with FinCEN and the bank-owned premium finance industry to also exclude it from CIP requirements, making use of exemptive authority as needed? Absent such confirmation, please explain the rationale, if any, for not using these agencies' exemptive authority or other authority to exclude bank-owned premium finance lenders from CIP requirements.
B. If the Federal Reserve sees risk in certain sectors of the premium finance industry, are there specific types of premium finance, for example with respect to property and casualty insurance that might be fully or partly exempted?

Question Two
An April 2016 GAO report found that the Fed "should revise the resolution plan rule's annual filing requirements to provide sufficient time not only for the regulators to complete their plan reviews and provide feedback but also for companies to address and incorporate regulators' feedback in subsequent plan filings." It suggests extending the annual filing cycle to every 2 years.

A. Does the Fed plan to adjust its living wills filing cycle to be in line with the GAO's recommendation? If so, when?
B. If not, why does the Fed disagree with the recommendations of the Government Accountability Office?

Question Three

This month, a report was published by Harvard University paper titled *The Financial Regulatory Reform Agenda in 2017* by Robin Greenwood, Samuel G. Hanson, Adi Sunderam, and former Federal Reserve Governor Jeremy C. Stein that makes some criticism of the Supplementary Leverage Ratio.[1] The paper states, "The problem with the current implementation of the SLR, however, is that it has been calibrated too aggressively. As a result, it has distorted risk choices, discouraging some banks from investing in the safest assets. These distortions have already had an adverse effect on the functioning of the Treasury market. We would urge that the SLR be dialed back, so that it serves only as a secondary backup to the risk-based capital regime, and is not among the primary regulatory constraints that banks face."

I was encouraged when I saw remarks from Governor Tarullo last December stating, "And as part of our efforts to tailor our regulations according to the business models of firms, we are considering ways to address the special issues posed for the large custody banks by certain elements of our regulatory framework."[2]

A. Does the Federal Reserve Board plan to tailor the Supplementary Leverage Ratio (SLR) to acknowledge that deposits at the Fed are low-risk off-balance sheet exposures? In other words, can we expect these deposits will be removed from the calculation of the SLR?
B. If so, will this be done via rulemaking? When will the Fed (and other banking regulators) propose a rule change?

Question Four

I want to follow-up on the answers you provided to my Questions for the Record regarding the treatment of segregated customer margin in the U.S. implementation of the Basel leverage ratios for your last appearance before the House Committee on Financial Services. You answered a fundamentally different question on the treatment of on-balance sheet cash in the denominator of leverage ratio calculation rather than address my question on the exposure reducing effect of segregated customer margin for off-balance sheet exposures.

You noted that the Supplementary Leverage Ratio ("SLR") "requires a banking organization to hold a minimum amount of capital against on balance sheet assets and off-balance sheet exposures, including with respect to segregated customer margin, regardless of the risk associated with the individual exposure." I was not disputing this application or the purpose of the SLR. This is not a question of "excluding select categories of on-balance sheet assets" as discussed in your response. Therefore, I would like to clarify the question.

A. Why is segregated customer margin for cleared derivatives not recognized as reducing the off-balance sheet exposure you mention? By its very nature, the customer margin received and segregated by a bank-affiliated clearing agent reduces the bank's exposure to guarantee the debt owed by its customers to the clearinghouse.

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[1] Greenwood, R., Hanson, S. G., Stein, J. C., & Sunderam, A. (2017). The Financial Regulatory Reform Agenda in 2017. *Harvard University.*

[2] Federal Reserve Board Governor Daniel K Tarullo. Federal Reserve Bank of Cleveland and Office of Financial Research Financial Stability Conference. December 2, 2016. Note: Governor Tarullo recently announced he will retire soon.
https://www.federalreserve.gov/newsevents/speech/tarullo20161202a.htm

Question Five

I am also not certain you understood the intention of my second question concerning the U.S. implementation of the Basel leverage ratios. You responded to my question suggesting that fewer bank-affiliated clearing firms will continue this line of business by stating, "the swap margin rule, issued in October 2015, incentivized firms to clear through central counterparties."

I am not disputing that clearing via central counterparties is increasingly required and/or "incentivized" by various regulations. As increased clearing takes hold, I am concerned that agents tasked with fulfilling the very rule you mention – those who act as intermediaries between the firms now "incentivized to clear" and the central counterparty – will find it increasingly unappealing to continue this service.

A. How will the new clearing requirements coming into effect be impacted as consolidation among those who guarantee customer clearing obligations with the central counterparty (sometimes bank-affiliated clearing members) exit the business or reduce such services available to customers? These are customers who now more than ever need access to central clearing.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 19, 2017

The Honorable Tom Emmer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 1 that you submitted following the February 15, 2017,[1] hearing before the Committee on Financial Services. On May 1, 2017, I provided a response to question 2. Additionally, on April 20, 2017, I provided a response to question 3. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on March 21, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Emmer:</u>

1. In addition to monetary policy, the Federal Reserve also plays an important role regulating and supervising the financial industry. As part of those activities, the Federal Reserve has "gold plated" international capital regulations, specifically the Supplementary Leverage Ratio or SLR.

In February 2016 when you testified before this committee you were asked about the SLR, its effect specifically on custody banks, and the harm a higher SLR for custody banks might create for pension funds, mutual funds, and the financial system as a whole. At that point you said that the SLR was a "crude" tool and you were looking into the concerns raised about the rule's application to custody banks.

I appreciated your answer last year as well as Federal Reserve Governor Dan Tarullo's statement in December on making changes to capital standards that would reflect custody bank's needs to provide services to their clients. In December, Governor Tarullo specifically said that, "as part of our efforts to tailor our regulations according to the business models of firms, we are considering ways to address the special issues posed for the large custody banks by certain elements of our regulatory framework."

In light of that statement, can you provide some more details on what steps the Federal Reserve is taking to tailor regulations to the custody bank business model, and when we will see those reforms rolled out?

By its very nature, the Supplementary Leverage Ratio (SLR) does not differentiate among asset classes according to the level of risk they pose. The purpose of the SLR is to be a simple complement to the more complex risk-based capital ratios, such that each offsets the potential weaknesses of the other. The total leverage exposure measure, which is the denominator of the SLR, includes all assets reported on the balance sheet and certain off-balance sheet items, regardless of the risk associated with individual exposures. This includes certain very low-risk exposures, such as deposits with the Federal Reserve, which is a common asset of custody banks.

Some custody banks have raised concerns regarding the potential unintended consequences associated with the enhanced SLR standard. The enhanced SLR (which applies only to the largest, most systemically important U.S. banking organizations) is calculated in the same manner as the SLR (which applies to all advanced approaches U.S. banking organizations). However, the enhanced SLR is calibrated at a higher level (i.e., five percent for bank holding companies). A specific concern raised by the custody banks is the relatively high capital requirement that the enhanced SLR standard imposes on the large volume of deposits that custody banks place with the Federal Reserve as they reinvest their clients' excess cash.

The Federal Reserve Board (Board) has had an ongoing dialogue with the custody banks about potential ways to address their concerns about the calibration of the enhanced SLR and welcomes continued engagement. The Board is actively considering ways to address the concerns raised by the custody banks and other market participants about the leverage ratio framework, including the calibration of the enhanced SLR. Before making any changes to its rules, including those relating to the SLR and enhanced SLR, the Board would provide notice and invite public comment.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 1, 2017

The Honorable Tom Emmer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 2 that you submitted following the February 15, 2017,[1] hearing before the Committee on Financial Services. On April 20, 2017, I provided a response to question 3. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on March 21, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Emmer:</u>

2. In one of your previous appearances before this committee, I asked you about the impact that raising the Fed Funds rate could have on farmers and agriculture affiliated businesses. You mentioned that the Fed has studied this impact, however, given the very pessimistic outlooks for our farm economy and the continued strength of the U.S. dollar, I am interested to see if the Fed has revisited and reexamined this issue at all?

In the time since our earlier exchange on this topic, the financial situation has not changed greatly. The Federal Open Market Committee (FOMC) increased the target range for the federal funds rate by 25 basis points in late 2015--right around the time of our earlier exchange; by another 25 basis points in late 2016; and by a third increment of 25 basis points at its meeting in March of this year. The current target range--which extends from ¾ percent to 1 percent--is still low by historical standards. As of early 2016, when I last wrote to you, I noted that the FOMC was anticipating "modest increases in interest rates," and that has certainly been the outcome in terms of the policy rates that we set.

In agriculture, bank lending rates have also increased by about 70 basis points on average since late 2015. Although farmers' interest expenses are anticipated to be about 12 percent higher in 2017 than in 2015, interest expenses on farm debt still account for less than 6 percent of total farm sector expenses.

With regard to the effects of the dollar, the foreign exchange value of the dollar has increased only modestly since late 2015, and the value of U.S. agricultural exports have actually increased by about 5 percent over the past year compared with the prior 12 months. However, U.S. agricultural commodity prices have generally remained suppressed since 2015, reflecting several consecutive years of strong production. Some farmers have faced greater financial pressure in this environment, but on average farm loan delinquencies remain at historically low levels.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 20, 2017

The Honorable Tom Emmer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 3 that you submitted following the February 15, 2017[1], hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 15, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Emmer:

3. Can you give the Committee some insights on the current positioning of the Fed's balance sheet and thinking on retention at current levels and the potential for reducing holdings?

As noted in recent Federal Open Market Committee (FOMC) statements, the Committee has indicated that it expects to continue its current policy of reinvestments until the process of normalizing the level of the federal funds rate is well underway. However, the Committee has not established a formal linkage between a particular level of the federal funds rate and a change in its reinvestment policy.

The FOMC conducts monetary policy to promote its longer-term objectives of maximum employment and stable prices. Consistent with this overarching principle, the FOMC will reach a judgment about reinvestments and the balance sheet based on its assessment of the economic outlook and the prospects for continued progress toward its longer run objectives. This process will include an evaluation of the anticipated trajectory for the economy as well as the risks to the economic outlook.

As noted in the minutes of the March 2017 FOMC meeting, provided that the economy continued to perform about as expected, most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year.

As noted in the FOMC's statement of Policy Normalization Principles and Plans, the Committee intends that the Federal Reserve will, in the longer run, hold no more securities than necessary to implement monetary policy efficiently and effectively. Moreover, in the longer run, the FOMC intends to hold primarily Treasury securities. As always, the Committee is prepared to adjust the details of its approach to policy normalization in light of economic and financial developments.

Hearing on "Monetary Policy and the State of the Economy"
Date: 2/15/2017
Member: Rep. Tom Emmer (MN-06)
Witness: The Honorable Janet Yellen, Chair of the Board of Governors of the Federal Reserve System

1. In addition to monetary policy, the Federal Reserve also plays an important role regulating and supervising the financial industry. As part of those activities, the Federal Reserve has "gold plated" international capital regulations, specifically the Supplementary Leverage Ratio or SLR.

   In February 2016 when you testified before this committee you were asked about the SLR, its effect specifically on custody banks, and the harm a higher SLR for custody banks might create for pension funds, mutual funds, and the financial system as a whole. At that point you said that the SLR was a "crude" tool and you were looking into the concerns raised about the rule's application to custody banks.

   I appreciated your answer last year as well as Federal Reserve Governor Dan Tarullo's statement in December on making changes to capital standards that would reflect custody bank's needs to provide services to their clients. In December, Governor Tarullo specifically said that, "as part of our efforts to tailor our regulations according to the business models of firms, we are considering ways to address the special issues posed for the large custody banks by certain elements of our regulatory framework."

   In light of that statement, can you provide some more details on what steps the Federal Reserve is taking to tailor regulations to the custody bank business model, and when we will see those reforms rolled out?

2. In one of your previous appearances before this committee, I asked you about the impact that raising the Fed Funds rate could have on farmers and agriculture affiliated businesses. You mentioned that the Fed has studied this impact, however, given the very pessimistic outlooks for our farm economy and the continued strength of the U.S. dollar, I am interested to see if the Fed has revisited and reexamined this issue at all?

3. Can you give the Committee some insights on the current positioning of the Fed's balance sheet and thinking on retention at current levels and the potential for reducing holdings?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 25, 2017

The Honorable Patrick Toomey
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the February 14, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on February 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Toomey:

1. You indicated that you disagreed with a recent study that attempted to derive the relative risk weightings and capital charges for assets under CCAR, when compared to the risk weightings imposed under capital methodologies. Please indicate whether the Board has conducted its own independent analysis of the relative risk weights implicit in the CCAR exercise and the potential impact thereof on bank lending activity. If so, please provide the analysis. If not, please undertake such analysis and provide it as promptly as possible.

Although I agree with the spirit of the particular study you mention, which is to improve understanding of the benefits and costs of the Federal Reserve Board's (Board) regulations, including the stress testing rules, I disagree with the study's conclusions and methodology.[1] The study attempts to derive an "average implicit risk weight" from the losses projected in the Board's supervisory stress tests. This approach fundamentally mischaracterizes the nature and purpose of stress tests. Stress tests differ from capital regulations, where assets are allocated to relatively simple categories and then assigned risk weights that are roughly proportional to the average risk of these asset categories in order to establish a minimum capital standard at any given point in time. Instead, stress tests serve a complementary purpose, which is to determine the amount of a bank's losses and revenues through severe recession, like the one we experienced in 2007-2009. Unlike the capital rules, which have as a chief aim making sure that banks have sufficient capital in normal times, the stress tests address whether a bank can remain a going concern and continue to make loans through a severe recession.

Some examples highlight this point:

In a stress test, a bank's revenues and losses have to be projected – income is an important source of loss-absorbing capacity. However, many of the banks that are the focus of our supervisory stress tests earn significant income from activities that are not connected to particular assets on their balance sheet, such as asset management fees. An approach like the one taken in the study that attempts to convert the dynamic firm-wide path of revenues and expenses produced by the stress test into a single factor attached only to the firm's assets at a single point in time, likely will misattribute the benefits from such income, producing potentially inaccurate results.

An additional important feature of stress tests is their ability to use extremely granular, loan-level data. This results in projections of losses that are quite sensitive to the risks of the underlying assets and thus will necessarily differ across banks depending on portfolio characteristics. In contrast, the study attempts to infer a single average "implicit risk weight" across banks for each asset category. Further, the study does not control for any difference in the riskiness of those portfolios across banks. Thus, the study treats a bank with a portfolio of auto loans weighted towards subprime borrowers as having the same risk profile as a bank with a portfolio of auto loans weighted towards prime borrowers. This has the potential to result in misleading results

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[1] https://www.theclearinghouse.org/~/media/TCH/Documents/TCH WEEKLY/2017/20170130_WP_Implicit_Risk_Weights_in_CCAR.pdf.

because loan loss rates in the stress tests for a particular asset class, such as auto loans, may differ substantially across banks, depending on how the risk profile of the banks differ for that asset class.

Table 1 summarizes the projected loan loss rates across banks for eight of the asset categories considered in the supervisory stress test and Comprehensive Capital Analysis and Review (CCAR). The results show how the assumption of a single average implicit risk weight can be quite misleading. This is because the loss rates differ across banks due to differences in the relative riskiness of their portfolios for a given asset class.[2] Thus, the appropriate way to calculate an "implicit risk weight" in CCAR would be to consider the riskiness of a specific loan or subportfolio of loans at a specific bank. As with point-in-time risk weights, an average risk weight across all loans of a certain broad type – such as "auto loans" – that is bluntly applied to all banks will miss important differences in how the individual loan portfolios would perform in an actual economic downturn. For these reasons, the results from the study should not be interpreted as capturing "implicit risk weights" from the CCAR, as the study suggested.[3]

We also note the Federal Reserve closely monitors bank lending and credit availability as part of its bank supervision and research functions, including the distribution of credit across segments of the U.S. economy. For instance, the availability of credit to new and small businesses is an area of the economy that we pay particular attention to. The Federal Reserve's most direct measures of the amount of credit provided to small businesses by banks are commercial and industrial (C&I) and commercial real estate (CRE) loans with balances under $1 million. If regulation is impeding the flow of credit to small businesses, we would expect slower growth in small business lending by banks that face greater regulation, for example, banks with assets over $50 billion. Since 2011, however, small C&I loans held at banks with assets over $50 billion have grown more quickly than at the smaller banks. Small CRE loans have declined somewhat in recent years at both large and small banks. Although we continue to study these trends, these results are not consistent with the view that either supervisory stress tests or the Board's more stringent capital rules for large institutions are meaningful constraints on the provision of credit to small businesses. In addition, Federal Reserve staff continue to investigate the expanding role of nonbank providers of small business credit, who we estimate account for more than half of all credit provided to small businesses, based on available data. These firms, which include credit unions, finance companies, farm credit bureaus, and online platforms, could help to offset any reduction in credit availability from banks.

More generally, however, quantifying the specific effects of capital regulation, and CCAR in particular, on credit provision is made more difficult by a number of confounding factors, which could also result in less credit provision by large banks. For instance, one of the goals of incentivizing large banks to fund assets with additional capital is to reduce the value of any remaining too-big-to-fail subsidy. With the reduction in that subsidy, the funding costs of large

[2] These projected loss rates are determined by the relative amount of each risk portfolio within an asset class at a given bank. A bank that does not have any portfolios in a particular asset class will have a projected loan loss rate of zero for that class.

[3] In addition to the conceptual arguments above, certain results from the study suggest that something other than implicit risk weights are being captured. An example is that the "implicit risk weight" for junior liens and HELOCs is estimated to be negative or zero, which is inconsistent with the actual CCAR loss rates (which are not zero) shown in Table 1.

banks should rise relative to community banks, thus making the community banks more competitive in attracting new business. It will take some time to gain a more concrete understanding of the effects of new financial regulations, including capital regulation, on bank lending and the availability of credit, but the Federal Reserve is engaged and will continue to push ahead on this research agenda. [4]

Finally, undercapitalized banks are unlikely to be able to provide credit on a sustainable basis. Loans that are withdrawn at the first signs of a downturn exacerbate recessions with a "credit crunch." Indeed, research by Federal Reserve economists has shown that banks with higher capital buffers (i.e., banks with capital ratios well above regulatory minimums) lend more freely during downturns, reducing both the severity of the downturn and the likelihood of a crisis.[5] The supervisory stress tests and CCAR help to ensure that banks will be able to maintain such buffers above the regulatory minimums even during a downturn. Related research by Federal Reserve economists focuses on different channels through which bank capital levels affect the likelihood and severity of a financial crisis.[6]

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[4] At present, most research on the new regulations focuses on specific pockets of the economy or financial system. For example, Calem, Correa, and Lee (2016) find that the market share of jumbo mortgage originations at banks participating in the 2011 CCAR exercise declined after that exercise (Paul Calem, Ricardo Correa, and Seung Jung Lee (2016), "Prudential Policies and Their Impact on Credit in the United States," International Finance Discussion Papers 1186 (Washington: Board of Governors of the Federal Reserve System, November), https://doi.org/10.17016/IFDP.2016.1186). Morris-Levenson, Sarama, and Ungerer (2017) find that while recent bank regulation has contributed to a reduction in mortgage lending by large banks, counties most dependent on lending from the most heavily regulated banks have not experienced significantly slower mortgage origination or house price growth than less dependent counties (Joshua A. Morris-Levenson, Robert F. Sarama, and Christoph Underer (2017), "Does Tighter Bank Regulation Affect Mortgage Originations?" paper, January, available at Social Science Research Network, http://dx.doi.org/10.2139/ssrn.2941177). This suggests that the reduction in lending by the largest banks has been largely filled by expanded origination activity from small banks and nonbanks.

[5] See, for example, Mark Carlson, Hui Shan, and Missaka Warusawitharana (2013), "Capital Ratios and Bank Lending: A Matched Bank Approach," *Journal of Financial Intermediation,* vol. 22 (October), pp. 663–87; Seung Jung Lee and Viktors Stebunovs (2016), "Bank Capital Pressures, Loan Substitutability, and Nonfinancial Employment," *Journal of Economics and Business,* vol. 83 (January–February), pp. 44–69; and Ozge Akinci and Albert Queralto (2014), "Banks, Capital Flows and Financial Crises," International Finance Discussion Papers 1121 (Washington: Board of Governors of the Federal Reserve System, October), https://www.federalreserve.gov/econresdata/ifdp/2014/files/ifdp1121.pdf.

[6] See Luca Guerrieri, Matteo Iacoviello, Francisco B. Covas, John C. Driscoll, Michael T. Kiley, Mohammad Jahan-Parvar, Albert Queralto Olive, and Jae W. Sim (2015), "Macroeconomic Effects of Banking Sector Losses across Structural Models," Finance and Economics Discussion Series 2015-044 (Washington: Board of Governors of the Federal Reserve System, June), http://dx.doi.org/10.17016/FEDS.2015.044; and Gazi I. Kara and S. Mehmet Ozsoy (2016), "Bank Regulation under Fire Sale Externalities," Finance and Economics Discussion Series 2016-026 (Washington: Board of Governors of the Federal Reserve System, April), http://dx.doi.org/10.17016/FEDS.2016.026.

Table 1: CCAR Loan loss rates for the severely adverse scenario (as a % of loan balances)

		Loan Losses	First lien mortgages	Junior liens and HELOCs	Commercial and Industrial	Commercial Real Estate	Credit Cards	Other Consumer Loans	Other Loans
2014	Minimum	1.6	0.0	0.0	2.8	0.0	0.0	0.0	1.0
2014	25th Percentile	4.9	2.3	5.4	4.0	7.1	2.0	3.2	2.1
2014	Median	5.7	4.1	7.9	4.9	9.2	15.2	5.1	2.7
2014	75th Percentile	7.2	5.8	10.8	7.0	10.3	16.4	9.5	4.2
2014	Maximum	15.2	16.7	18.3	13.2	35.4	20.5	17.9	7.8
2015	Minimum	2.3	0.0	0.0	3.0	0.0	0.0	0.6	0.0
2015	25th Percentile	4.6	2.7	4.5	4.0	7.4	0.0	3.2	2.0
2015	Median	5.0	3.1	6.8	4.8	8.3	12.7	5.8	2.7
2015	75th Percentile	6.5	4.4	9.3	7.2	10.7	14.7	9.5	3.8
2015	Maximum	12.2	12.5	22.3	14.0	31.6	18.5	17.2	12.7
2016	Minimum	1.9	0.0	0.0	2.6	0.0	0.0	0.6	1.2
2016	25th Percentile	4.8	2.7	4.3	4.7	5.6	0.0	3.8	2.7
2016	Median	5.6	3.4	6.3	5.5	6.8	12.8	6.1	3.7
2016	75th Percentile	6.5	3.9	8.4	8.5	8.6	15.0	8.5	4.4
2016	Maximum	12.4	50.1	16.3	15.5	22.9	19.3	16.5	9.4

Note: Tabulations from *Dodd-Frank Act Stress Test 2014 (2015, 2016): Supervisory Stress Test Methodology and Results* (see https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20140320a1.pdf, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20150305a1.pdf, and https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160623a1.pdf, respectively).

2. Last year, the Federal Reserve agreed to implement a series of changes to its CCAR processes recommended in both an internal IG report and a GAO study. Please provide a detailed update identifying what progress the Federal Reserve has made in addressing each of these individual recommendations and, with respect to any item not yet fully addressed, please describe the Federal Reserve's remediation plan to ensure its implementation and identify the resources dedicated to that remediation.

The Federal Reserve is making progress on addressing the recommendations made in U.S. Government Accountability Office Report GAO-17-18, Additional Actions Could Help Ensure the Achievement of Stress Test Goals (GAO report). In a January 13, 2017, letter to Members of the House of Representative's Committee on Oversight and Government Reform and the Senate's Committee on Homeland Security and Governmental Affairs, I provided an update on the Federal Reserve's plans to address these recommendations. Additional information on these plans is provided below:

Inter-agency Coordination

The GAO report recommended that the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) (collectively, the agencies) harmonize their approach to granting extensions and exemptions from stress test requirements.

Consistent with the plans outlined in the January 13 letter, Federal Reserve staff, in consultation with staff of the OCC and FDIC, have established a process to meet at least annually, and more frequently as needed, to coordinate regarding requests for extensions and exemptions from stress test rules. Federal Reserve staff met with staff of the OCC and FDIC on January 26, 2017, to review all the stress testing-related exemptions and extensions that the agencies granted to firms in 2016. The staff of the agencies have agreed to continue this practice. Federal Reserve staff will continue to work with the FDIC and OCC on a harmonized approach to granting extensions and exemptions from stress testing requirements.

Exclusion of Company-Run Tests from CCAR

The GAO report recommended that the Federal Reserve remove company-run stress tests from the CCAR quantitative assessment.

As indicated in the January 13 letter, Federal Reserve staff continue to evaluate the benefits and costs of modifying its rules to remove company-run stress test results from the factors that are considered in the CCAR quantitative assessment. Before modifying its rules, the Board would provide notice and invite public comments regarding any proposed changes.

Transparency of the Qualitative Assessment

The GAO's report recommended that the Federal Reserve publicly disclose additional information about the CCAR qualitative assessments; the basis for the Federal Reserve's decisions to object or conditionally not object to a company's capital plan on qualitative grounds; and information on capital planning practices observed during CCAR qualitative assessments, including practices the Federal Reserve considers stronger or leading practices. The GAO report also recommends that the Federal Reserve notify companies about time frames relating to Federal Reserve responses to company inquiries.

We continue to look for ways to further enhance the transparency of CCAR and respond to the GAO findings. For example, the Federal Reserve expects to publish a summary of the current range of capital planning practices after the completion of CCAR 2017.

In addition, consistent with the plans outlined in the January 13 letter, effective with the first quarter of 2017, all firms that are subject to the Board's capital plan rule, including FR-Y14 regulatory report filers, receive a confirmation email that acknowledges receipt of their question and provides an expected timeline for a response. Additionally, firms now receive a direct response to questions related to CCAR in accordance with the communicated timeline. Questions that the Federal Reserve receives regarding CCAR which pertain to all firms subject to the Board's capital plan rule are included in a general communication sent to all firms at least quarterly, or more frequently, as needed.

Scenario Design Process

The GAO's report recommends the Federal Reserve take several actions to broaden the consideration of the types of scenarios to use in the stress tests and to better understand the implications of scenario choices.

The Federal Reserve has procedures for generating and considering scenarios with severity that falls outside of post-war U.S. history, and that is reflected in the published scenarios. Federal Reserve staff continue to explore mechanisms in which the severely adverse scenario in the stress tests would include deteriorations in scenario variables that lie beyond those historically observed. Staff also are developing additional analytical tools, including exploring a stress testing model based on more aggregated, bank-level data, to assess the capital levels that will likely be implied by scenarios of differing severities. Finally, staff are developing a process to analyze the severely adverse scenario for potential procyclicality.

Model Risk Management and Communication

The GAO's report recommends the Federal Reserve take several actions to improve its ability to manage model risk and ensure decisions based on supervisory stress test results are informed by an understanding of model risk, such as by applying model development principles to the entire system of models that are used to estimate losses and revenue in the stress tests.

Consistent with the plans outlined in the January 13 letter, Federal Reserve staff have amended the principles used to develop models to explicitly state that the principles apply to the overarching system of models, in addition to each of its component models. In addition, Federal Reserve staff are developing separate documentation that describes the system of models. Several projects are currently underway to further test and document the sensitivity and uncertainty of the system of models, including reviewing the relevant finance and statistics literature and exploring various methods to test the sensitivity and measure uncertainty. Finally, the Supervisory Stress Test Model Governance Committee has issued a memo to the Board describing the state of model risk and plans to issue this memo annually at the conclusion of each year's supervisory stress test. This memo describes the general outcomes of the model development and validation processes for the models used in the supervisory stress test exercise, and provides a more detailed discussion of the potential impact of modeling issues on the uncertainty of post-stress capital ratio estimates.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
February 14, 2017

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Toomey:</u>

1. You indicated that you disagreed with a recent study that attempted to derive the relative risk weightings and capital charges for assets under CCAR, when compared to the risk weightings imposed under capital methodologies. Please indicate whether the Board has conducted its own independent analysis of the relative risk weights implicit in the CCAR exercise and the potential impact thereof on bank lending activity. If so, please provide the analysis. If not, please undertake such analysis and provide it as promptly as possible.

2. Last year, the Federal Reserve agreed to implement a series of changes to its CCAR processes recommended in both an internal IG report and a GAO study. Please provide a detailed update identifying what progress the Federal Reserve has made in addressing each of these individual recommendations and, with respect to any item not yet fully addressed, please describe the Federal Reserve's remediation plan to ensure its implementation and identify the resources dedicated to that remediation.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

August 1, 2017

The Honorable Tim Scott
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 29, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Scott:</u>

1. Each of you serve at ageneies that are members of the Financial Stability Oversight Council (FSOC). Insurance has been regulated at the state level for over 150 years – it's a system that works. But FSOC designations of nonbank systemically important financial institutions (SIFIs) have made all of you insurance regulators, despite the fact that you are bank regulators at your core.

Strong market incentives exist for insurers to hold sufficient capital to make distress unlikely and to achieve high ratings from financial rating agencies, including incentives provided by risk sensitive demand of contract holders and the potential loss of firms' intangible assets that financial distress would entail. Additionally, insurance companies are required by law to hold high levels of capital in order to meet their obligations to policyholders. Bottom linc: Insurance companies aren't banks, and shouldn't be treated as such.

In March, my colleagues and I on the Senate Banking Committee sent a letter to Treasury Secretary Mnuchin indicating our concerns regarding the FSOC's designation process for nonbanks. I support efforts to eliminate the designation process completely.

I was pleased that President Trump issued a "Presidential Memorandum for the Secretary of the Treasury on the Financial Stability Oversight Council" (FSOC Memorandum) on April 21, 2017, which directs the Treasury Department to conduct a thorough review of the designation process and states there will be no new nonbank SIFI designations by the FSOC until the report is issued. Relevant decision makers should have the benefit of the findings and recommendations of the Treasury report as they carry out their responsibilities with respect to FSOC matters.

Please answer the following with specificity:

1. What insurance expertise do you and your respective regulator possess when it comes to your role overseeing the business of insurance at FSOC?

The Federal Reserve System contains a significant amount of insurance expertise and resources with prior experience in the insurance industry. Staff who participate in the development of policy concerning and supervision of insurance companies subject to Federal Reserve Board (Board) supervision include former state insurance regulators, practitioners from insurance advisory services, catastrophe modeling specialists, and analysts from credit rating agencies that cover insurance companies, as well as life and property/casualty actuaries and accountants versed in U.S. Statutory Accounting Principles.

In its consolidated supervision of insurance firms, the Board remains committed to tailoring its supervisory approach to the business of insurance. The Board's supervisory program, complementary to and in coordination with the states in their protection of policyholders, continues to be tailored to consider the unique characteristics of the firms and their insurance operations.

Board principals at the Financial Stability Oversight Council (FSOC) are briefed by these experts, or senior staff that oversee them, in advance of FSOC discussions on insurance matters.

2. Do you support the Senate Banking Committee's recent legislative effort, the Financial Stability Oversight Council Insurance Member Continuity Act, to ensure that there is insurance expertise on the Council in the event that the term of the current FSOC independent insurance member expires without a replacement having been confirmed?

The independent member with insurance expertise has provided important contributions to the work of the Council. However, membership in the Council is a matter for Congress to decide.

QUESTIONS FOR THE RECORD

Hearing: "Fostering Economic Growth: Regulator Perspective"

U.S. Senator Tim Scott (R-SC)

Date of Hearing: Thursday, June 22, 2017

Questions for:

- The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System
- The Honorable Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
- The Honorable J. Mark McWatters, Acting Chairman, National Credit Union Administration
- Mr. Keith A. Noreika, Acting Comptroller, Office of the Comptroller of the Currency

Each of you serve at agencies that are members of the Financial Stability Oversight Council (FSOC). Insurance has been regulated at the state level for over 150 years – it's a system that works. But FSOC designations of nonbank systemically important financial institutions (SIFIs) have made all of you insurance regulators, despite the fact that you are bank regulators at your core.

Strong market incentives exist for insurers to hold sufficient capital to make distress unlikely and to achieve high ratings from financial rating agencies, including incentives provided by risk sensitive demand of contract holders and the potential loss of firms' intangible assets that financial distress would entail. Additionally, insurance companies are required by law to hold high levels of capital in order to meet their obligations to policyholders. Bottom line: Insurance companies aren't banks, and shouldn't be treated as such.

In March, my colleagues and I on the Senate Banking Committee sent a letter to Treasury Secretary Mnuchin indicating our concerns regarding the FSOC's designation process for nonbanks. I support efforts to eliminate the designation process completely.

I was pleased that President Trump issued a "Presidential Memorandum for the Secretary of the Treasury on the Financial Stability Oversight Council" (FSOC

Memorandum) on April 21, 2017, which directs the Treasury Department to conduct a thorough review of the designation process and states there will be no new nonbank SIFI designations by the FSOC until the report is issued. Relevant decision makers should have the benefit of the findings and recommendations of the Treasury report as they carry out their responsibilities with respect to FSOC matters.

Please answer the following with specificity:

1. What insurance expertise do you and your respective regulator possess when it comes to your role overseeing the business of insurance at FSOC?
2. Do you support the Senate Banking Committee's recent legislative effort, the Financial Stability Oversight Council Insurance Member Continuity Act, to ensure that there is insurance expertise on the Council in the event that the term of the current FSOC independent insurance member expires without a replacement having been confirmed?

Questions for:

- The Honorable J. Mark McWatters, Acting Chairman, National Credit Union Administration

I served on the board of Heritage Trust Federal Credit Union, a great institution based in Charleston. During my time at Heritage Trust, we wanted to make loan decisions based on more than what people looked like on paper. We were able to do so because we had such close relationships with our members. Our loan delinquency rate was only 2%, I might add.

I've been on the other side of the equation: I received my first car loan from a credit union. It wasn't a handout – it was a hand up. The credit union sat me down and we talked about the importance of staying on top of my finances, the obligations associated with taking a loan, and how I could pay it back.

As community banks and credit unions close up shop, we lose that personal touch.

Regulatory burdens are driving the consolidation. I think too many regulators are acting without an eye to the consequences of their actions on economic growth.

But the NCUA's approach has been refreshing.

After my friend, and now Director of the Office of Management and Budget, Mick Mulvaney introduced legislation mandating more budget transparency at the NCUA, you made it happen.

You reduced the number of exams for well-capitalized credit unions, meaning they can hire more loan officers than compliance lawyers.

You've also engaged in rulemaking on field-of-membership issues in economically distressed areas, which I think is encouraging.

Please answer the following with specificity:

1. What kind of economic cost-benefit analysis does the NCUA engage in?
2. What credit-union specific proposals in the Treasury Department's recent report on regulatory relief should Congress pursue to help grow the economy?
3. What specific revisions to the NCUA-issued risk-based capital rule that is slated to go into effect January 1, 2019, are you considering or pursuing?
4. Do you believe that the CFPB should consult with the NCUA when it is writing rules that impact credit unions? Do you think this coordination has been sufficient up until this point?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

September 8, 2017

The Honorable Ben Sasse
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Sasse:</u>

1. Has the CFPB effectively coordinated with the Federal Reserve on rulemaking and enforcement actions? If not, how could coordination be improved?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), section 1022, requires the Consumer Financial Protection Bureau (CFPB) to consult with the Federal Reserve Board (Board) and other prudential regulators before issuing a proposed rule and during the public comment process before issuing a final rule. The consultation is intended to provide the CFPB with views on the consistency of the CFPB's proposal with prudential, market, or systemic objectives administered by the other agencies. After consulting with the other agencies and considering the public comments on a proposed rule, the CFPB is solely responsible for decisions regarding the issuance of a final rule.

The CFPB has effectively coordinated on rulemakings with Board staff who have participated in the CFPB's consultation process. Board staff have been able to identify issues, raise questions, contribute subject matter expertise about consumer financial services, and provide technical assistance.

With respect to supervision and enforcement, it is critical that all federal banking regulators work together as cooperatively and efficiently as possible. Board supervision staff are in regular contact with their CFPB counterparts to coordinate supervision.

In May 2012, the Board, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, and the Office of the Comptroller of the Currency (OCC) entered into a Memorandum of Understanding (MOU) with the CFPB on Supervisory Coordination to fulfill the agencies' responsibilities with provisions of the Dodd-Frank Act. The MOU has been fully implemented and generally, the agencies have agreed that the MOU satisfactorily addresses coordination efforts, with adjustments and clarification adopted as necessary. For example, the Board and the CFPB have enhanced coordination related to enforcement actions by including discussion of potential actions during the two agencies' routine monthly meetings.

The Office of Inspector General (OIG) issued a memorandum in June 2015 of its limited scope evaluation of the extent to which the CFPB and prudential regulators are coordinating their supervisory activities and avoiding duplication of regulatory oversight responsibilities. Overall, the OIG found that the CFPB and prudential regulators were generally coordinating their regulatory oversight activities consistent with the Dodd-Frank Act and did not issue any formal recommendations, but did suggest opportunities for enhanced coordination.

2. Constituents in my state tell me that the EGRPRA report inadequately highlighted concrete ways to reduce the regulatory paperwork burden.

a. What more can the Federal Reserve do to reduce the regulatory paperwork burden on community banks?
b. Do any of these changes require statutory authorization?

The Board, FDIC, and OCC (agencies), through the Federal Financial Institutions Examination Council, reduced burden for small banks by creating a new, streamlined Call Report available for first quarter 2017 reporting. This is part of a multi-phase effort to reduce paperwork burden on community banks. The new small bank Call Report reduced the burden associated with the prior report filed by small banks by removing, raising the reporting threshold for, or reducing the reporting frequency of nearly half of the data items collected. Nearly two-thirds (approximately 3,500 of 5,100 institutions eligible to file the small bank Call Report) did so in March. The next phase is a proposal to reduce the reporting burden of the new, streamlined Call Report associated with approximately 7 percent of the data items. This proposal was published in the Federal Register on June 27, 2017, and a corresponding press release was issued on June 20, 2017. The third and final phase of the current Call Report burden reduction effort is a proposal that will be issued later this year. These remaining efforts are expected to be effective for first quarter 2018 reporting.

The agencies are also working on a joint proposal to simplify certain requirements of the capital framework, which were noted in the Economic Growth and Regulatory Paperwork Reduction Act report. These simplifications could result in targeted burden reductions related to the Call Report's regulatory capital schedule or instructions.

In addition to the aforementioned burden-reducing changes, the agencies continue to consider ways to reduce reporting and other burdens for small banks. None of the planned or considered changes would require statutory authorization.

3. Our financial system has become increasingly consolidated, as community banks and credit unions either close their doors or merge with larger institutions.

a. Are you concerned about this pattern? Why?
b. What services can these smaller institutions provide that larger institutions cannot provide?

The Board recognizes the vital role community banks play in local economies and closely monitors consolidation trends at community banks. The banking industry has been consolidating at a relatively steady pace for more than 30 years.[1] Despite this, community banks (defined as banks with assets totaling less than $10 billion) have continued to play a vital role in local economies and serve as a key source of financing to small businesses and small farms. While community banks accounted for 20 percent of all insured depository institution assets at year-end 2016, they accounted for nearly 50 percent of all dollars lent to small businesses by insured depositories, and 88 percent of all dollars lent to small farms. The Board believes it is important to maintain a diversified and competitive banking industry that comprises banking organizations of many sizes and specializations, including a healthy community banking segment.

Research conducted over many years has concluded that community banks provide distinct advantages to their customers compared to larger banks. Because of their smaller size and less complex organizational structure, community banks are often able to respond with greater agility

[1] https://www.federalreserve.gov/pubs/feds/2008/200860/200860pap.pdf.

to lending requests than their large national competitors. In addition, community banks often have close ties to the communities they serve and detailed knowledge of their customers, which enables them to meet the needs of their local communities and small business and small farm customers in a more customized and flexible way than larger banks. Community banks are particularly important for rural communities, where the closing of a bank can be associated with a material decline in local economic activity.

4. Multiple anecdotes from constituents make it clear that there are several Nebraska counties where consumers cannot get a mortgage, due to CFPB regulations such as TRID and the QM rule. What is the best way to address this problem from a regulatory standpoint?

Many of the new standards for mortgage lending were enacted in the Dodd-Frank Act in response to certain underwriting practices that contributed to the 2008 financial crisis. We understand there are concerns that the mortgage rules that implement the legislation are complex and have required additional investment and resources by the banks to ensure compliance. At the same time, we understand it is important that the mortgage regulations allow lenders to properly serve their communities, which is why tailoring of regulations to reduce unnecessary burden should be considered in the context of safeguarding the safety and soundness of our financial system and promoting protections and fairness for all consumers.

Congress granted rule-writing authority to the CFPB for consumer mortgage lending, including the Truth in Lending Act - Real Estate Settlement Procedures Act Integrated Disclosure rule and the Qualified Mortgage rule. However, the Board has taken steps to clarify and promote consistent supervisory expectations and approaches, including issuing supervisory guidance as appropriate. Further, the banking agencies and the CFPB discuss compliance issues on a regular basis. We take these opportunities to communicate information about the types of compliance burdens and issues our examiners are seeing in the smaller institutions we supervise.

5. My understanding is that very few banks have opened since the passage of Dodd-Frank.

a. Why do you believe this is the case?
b. What potential impacts does this have on our financial system?
c. Is there anything more the Federal Reserve can do to encourage the opening of new banks?
d. Is there anything more Congress should do to encourage the opening of new banks?

Historically, new bank formations have been cyclical and have fallen after the financial crises in the 1980s and 1990s, before recovering as economic conditions improved.[2] More recent research has found evidence of this pattern following the most recent financial crisis, and has shown that about three quarters of the time, most of the decline in new charters since the crisis can be explained by non-regulatory factors such as a weak economy, low interest rates, and weak

[2] https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum16/SI_Summer16.pdf.

demand for banking services.[3] The Board recognizes that new regulations may play a role in the lack of new entrants although additional research is necessary.[4]

Potential impacts to our financial system could include lack of innovation, reduced competition, lack of local lending and banking services, and reduced availability of credit. In addition, the lack of new entrants today could affect the competitive landscape in the future as it could be expected that at least some of these banks would grow much larger.

The Board does not have chartering authority for insured depository institutions, which is the responsibility of the states and the OCC, nor does the Board grant deposit insurance. The Board does review proposals by state chartered banks, or state chartered banks in formation, for Federal Reserve System (Federal Reserve) membership. In that regard, Board staff is always available to meet with potential organizers to discuss the Federal Reserve membership process.

The FDIC, which is responsible for granting deposit insurance, has hosted public outreach symposiums regarding de novo bank formations in several cities across the United States. The symposiums targeted a variety of participants including investors, community bank organizers, lawyers, and consultants. The symposium panel included representatives from each relevant agency, including the Board. The Board representatives discussed Federal Reserve membership and bank holding company formations in particular.

The FDIC outreach, improving economic conditions for banks, and the slowdown in the issuance of new rules, will likely provide a better environment for new banks in coming years.

6. I'm concerned that our federal banking regulatory regime relies upon too many arbitrary asset thresholds to impose prudential regulations, instead of relying on an analysis of a financial institution's unique risk profile.

a. Should a bank's asset size be dispositive in evaluating its risk profile in order to impose appropriate prudential regulations?
b. If not, what replacement test should regulators follow instead of, or in addition to, an asset-based test?

In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. The Federal Reserve has been working for many years to make sure that our regulation and supervision is tailored to the size and risk posed by individual institutions.

The failure or distress of a large bank can harm the U.S. economy. The recent financial crisis demonstrated that excessive risk-taking at large banks makes the U.S. economy vulnerable. The crisis led to a deep recession and the loss of nearly nine million jobs. Our regulatory framework must reduce the risk that bank failures or distress will have such a harmful impact on economic growth in the future.

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[3] https://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf.
[4] https://www.federalreserve.gov/newsevents/speech/powell20160929a.pdf.

The Board has already implemented, via a regulation that was proposed and adopted following a period of public notice and comment, a methodology to identify global systemically important banking organizations (GSIBs), whose failure could pose a significant risk to the financial stability of the United States.[5] The "systemic footprint" measure, that determines whether a large firm is identified as a GSIB, includes attributes that serve as proxies for the firm's systemic importance across a number of categories: size, interconnectedness, complexity, cross-jurisdictional activity, substitutability, and reliance on short-term wholesale funding.

There are many large financial firms whose failure would pose a less significant risk to U.S. financial stability, but whose distress could nonetheless cause notable harm to the U.S. economy (large regional banks). Some level of tailored enhanced regulation is appropriate for these large regional banks. The failure or distress of a large regional bank could harm the U.S. economy in several ways: by disrupting the flow of credit to households and businesses, by disrupting the functioning of financial markets, or by interrupting the provision of critical financial services, including payments, clearing, and settlement. Economic research has documented that a disruption in the flow of credit through banks or a disruption to financial market functioning can affect economic growth.[6]

The application of tailored enhanced regulation should consider the size, complexity, and business models of large regional banks. The impact on economic growth of a large regional bank's failure will depend on factors such as the size of the bank's customer base and how many borrowers depend on the bank for credit. Asset size is a simple way to proxy for these impacts, although other measures may also be appropriate. For large regional banks with more complex business models, more sophisticated supervisory and regulatory tools may be appropriate. For example, the Board recently tailored our Comprehensive Capital Analysis and Review qualitative assessment to exclude some smaller and less complex large regional banks, using asset size and nonbank assets to measure size and complexity, respectively.[7] In other contexts, foreign activity or short-term wholesale funding may be another dimension of complexity to consider. Any characteristics or measures that are used to tailor enhanced regulation for large regional banks should be supported with clear analysis that links them with the potential for the bank's failure or distress to cause notable harm to the U.S. economy.

The Board currently has only limited authority to tailor the enhanced prudential standards included in section 165 of the Dodd-Frank Act. In particular, Congress required that certain enhanced prudential standards must apply to firms with $10 billion in total assets, with other standards beginning to apply at $50 billion in total assets.

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[5] Board of Governors of the Federal Reserve System (2015), "Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies," final rule, Federal Register, vol 80 (August 14), pp. 49082-49116.

[6] For evidence on the link between bank distress and economic growth, see Mark A. Carlson, Thomas King, and Kurt Lewis (2011) "Distress in the Financial Sector and Economic Activity," The B.E. Journal of Economic Analysis & Policy: Vol. 11: Iss. 1 (Contributions), Article 35. For evidence on the link between financial market functioning and economic growth, see Simon Gilchrist and Egon Zakrajšek (2012), "Credit Spreads and Business Cycle Fluctuations," American Economic Review, Vol. 102 (4): 1692-1720.

[7] Board of Governors of the Federal Reserve System (2017), "Amendments to the Capital Plan and Stress Test Rules; Regulations Y and YY," final rule, Federal Register, vol 82 (February 3), pp. 9308-9330.

I understand that Congress is currently considering whether and how to raise these statutory thresholds, and the Board has supported increasing these thresholds..

As an alternative to simply raising the thresholds, your question asks whether arbitrary thresholds could be effectively and appropriately used for enhanced regulation using other factors, in addition to asset size. Congress could usefully decide to pursue either raising dollar thresholds or giving authority to the Federal Reserve to decide which firms are subject to enhanced prudential standards. As my answer noted above, I believe that it would be logical to use a wider range of factors than asset size to determine the application of tailored enhanced regulation for large regional banks. The Board stands ready to work with Members on the design of either approach.

7. As you know, the CFPB may be moving forward on a rulemaking for Section 1071 of Dodd-Frank, which granted the CFPB the authority to collect small business loan data. I've heard some concerns that implementing Section 1071 could impose substantial costs on small financial institutions and even constrict small business lending.

a. Are you concerned how a Section 1071 rulemaking could hurt small business access to credit?

Section 1071 of the Dodd-Frank Act amended the Equal Credit Opportunity Act to require that lenders collect information on credit applications and outcomes for small businesses, and women-owned and minority-owned businesses. The purpose is to facilitate enforcement of the fair lending laws, and allow communities, governmental entities, and creditors to identify business and community development needs and opportunities.

The CFPB has primary rule-writing authority and must issue rules to implement section 1071 for most creditors. The Board is responsible for issuing rules that would apply to certain motor vehicle dealers that originate installment contracts to finance vehicle purchases by small businesses, and routinely sell or assign the contracts to a third party.

Because the CFPB is still considering how to implement the law and has not yet issued a proposed rule, the type of creditors, transactions, or data that will be covered has not been established. We expect the rulemaking process to include consideration of the relative costs and benefits of the proposed rule to assess its impact. In addition, as described in more detail in the answer to the following sub-question, the CFPB (both on its own and in coordination with the Board) is conducting outreach to consider the impact and appropriate scope of the proposed rule.

b. Has the Federal Reserve coordinated with the CFPB to ensure that implementing these requirements does not constrict small business access to credit?

CFPB and Board staff have recently started to coordinate outreach efforts and gather information to assist in developing their regulatory proposals. In May 2017, the CFPB held a public field hearing in Los Angeles on small business lending and published a "Request for Information" outlining the major issues on which the CFPB is seeking data and information from stakeholders that may be affected by the rules. This information is expected to assist the CFPB and the Board as they consider the scope of their proposed rules. The CFPB is also required to conduct a small business review panel pursuant to the Small Business Regulatory Enforcement Fairness Act. The panel would meet with representatives of small businesses that can provide feedback on the impact of the proposed regulations and on regulatory options and alternatives that might minimize the impact.

The Board believes that the two agencies should jointly develop rules that use consistent definitions and standards to ensure data are collected and reported uniformly, whether the loans are made by depository institutions, motor vehicle dealers, or another type of creditor. The Board will also participate in the CFPB consultation process, along with the other prudential regulators that is mandated for all CFPB rulemakings under section 1022 of the Dodd-Frank Act. The CFPB has yet to commence its rulemaking consultation process.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator Ben Sasse:

1. Has the CFPB effectively coordinated with the Federal Reserve on rulemaking and enforcement actions? If not, how could coordination be improved?
2. Constituents in my state tell me that the EGRPRA report inadequately highlighted concrete ways to reduce the regulatory paperwork burden.
    a. What more can the Federal Reserve do to reduce the regulatory paperwork burden on community banks?
    b. Do any of these changes require statutory authorization?
3. Our financial system has become increasingly consolidated, as community banks and credit unions either close their doors or merge with larger institutions.
    a. Are you concerned about this pattern? Why?
    b. What services can these smaller institutions provide that larger institutions cannot provide?
4. Multiple anecdotes from constituents make it clear that there are several Nebraska counties where consumers cannot get a mortgage, due to CFPB regulations such as TRID and the QM rule. What is the best way to address this problem from a regulatory standpoint?
5. My understanding is that very few banks have opened since the passage of Dodd-Frank.
    a. Why do you believe this is the case?
    b. What potential impacts does this have on our financial system?
    c. Is there anything more the Federal Reserve can do to encourage the opening of new banks?
    d. Is there anything more Congress should do to encourage the opening of new banks?
6. I'm concerned that our federal banking regulatory regime relies upon too many arbitrary asset thresholds to impose prudential regulations, instead of relying on an analysis of a financial institution's unique risk profile.
    a. Should a bank's asset size be dispositive in evaluating its risk profile in order to impose appropriate prudential regulations?
    b. If not, what replacement test should regulators follow instead of, or in addition to, an asset-based test?
7. As you know, the CFPB may be moving forward on a rulemaking for Section 1071 of Dodd-Frank, which granted the CFPB the authority to collect small business loan data. I've heard some concerns that implementing Section 1071 could impose substantial costs on small financial institutions and even constrict small business lending.
    a. Are you concerned how a Section 1071 rulemaking could hurt small business access to credit?
    b. Has the Federal Reserve coordinated with the CFPB to ensure that implementing these requirements does not constrict small business access to credit?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

August 11, 2017

The Honorable Elizabeth Warren
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Warren:</u>

1. At the hearing, you stated that you did not support changing "risk-based capital" standards for the country's biggest financial institutions. Do you support changing any capital, leverage, or liquidity standards for banks with more than $500 billion in assets? If so, please describe which standards you support modifying and why.

The safety and soundness of large banks is crucial to the stability of the U.S. financial system. To clarify, I do not support reducing risk-based capital requirements for firms with total consolidated assets of more than $500 billion. The Federal Reserve Board (Board) does review and update its regulations on an ongoing basis to ensure that they are achieving their intended objectives, to address developments in the banking industry, and to limit regulatory burden. In addition, the Board is considering revising certain requirements for firms subject to its Comprehensive Capital Analysis and Review, which would include firms with more than $500 billion in total assets. Specifically, the Board is contemplating ways to better integrate the Board's regulatory capital rule and the capital requirements related to the annual supervisory stress test in a manner that simplifies the Board's overall approach to capital regulation. With respect to other requirements applicable to these firms, the Board also intends to review the current calibration of its enhanced supplementary leverage ratio standards in order to mitigate possible adverse incentives or market distortions that it may create.

2. The common argument in favor of reducing capital standards for large financial institutions is that it will increase lending and economic growth. I am aware of research showing that well-capitalized institutions actually provide more loans than less-well-capitalized competitors. Can you provide any empirical research that demonstrates that the opposite is true?

As stated in my testimony, stronger capital requirements increase bank costs, and at least some of those costs are passed along to customers. But in the longer term, stronger prudential requirements for large banking firms will produce more sustainable credit availability and economic growth. Our objective should be to set capital and other prudential requirements for large banking firms at a level that protects financial stability and maximizes long-term, through-the-cycle credit availability and economic growth.

Existing economic research provides mixed results regarding the link between bank capital requirements and economic growth. There are studies on both sides of the issue, some suggesting that higher capital levels increase economic growth and others suggesting the opposite. Recent studies focusing on the costs and benefits of bank capital suggest that heightened capital requirements are good for economic growth up to some point, but would have a negative impact on social welfare beyond that point.

While there are several studies which suggest that raising capital standards reduces bank lending, these studies typically do not address the broader impact of capital standards on economic growth. For example, Furfine[1] analyzes data on large U.S. commercial banks between 1989 and 1997 and concludes that a one percentage point increase in capital standards reduces loan growth by 5.5 percent. Berrospide and Edge[2] find a more modest impact. Using U.S. bank holding company data from 1992 to 2009, the authors conclude that a one percentage point increase in capital requirements reduces loan growth by roughly 1.2 percentage points. Other studies tell a similar story using non-U.S. data. For instance, Francis and Osborne[3] find, using U.K. data, that a one percentage point increase in capital requirements reduces bank lending by approximately 1.2 percent. Finally, Martynova's[4] survey of the literature--mostly of studies using non-U.S. data--shows that an increase in capital requirements by one percentage point reduces loan growth by 1.2 to 4.6 percentage points.

There is a growing body of research regarding the costs and benefits of bank capital that addresses the impact of capital standards on economic growth. A number of studies, including the Basel Committee on Banking Supervision,[5] the Bank of England,[6] the Federal Reserve Bank of Minneapolis,[7] and Firestone et al.[8] suggest that higher bank capital requirements (up to a point) are good for long-term credit availability and economic growth, and only at levels of capital beyond that point is social welfare decreased. While the optimal level of capital varies between studies, the basic framework is the same.

A variety of assumptions are required of all studies in the literature, and changes to the assumptions could result in either higher or lower levels of optimal bank capital. The current calibration of our risk-based capital requirements for U.S. banks is roughly in line with the optimal level of capital found under a wide range of these studies.

3. You have said that you support providing banks with more "transparency" into the stress test process. The goal of the stress test is gauge how banks would fare in times of severe economic distress. Historically, the source of that economic distress is unforeseen, as we witnessed during the 2008 crisis. Indeed, the very reason there is economic distress is that banks and regulators have failed to anticipate the source or severity of that distress. In light of that, please explain how it is consistent with the goal of the stress tests to provide banks with more advance knowledge of what kinds of stresses they can expect to face?

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1 Furfine, Craig (2000). "Evidence on the Response of US Banks to Changes in Capital Requirements." BIS Working Papers No 88.

2 Berrospide, Jose M. and Rochelle M. Edge (2010). "The Effects of Bank Capital on Lending: What Do We Know, and What Does It Mean?" Federal Reserve Board Finance and Economics Discussion Series 2010-44.

3 Francis, William B. and Matthew Osborne (2012). "Capital Requirements and Bank Behavior in the UK: Are There Lessons for International Capital Standards?" Journal of Banking and Finance, 36, 803-816.

4 Martynova, Natalya (2015). "Effect of Bank Capital Requirements on Economic Growth: A Survey." DNB Working Paper No. 467.

5 Basel Committee on Banking Supervision (2010). "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements."

6 Brooke, Martin et al. (2015). "Measuring the Macroeconomic Costs and Benefits of Higher U.K. Bank Capital Requirements." Bank of England Financial Stability Paper No. 35.

7 Federal Reserve Bank of Minneapolis (2016). "The Minneapolis Plan to End Too Big To Fail."

8 Firestone, Simon, Amy Lorenc, and Ben Ranish (2017). "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S." Federal Reserve Board Finance and Economics Discussion Series 2017-034.

Capital stress tests, which play a critical role in bolstering confidence in the capital position of the U.S. firms in the wake of the financial crisis, have become one of the most important features of our supervisory program in the post-crisis era. Stress tests better ensure that large firms have sufficient capital to continue lending through periods of economic stress and market turbulences, and that they are sufficiently capitalized for their risk profile.

The Board's annual Comprehensive Capital Analysis and Review, or CCAR, is the binding capital constraint for many of the largest firms, and their concerns about transparency are warranted. The Board has made a wide variety of information available about our stress testing process, and is committed to finding ways to safely enhance the transparency of that process. However, because of the concerns you raise in your question and other issues discussed below, we have not disclosed the full details of our stress testing models, nor have we provided firms with our stress scenarios in advance of the stress testing cycle.

One implication of releasing all details of the models is that firms could use them to guide modifications to their businesses that change the results of the stress test without changing the risks faced by the firms; that is, full disclosure could encourage firms to "manage to the test." In the presence of such behavior, the stress test could give a misleading picture of the actual vulnerabilities faced by firms. Further, such behavior could increase correlations in asset holdings among the largest banks, making the financial system more vulnerable to adverse financial shocks. Another implication is that full model disclosure could incent banks to simply use models similar to the Board's, rather than build their own capacity to identify, measure, and manage risk. That convergence to the Board's model would create a "model monoculture," in which all firms have similar internal stress testing models which may miss key idiosyncratic risks faced by the firms.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator Elizabeth Warren:

1. At the hearing, you stated that you did not support changing "risk-based capital" standards for the country's biggest financial institutions. Do you support changing *any* capital, leverage, or liquidity standards for banks with more than $500 billion in assets? If so, please describe which standards you support modifying and why.

2. The common argument in favor of reducing capital standards for large financial institutions is that it will increase lending and economic growth. I am aware of research showing that well-capitalized institutions actually provide more loans than less-well-capitalized competitors. Can you provide any empirical research that demonstrates that the opposite is true?

3. You have said that you support providing banks with more "transparency" into the stress test process. The goal of the stress test is gauge how banks would fare in times of severe economic distress. Historically, the source of that economic distress is unforeseen, as we witnessed during the 2008 crisis. Indeed, the very reason there is economic distress is that banks and regulators have failed to anticipate the source or severity of that distress. In light of that, please explain how it is consistent with the goal of the stress tests to provide banks with more advance knowledge of what kinds of stresses they can expect to face?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

September 8, 2017

The Honorable Heidi Heitkamp
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Heitkamp:</u>

1. As watchdogs of the financial system, we know that the Fed, OCC, and FDIC focus on promoting safety and soundness, and support transparency. To that end, firms are required to disclose extensive information on their financial health to the public.

Like all things, balance is important and in drafting rules and regulations, the agencies consider what is useful information versus what can be misleading and inadvertently hurt the markets. We've seen the Federal Reserve be thoughtful about that -- for example, the Fed does not disclose to the public who accesses its discount window for at least 2 years, balancing transparency with risk of public misconception. The Fed has recognized in that case that immediate information could actually lead to a market stress.

In December, the Federal Reserve finalized a rule requiring banks to publicly disclose – within 45 days of the end of quarter - the details of a complex liquidity metric called the Liquidity Coverage Ratio.

a. Why does the Fed allow a 2 year disclosure period for the discount window and only 45 days for this complex metric when the risks of public misconception are the same?

b. How is the Fed promoting safety and soundness by asking banks to disclose complicated liquidity information that could lead to a financial stress?

c. Since the Fed is already monitoring firms' liquidity data every day, why do we need this additional disclosure requirement?

d. Would the Fed find it beneficial to conduct further study on the rule before requiring disclosures?

The different timelines required for discount window and Liquidity Coverage Ratio (LCR) disclosures reflect the different purposes of the disclosures.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) specified the content of the discount window disclosures as well as the two year disclosure period. The primary purpose of the discount window disclosure is to provide transparency and accountability to the public regarding the Federal Reserve Board's (Board) lending activities. Eligible borrowers may choose to borrow from the discount window both under normal conditions and when they are experiencing a liquidity stress. The discount window disclosures require all borrowing institutions to disclose transaction-specific information about a bank's business decision to borrow at the window, including the amounts borrowed and the collateral provided to secure each loan. A key reason for the two-year lag in disclosing this information is to preserve the willingness of solvent institutions to use the discount window, ensuring the effectiveness of the discount window as a backstop liquidity facility and systemic liquidity shock absorber for solvent institutions. In passing the Dodd-Frank Act, the Congress weighed the need for greater transparency about the Board's lending operations and the need to maintain the discount window as an effective liquidity backstop, and concluded that a two-year lag in disclosing transaction-level information on discount window borrowing appropriately balanced these two policy objectives.

In contrast, the primary purpose of the LCR public disclosure requirements is to promote safety and soundness by providing market participants high-level information about the liquidity risk profile of large banking organizations to support the ability of market participants to understand and constrain bank risk-taking. This sort of market discipline can usefully complement the Board's supervisory practices and policies. During times of stress, public disclosures can also enhance stability by providing relevant and sufficiently timely information that assures counterparties and other market participants regarding the resilience of covered companies. Without information about the liquidity strength of their counterparties, market participants may assume the worst regarding banking institutions and draw back from the entire market, exacerbating the problem.

The LCR public disclosures must be sufficiently informative and timely to serve their intended purpose. In order to mitigate potential financial stability and firm-specific risks related to disclosing real-time liquidity information, the LCR public disclosure rule requires covered companies to disclose average values of broad categories of liquidity sources and uses over a quarter, with a 45 day lag after the end of the quarter. Unlike event-driven discount window disclosures, the LCR public disclosure rule requires a set of firms to make regular periodic disclosures and does not require disclosure of transaction-specific information. They are more analogous to the Board's quarterly capital public disclosure requirements, which also focus on a firms' financial condition and risk management practices.

Given the fundamentally different purposes of the discount window and LCR disclosures, the Board did not provide for a common timeframe for the disclosures. While I do not believe it is necessary to conduct further study on the LCR public disclosure rule at this time, the Board will carefully monitor the implementation of these requirements going forward. If warranted, I would be willing to revisit aspects of the LCR disclosures that result in significant undesirable or unintended consequences.

2. As part of the EGRPRA process, regulators identified access to timely appraisals – especially in rural America – as a major challenge for small lenders. Yet the report itself did little to address residential appraisal requirements.

a. Do you share my concerns that the appraisal system in rural America is broken?

The Federal Reserve Board (Board) is sensitive to this issue and hopes to be able to explore additional actions in the near term. During the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) process, the Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (agencies) heard directly from lenders across the country, many of them community bankers and many located in rural areas. Appraiser availability, appraisal cost, and delays related to appraisals were high on the list of concerns for lenders. While the agencies have not found evidence of widespread appraiser shortages in rural areas, regional shortages do occur.

The agencies have recently taken several actions to address burden associated with appraisal requirements, consistent with the commitments made in the EGRPRA report. The agencies recently published a proposal to increase the appraisal threshold in their respective appraisal regulations for commercial real estate loans from $250,000 to $400,000.[1] Institutions in rural areas, many of which are small institutions that make smaller sized loans, would benefit from the change in the threshold for commercial real estate. The agencies and the National Credit Union Administration (NCUA) also recently issued an advisory on appraiser availability that describes options that may address appraiser shortages in rural areas: temporary practice permits and temporary waivers of certification and licensing requirements.[2]

The appraisal system in rural America is shaped not only by the requirements of the agencies, but also by requirements of state regulators, other federal agencies -- such as the Federal Housing Administration, Department of Veterans Affairs, and Rural Housing Service and government-sponsored entities (e.g., Fannie Mae and Freddie Mac) -- as well as the standards for appraisals set by the Appraisal Foundation. The impact of these requirements should also be considered in the assessment of solutions that could aid rural communities in addressing the challenges related to appraisals. We stand ready to work with the agencies on these related issues as well.

b. In the EGRPRA report, you provide a "temporary waiver" option however most lenders view this as cumbersome and unworkable. How can you streamline this process and what steps have you taken to make this option accessible to lenders?

As described above, the agencies and NCUA published an advisory that describes the temporary waiver option and notifies regulated financial institutions that they may submit requests for a temporary waiver. The Appraisal Subcommittee (ASC) of the Federal Financial Institutions Examination Council (FFIEC) has prescribed regulations that describe the process for requesting a temporary waiver, including the specific actions that the ASC and the FFIEC must take in order to grant a temporary waiver. The advisory notes that the agencies and NCUA, as FFIEC members, will work with the ASC to streamline the process for evaluating temporary waiver requests.

c. What concerns would you have with raising the residential exemption threshold – which was last modified in 1994 – above its current limit of $250K?

In the proposal to raise the threshold for commercial real estate transactions noted previously, the agencies have asked for comment on whether there are other factors that the agencies should consider regarding the appropriate threshold for residential loans. The agencies also stated that they will consider other ways to relieve burden related to appraisals for residential mortgage

[1] Available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170719a.htm. Board staff understands that the NCUA is evaluating options to develop a separate proposal to provide comparable relief for federally insured credit unions.

[2] Interagency Advisory on the Availability of Appraisers. See OCC Bulletin 2017-19 (May 31, 2017); Board SR Letter 17-4 (May 31, 2017); FDIC FIL-19-2017 (May 31, 2017); NCUA, "Financial Institution Regulatory Agencies Issue Advisory on Appraiser Availability" (May 31, 2017), available at https://www.ncua.gov/newsroom/Pages/news-2017-may-financial-institution-regulatory-agencies-issue-advisory-appraiser-availability.aspx.

loans, such as coordinating appraisal practices across federal government agencies and with the government-sponsored enterprises.

3. On several occasions before this Committee Governor Tarullo stated that the dollar asset thresholds in Dodd Frank such as the $50 billion threshold for SIFI designation, is far too high.

a. Do you believe regulators could effectively address systemic risk if the threshold were raised above $50 billion?

b. Are there specific provisions in Dodd Frank which you believe are particularly costly or unnecessary for a certain subset of banks above the $50 billion threshold?

c. Are there specific provisions in Dodd Frank which you believe are necessary for all banks above $50 billion in assets that should be retained in order to mitigate systemic risk?

d. What concerns do you have with having a purely qualitative test for identifying systemic risk?

In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. The Board has been working for many years to make sure that our regulation and supervision is tailored to the size and risk posed by individual institutions.

The failure or distress of a large bank can harm the U.S. economy. The recent financial crisis demonstrated that excessive risk-taking at large banks makes the U.S. economy vulnerable. The crisis led to a deep recession and the loss of nearly nine million jobs. Our regulatory framework must reduce the risk that bank failures or distress will have such a harmful impact on economic growth in the future.

The Board has already implemented, via a regulation that was proposed and adopted following a period of public notice and comment, a methodology to identify global systemically important banking organizations (GSIBs), whose failure could pose a significant risk to the financial stability of the United States.[3] The "systemic footprint" measure that determines whether a large firm is identified as a GSIB includes attributes that serve as proxies for the firm's systemic importance across a number of categories: size, interconnectedness, complexity, cross-jurisdictional activity, substitutability, and reliance on short-term wholesale funding.

There are many large financial firms whose failure would pose a less significant risk to U.S. financial stability, but whose distress could nonetheless cause notable harm to the U.S. economy (large regional banks). Some level of tailored enhanced regulation is appropriate for these large regional banks. The failure or distress of a large regional bank could harm the U.S. economy in several ways: by disrupting the flow of credit to households and businesses, by disrupting the

[3] Board of Governors of the Federal Reserve System (2015), "Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies," final rule, Federal Register, vol 80 (August 14), pp. 49082-49116.

functioning of financial markets, or by interrupting the provision of critical financial services, including payments, clearing, and settlement. Economic research has documented that a disruption in the flow of credit through banks or a disruption to financial market functioning can affect economic growth.[4]

The application of tailored enhanced regulation should consider the size, complexity, and business models of large regional banks. The impact on economic growth of a large regional bank's failure will depend on factors such as the size of the bank's customer base and how many borrowers depend on the bank for credit. Asset size is a simple way to proxy for these impacts, although other measures may also be appropriate. For large regional banks with more complex business models, more sophisticated supervisory and regulatory tools may be appropriate. For example, the Board recently tailored our Comprehensive Capital Analysis and Review qualitative assessment to exclude some smaller and less complex large regional banks, using asset size and nonbank assets to measure size and complexity, respectively.[5] In other contexts, foreign activity or short-term wholesale funding may be another dimension of complexity to consider. Any characteristics or measures that are used to tailor enhanced regulation for large regional banks should be supported with clear analysis that links them with the potential for the bank's failure or distress to cause notable harm to the U.S. economy.

The Board currently has only limited authority to tailor the enhanced prudential standards included in section 165 of the Dodd-Frank Act. In particular, Congress required that certain enhanced prudential standards must apply to firms with $10 billion in total assets, with other standards beginning to apply at $50 billion in total assets.

You asked whether regulators could effectively address systemic risk if these statutory thresholds were raised. The Board has supported increasing these thresholds. We believe that the risks to financial stability from large banks, as noted above, can be addressed with tailored enhanced regulation, including higher thresholds.

You also asked about the specific provisions in section 165 of the Dodd-Frank Act. The Board has not taken a position on the relative merits of these provisions. As noted above, some level of tailored enhanced regulation is appropriate for large banks, taking into account how a particular regulatory standard affects a bank's size, complexity, and business model. Among these many provisions, the Board believes that supervisory stress testing is one of the most valuable, providing a forward-looking assessment of the largest firms' ability to continue providing credit to the real economy in the event of a significant macroeconomic and financial stress.

You asked whether I have concerns about using a qualitative test in place of the existing quantitative thresholds. As my answer above noted, I believe that it would be logical to use a

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[4] For evidence on the link between bank distress and economic growth, see Mark A. Carlson, Thomas King, and Kurt Lewis (2011) "Distress in the Financial Sector and Economic Activity," The B.E. Journal of Economic Analysis & Policy: Vol. 11: Iss. 1 (Contributions), Article 35. For evidence on the link between financial market functioning and economic growth, see Simon Gilchrist and Egon Zakrajšek (2012), "Credit Spreads and Business Cycle Fluctuations," American Economic Review, Vol. 102 (4): 1692-1720.

[5] Board of Governors of the Federal Reserve System (2017), "Amendments to the Capital Plan and Stress Test Rules; Regulations Y and YY," final rule, Federal Register, vol 82 (February 3), pp. 9308-9330.

wider range of factors than asset size to determine the application of tailored enhanced regulation for large regional banks. Such factors should include quantitative metrics.

Congress could usefully decide to pursue either raising dollar thresholds or giving authority to the Board to decide which firms are subject to enhanced prudential standards. The Board stands ready to work with Members on the design of either approach.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator Heidi Heitkamp:

As watchdogs of the financial system, we know that the Fed, OCC, and FDIC focus on promoting safety and soundness, and support transparency. To that end, firms are required to disclose extensive information on their financial health to the public.

Like all things, balance is important and in drafting rules and regulations, the agencies consider what is useful information versus what can be misleading and inadvertently hurt the markets. We've seen the Federal Reserve be thoughtful about that -- for example, the Fed does not disclose to the public who accesses its discount window for at least 2 years, balancing transparency with risk of public misconception. The Fed has recognized in that case that immediate information could actually lead to a market stress.

In December, the Federal Reserve finalized a rule requiring banks to publicly disclose – within 45 days of the end of quarter - the details of a complex liquidity metric called the Liquidity Coverage Ratio.

- Why does the Fed allow a 2 year disclosure period for the discount window and only 45 days for this complex metric when the risks of public misconception are the same?
- How is the Fed promoting safety and soundness by asking banks to disclose complicated liquidity information that could lead to a financial stress?
- Since the Fed is already monitoring firms' liquidity data every day, why do we need this additional disclosure requirement?
- Would the Fed find it beneficial to conduct further study on the rule before requiring disclosures?

As part of the EGRPRA process, regulators identified access to timely appraisals – especially in rural America – as a major challenge for small lenders. Yet the report itself did little to address residential appraisal requirements.

- Do you share my concerns that the appraisal system in rural America is broken?
- In the EGRPRA report, you provide a "temporary waiver" option however most lenders view this as cumbersome and unworkable. How can you streamline this process and what steps have you taken to make this option accessible to lenders?
- What concerns would you have with raising the residential exemption threshold – which was last modified in 1994 – above its current limit of $250K?

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

On several occasions before this Committee Governor Tarullo stated that the dollar asset thresholds in Dodd Frank such as the $50 billion threshold for SIFI designation, is far too high.

- Do you believe regulators could effectively address systemic risk if the threshold were raised above $50 billion?

- Are there specific provisions in Dodd Frank which you believe are particularly costly or unnecessary for a certain subset of banks above the $50 billion threshold?

- Are there specific provisions in Dodd Frank which you believe are necessary for all banks above $50 billion in assets that should be retained in order to mitigate systemic risk?

- What concerns do you have with having a purely qualitative test for identifying systemic risk?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

August 11, 2017

The Honorable Jack Reed
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to question that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor Board of Governors of the Federal Reserve System from Senator Reed:</u>

1. Some have called for the FDIC to be removed from the living will process. Do you believe the FDIC should be removed from this process?

The Federal Reserve Board (Board) does not support removing the Federal Deposit Insurance Corporation (FDIC) from the living will process. The Board and FDIC have developed a strong and productive working relationship in their oversight of the living will process. Each agency has made important contributions and brought relevant experience to the process. The FDIC is the agency that acts as the receiver, or liquidating agent, for failed federally insured depository institutions and that perspective has been highly valuable to the process.

2. Many of us have come to recognize that the Orderly Liquidation Authority is an incredibly important part of the Wall Street Reform and Consumer Protection Act. Could you please explain in plain terms why OLA is so important?

A key lesson we learned from the financial crisis was that we needed a better way to deal with a large financial firm that fails. In the crisis, government authorities were faced with the choice between a government bailout of a failing large financial firm (for example, AIG), or a chaotic and disorderly collapse of the firm (for example, Lehman Brothers). The Orderly Liquidation Authority (OLA) in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act provides the government with a workable framework for the orderly resolution of a large financial firm that fails – thus reducing the need for government bailouts in any future financial crisis.

OLA has a number of key strengths as a resolution regime. First, it allows the FDIC, as resolution authority, to move quickly to reorganize the failed firm and prevent a disorderly unraveling of the financial contracts of the failed firm. Second, it enables the FDIC to coordinate effectively with the foreign regulators of the cross-border operations of the failed firm. Third, it allows the FDIC to provide temporary funding to stabilize the failed firm's operations if necessary. Critically, it does not allow for government capital injections and requires that taxpayers suffer no losses from the resolution.

The primary beneficiary of an OLA resolution would be the U.S. financial system and, by extension, taxpayers. In an OLA resolution, the shareholders of the failed firm would bear full losses. Long-term creditors of the failed firm would bear any additional losses. But there would be mechanisms to minimize excessive shocks to the financial system and the economy that could negatively impact Main Street. Market discipline would be maintained and taxpayers protected.

Bankruptcy should be the preferred route for a failing firm. We have made great strides through the living will process to make our largest banking firms easier to resolve under the traditional bankruptcy code. However, given the uncertainties around how financial crises unfold, it is prudent to keep OLA as a backstop resolution framework.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator Jack Reed:

Some have called for the FDIC to be removed from the living will process. Do you believe the FDIC should be removed from this process?

Many of us have come to recognize that the Orderly Liquidation Authority is an incredibly important part of the Wall Street Reform and Consumer Protection Act. Could you please explain in plain terms why OLA is so important?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

September 8, 2017

The Honorable John Kennedy
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 29, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Kennedy:</u>

1. In your written statement, you endorse the idea of raising both the $10 billion and $50 billion thresholds. In response to a question by Sen. Rounds, however, you answered that,

"In general... what Dodd Frank did was put these numerical cliffs in, and they're non-discretionary, they're arbitrary in a way, and that was a choice that Congress made for that. A different choice would have been to let us think about the size and business model and I think we can work with either, in fact for the largest institutions there is more discretion, so I think Congress did both, I think that if you want to change the way the thresholds work and put us in a situation of being more discretionary in looking at size and business model then we could certainly work with that and it would help us."

Would you agree that instead of arbitrary thresholds, a risk-based formula such as the one already developed and in use by the Federal Reserve to determine G-SIB surcharges, could be effectively and appropriately used to determine which firms are systemically important and should be subject to increased regulation?

In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. The Federal Reserve has been working for many years to make sure that our regulation and supervision is tailored to the size and risk posed by individual institutions.

The failure or distress of a large bank can harm the U.S. economy. The recent financial crisis demonstrated that excessive risk-taking at large banks makes the U.S. economy vulnerable. The crisis led to a deep recession and the loss of nearly nine million jobs. Our regulatory framework must reduce the risk that bank failures or distress will have such a harmful impact on economic growth in the future.

The Board has already implemented, via a regulation that was proposed and adopted following a period of public notice and comment, a methodology to identify global systemically important banking organizations (GSIBs), whose failure could pose a significant risk to the financial stability of the United States.[1] The "systemic footprint" measure, that determines whether a large firm is identified as a GSIB, includes attributes that serve as proxies for the firm's systemic importance across a number of categories: size, interconnectedness, complexity, cross-jurisdictional activity, substitutability, and reliance on short-term wholesale funding.

There are many large financial firms whose failure would pose a less significant risk to U.S. financial stability, but whose distress could nonetheless cause notable harm to the U.S. economy (large regional banks). Some level of tailored enhanced regulation is appropriate for these large regional banks. The failure or distress of a large regional bank could harm the U.S. economy in several ways: by disrupting the flow of credit to households and businesses, by disrupting the

[1] Board of Governors of the Federal Reserve System (2015), "Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies," final rule, Federal Register, vol 80 (August 14), pp. 49082-49116.

functioning of financial markets, or by interrupting the provision of critical financial services, including payments, clearing, and settlement. Economic research has documented that a disruption in the flow of credit through banks or a disruption to financial market functioning can affect economic growth.[2]

The application of tailored enhanced regulation should consider the size, complexity, and business models of large regional banks. The impact on economic growth of a large regional bank's failure will depend on factors such as the size of the bank's customer base and how many borrowers depend on the bank for credit. Asset size is a simple way to proxy for these impacts, although other measures may also be appropriate. For large regional banks with more complex business models, more sophisticated supervisory and regulatory tools may be appropriate. For example, the Board recently tailored our Comprehensive Capital Analysis and Review qualitative assessment to exclude some smaller and less complex large regional banks, using asset size and nonbank assets to measure size and complexity, respectively.[3] In other contexts, foreign activity or short-term wholesale funding may be another dimension of complexity to consider. Any characteristics or measures that are used to tailor enhanced regulation for large regional banks should be supported with clear analysis that links them with the potential for the bank's failure or distress to cause notable harm to the U.S. economy.

The Board currently has only limited authority to tailor the enhanced prudential standards included in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In particular, Congress required that certain enhanced prudential standards must apply to firms with $10 billion in total assets, with other standards beginning to apply at $50 billion in total assets.

I understand that Congress is currently considering whether and how to raise these statutory thresholds. The Board has supported increasing these thresholds. As an alternative to simply raising the thresholds, your question asks whether a risk-based formula could be effectively and appropriately used for enhanced regulations. As my answer above noted, I believe that it would be logical to use a wider range of factors than asset size to determine the application of tailored enhanced regulation for large regional banks.

Congress could usefully decide to pursue either raising dollar thresholds or giving authority to the Federal Reserve to decide which firms are subject to enhanced prudential standards. The Board stands ready to work with Members on the design of either approach.

2. You both have spoken about the need to "right-size" or eliminate regulations that are duplicative, costly and that inhibit growth. Dodd-Frank added to an already complex set of overlapping capital regimes that could be considerably streamlined by your agency without the need for legislative action. Larger regional banks that do not pose the kinds of systemic risks as the larger global players remain subject to the Advanced Approaches

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[2] For evidence on the link between bank distress and economic growth, see Mark A. Carlson, Thomas King, and Kurt Lewis (2011) "Distress in the Financial Sector and Economic Activity," The B.E. Journal of Economic Analysis & Policy: Vol. 11: Iss. 1 (Contributions), Article 35. For evidence on the link between financial market functioning and economic growth, see Simon Gilchrist and Egon Zakrajšek (2012), "Credit Spreads and Business Cycle Fluctuations," American Economic Review, Vol. 102 (4): 1692-1720.

[3] Board of Governors of the Federal Reserve System (2017), "Amendments to the Capital Plan and Stress Test Rules; Regulations Y and YY," final rule, Federal Register, vol 82 (February 3), pp. 9308-9330.

regime under Basel. That regime compels regional banks to run complex internal capital models, deploying valuable resources and costing tens of millions of dollars in compliance costs, all for no risk management benefits. In fact, the Collins Amendment to the Dodd-Frank Act nullified the relevance of Advanced Approaches by requiring large regionals to adhere to the simpler Standardized Approach, which requires higher capital levels.

Would you support either raising the threshold for application of the Advanced Approaches regime from $250B to capture only truly global banks, or giving large regionals the opportunity to opt-out of this regime?

The Board is assessing the thresholds for applicability of its regulations, including the advanced approaches risk-based capital rule, and whether these thresholds are appropriate for the idiosyncratic and systemic risks these regulations are meant to address. The Board believes that capital and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle credit availability and economic growth. At the same time, the Board recognizes that requirements should be tailored to the size, risk, and complexity of the firms subject to those requirements and is considering ways to adjust its regulations that will simplify rules and reduce unnecessary regulatory burden without compromising safety and soundness.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

<u>Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator John Kennedy:</u>

1. In your written statement, you endorse the idea of raising both the \$10 billion and \$50 billion thresholds. In response to a question by Sen. Rounds, however, you answered that,

   "In general… what Dodd Frank did was put these numerical cliffs in, and they're non-discretionary, they're arbitrary in a way, and that was a choice that Congress made for that. A different choice would have been to let us think about the size and business model and I think we can work with either, in fact for the largest institutions there is more discretion, so I think Congress did both, I think that if you want to change the way the thresholds work and put us in a situation of being more discretionary in looking at size and business model then we could certainly work with that and it would help us."

   Would you agree that instead of arbitrary thresholds, a risk-based formula such as the one already developed and in use by the Federal Reserve to determine G-SIB surcharges, could be effectively and appropriately used to determine which firms are systemically important and should be subject to increased regulation?

2. You both have spoken about the need to "right-size" or eliminate regulations that are duplicative, costly and that inhibit growth. Dodd-Frank added to an already complex set of overlapping capital regimes that could be considerably streamlined by your agency without the need for legislative action. Larger regional banks that do not pose the kinds of systemic risks as the larger global players remain subject to the Advanced Approaches regime under Basel. That regime compels regional banks to run complex internal capital models, deploying valuable resources and costing tens of millions of dollars in compliance costs, all for no risk management benefits. In fact, the Collins Amendment to the Dodd-Frank Act nullified the relevance of Advanced Approaches by requiring large regionals to adhere to the simpler Standardized Approach, which requires higher capital levels.

   Would you support either raising the threshold for application of the Advanced Approaches regime from \$250B to capture only truly global banks, or giving large regionals the opportunity to opt-out of this regime?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

August 11, 2017

The Honorable Jon Tester
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to question that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Tester:</u>

1. Chair Gruenberg and Governor Powell, you've both talked about the Volcker Rule and the complexity that comes along with this rule. And in the past, Comptroller Curry had suggested that we could exempt community banks entirely. After having conversations with many of my community banks I agree with Mr. Curry and believe they should be entirely exempt from Volcker Rule compliance. Following these lines, I have introduced a bill with Senator Moran that would exempt community banks with less than $10 billion from compliance.

a) Is this a bill that both the FDIC and the Federal Reserve would support at this juncture?
b) Does eliminating the Volcker Rule for banks with less than $10 billion pose any real risk to our financial system?
c) Absent Congress passing legislation related to the Volcker Rule, does the FDIC or the Federal Reserve have any plans to make any changes on their own to the Volcker Rule?

The Volcker Rule is an area where relief for smaller institutions would be helpful. The risks identified by the Volcker Rule exist almost exclusively in larger financial institutions. Community banks rarely engage in any of the activities prohibited by the Volcker Rule.[1] Accordingly, the Federal Reserve Board (Board) supports exempting community banks with total consolidated assets of less than $10 billion from the statutory provisions. Moreover, in the event where the trading or investment funds activity of a community bank might raise concerns that could be addressed through our normal examination process.

As part of the rules implementing the Volcker Rule, the agencies charged with implementing that statutory provision endeavored to minimize compliance burdens for banking entities by reducing the compliance program and reporting requirements applicable to banking entities with $10 billion or less in total consolidated assets. This was based in part on information that indicated that banking entities of this size generally have little or no involvement in prohibited proprietary trading or investment activities in covered funds. Exempting banking entities of this size from the Volcker Rule would provide relief for thousands of community banks that incur ongoing compliance costs simply to confirm that their activities and investments are indeed exempt from the statute. At the same time, an exemption at this level of assets would not be likely to increase risks to U.S. financial stability. The vast majority of activity and investment that the Volcker Rule addresses takes place at the largest and most complex financial firms, whose failure could have a significant effect on the stability of the financial system. Moreover, even with an exemption, the federal banking agencies could continue to use existing prudential authority to address unsafe and unsound practices at a community bank that engaged in imprudent trading or investment activities.

The Board is working with the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Commodity Futures Trading Commission, and the Securities and Exchange

[1] See The Volcker Rule: Community Bank Applicability (Dec. 10, 2013), available at: http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a4.pdf.

Commission to identify areas of the implementing regulations that could be simplified. The core premise of the Volcker Rule is relatively straightforward: that financial institutions with access to the federal safety net – Federal Deposit Insurance Corporation insurance and the Board's discount window – should not engage in proprietary trading. The Volcker Rule's statutory provisions, however, are complex, which has led to a complex rule. There are some ways to streamline and simplify the Volcker Rule while adhering to the underlying goals. For example, the Volcker Rule could be focused on larger banks that engage in more material trading activities. Supervisors have taken some steps to mitigate compliance burdens for smaller firms, but a change to the law to exempt smaller firms would be a cleaner and more comprehensive way to reduce burdens for smaller firms. Even without a statutory change, there may be ways to streamline and simplify the interagency Volcker Rule regulation to reduce burdens without sacrificing key objectives, and the Board is exploring possibilities.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

<u>Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator Jon Tester:</u>

Chair Gruenberg and Governor Powell, you've both talked about the Volcker Rule and the complexity that comes along with this rule. And in the past, Comptroller Curry had suggested that we could exempt community banks entirely. After having conversations with many of my community banks I agree with Mr. Curry and believe they should be entirely exempt from Volcker Rule compliance. Following these lines, I have introduced a bill with Senator Moran that would exempt community banks with less than $10 billion from compliance.

- *Is this a bill that both the FDIC and the Federal Reserve would support at this juncture?*
- *Does eliminating the Volcker Rule for banks with less than $10 billion pose any real risk to our financial system?*
- *Absent Congress passing legislation related to the Volcker Rule, does the FDIC or the Federal Reserve have any plans to make any changes on their own to the Volcker Rule?*

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

August 11, 2017

The Honorable Mark R. Warner
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Warner:</u>

1. Gov. Powell, there seems to be developing consensus that there are improvements that can be made to the Volcker Rule's implementing rule such that the policy goals of prohibiting proprietary trading are preserved, while potential unintended consequences, such as illiquidity in the fixed income markets, are avoided or minimized. Can you please describe a) whether the Federal Reserve shares this view; and b) how the Federal Reserve may, along with the other four agencies responsible for implementing the Volcker Rule, be approaching this issue to protect taxpayers while minimizing adverse consequences for the markets?

The core premise of the Volcker Rule is relatively straightforward: that financial institutions with access to the federal safety net – Federal Deposit Insurance Corporation insurance and the Federal Reserve Board (Board) discount window -- should not engage in proprietary trading. The Volcker Rule's statutory provisions, however, are complex, which has led to a complex rule. While many changes to the Volcker Rule would require amendment to the statute, there may be ways to streamline and simplify the interagency Volcker Rule regulation to reduce burdens without sacrificing key objectives. The Board is exploring possibilities and is working with the other agencies.

2. Cybersecurity regulation is receiving increased emphasis by all financial institution regulators. How do your agencies coordinate with each other to harmonize the promulgation of new cybersecurity regulations? With the increased use of the NIST Cybersecurity Framework by both federal agencies and the private sector, how do your agencies intend to achieve greater alignment between the framework and your own regulatory initiatives?

The Federal Reserve is an active participant in the Financial and Banking Information Infrastructure Committee (FBIIC)[1], which coordinates efforts to improve the reliability and security of the financial sector infrastructure. Federal Reserve staff chair a harmonization sub-committee of the FBIIC focused on achieving greater harmonization of cyber requirements and examination approaches across FBIIC member entities. We intend to achieve greater alignment with National Institute of Standards and Technology (NIST) by using the subcommittee to map the cybersecurity requirements of the FBIIC member agencies to NIST and analyzing any gaps and differences. The Board also coordinates our examination of cybersecurity risks with the other federal banking agencies through the Federal Financial Institutions Examination Council (FFIEC).[2] The FFIEC agencies are actively sharing the lessons learned from our individual

[1] The FBIIC consists of representatives from the Department of the Treasury, American Council of State Savings Supervisors, Commodity Futures Trading Commission, Conference of State Bank Supervisors, Consumer Financial Protection Bureau, Farm Credit Administration, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Federal Reserve Bank of Chicago, Federal Reserve Bank of New York, Federal Reserve Board, National Association of Insurance Commissioners, National Association of State Credit Union Supervisors, National Credit Union Administration, North American Securities Administrators Association, Office of the Comptroller of the Currency, Securities and Exchange Commission, and Securities Investor Protection Corporation.

[2] The FFIEC is an interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the

examinations to promote greater consistency in supervisory practices and to reduce unnecessary regulatory burden on supervised institutions.

Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Consumer Financial Protection Bureau, and to make recommendations to promote uniformity in the supervision of financial institutions. In 2006, the State Liaison Committee (SLC) was added to the Council as a voting member. The SLC includes representatives from the Conference of State Bank Supervisors, the American Council of State Savings Supervisors, and the National Association of State Credit Union Supervisors.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator Mark R. Warner:

1. Gov. Powell, there seems to be developing consensus that there are improvements that can be made to the Volcker Rule's implementing rule such that the policy goals of prohibiting proprietary trading are preserved, while potential unintended consequences, such as illiquidity in the fixed income markets, are avoided or minimized. Can you please describe a) whether the Federal Reserve shares this view; and b) how the Federal Reserve may, along with the other four agencies responsible for implementing the Volcker Rule, be approaching this issue to protect taxpayers while minimizing adverse consequences for the markets?

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

August 11, 2017

The Honorable Sherrod Brown
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Ranking Member Brown</u>:

1. Governor Powell, in a speech in April, and echoed in your written testimony for this hearing, you have suggested changes that "allow boards of directors and management to spend a smaller portion of their time on technical compliance exercises and more time focusing on the activities that support sustainable economic growth." The issues at Wells Fargo seem to indicate that bank boards do need to play a more active oversight role, and compliance is especially important to ensure that activities aren't happening in the bank that can cause consumer, employee and reputational harm.

Do you think the lesson from the Wells Fargo episode is that the Board should have been less involved in Bank oversight?

The Federal Reserve Board (Board) strongly agrees with your assertion that boards need to play an active role in bank oversight. As supervisors, we need to refocus our expectations to redirect boards' time and attention towards fulfilling their core responsibilities, including oversight of bank compliance.

In my April speech, the reference to "technical compliance" exercises was a recognition that over the years, the Board has issued supervisory guidance that in the aggregate include hundreds of expectations for boards and senior management concerning a broad range of topics. Some of these expectations are outdated or redundant, some are overly prescriptive or improperly focused, and many fail to differentiate between the roles of boards and senior management.

Consequently, many boards feel compelled to devote a significant amount of time to satisfying these expectations rather than focusing on their core responsibilities, such as guiding the development of a firm's strategy and risk appetite, overseeing senior management and holding them accountable, supporting the stature and independence of the independent risk management and internal audit functions, and adopting effective governance practices.

To that end, the Board recently proposed new guidance for large financial institutions, such as Wells Fargo, identifying the key attributes of effective boards of directors, and more clearly distinguish between the roles and responsibilities of boards and senior management. In particular, the proposal emphasizes a board's responsibility to hold senior management accountable for, among other things, adhering to the firm's strategy and risk appetite and remediating material or persistent deficiencies in risk management and control practices. The Board also proposed to eliminate or revise supervisory expectations for boards included in certain existing Board Supervision and Regulation letters to ensure that guidance is aligned with the Board's current consolidated supervisory frameworks for both smaller and larger firms.

2. The Treasury Report released on June 12 recommended that the FDIC be removed from the process to approve banks' living wills. Governor Powell, do you believe that he FDIC should remain part of the process?

I do. The Board and Federal Deposit Insurance Corporation (FDIC) have developed a strong and productive working relationship in their oversight of the living will process. Each agency has made important contributions and brought relevant experience to the process. The FDIC is the agency that acts as the receiver, or liquidating agent, for failed federally insured depository institutions and that perspective has been highly valuable to the process.

3. A working paper by Federal Reserve Board economists concluded that "optimal [ticr 1] bank capital levels in the United States range from just over 13 percent to over 26 percent [relative to risk-weightcd assets]." Current capital ratios for the largest U.S. GSIBs are between 8 and 11.5 percent. In your oral testimony, you said,
Higher capital requirements increase bank costs, and at least some of those costs will be passed along to bank customers and shareholders. But in the longer term, stronger prudential requirements for large banking firms will produce more sustainable credit availability and economic growth through the cycle. Our objective should be to sct capital and other prudential requirements for large banking firms at a level that protects financial stability and maximizes long-term, through-the-cycle credit availability, and economic growth. And to accomplish that goal, it is essential that we protect the core elements of these reforms for our most systemic firms in capital, liquidity, stress testing, and resolution.

To get optimal results, it seems that capital rcquiremeuts should be increased furtber. Do you agree?

No. I do not believe that current capital requirements are too low. I believe that the combination of bank capital standards and stress tests has raised overall levels of capital to appropriately high levels. Capital requirements are one of the strongest prudential tools available for maintaining a stable financial system, although there is a tradeoff between the increased resiliency arising from higher levels of bank capital and the associated increase in costs, some of which are passed along to bank customers and shareholders. The paper referenced in the question attempts to estimate the costs and benefits associated with various capital levels but many assumptions are required of the analysis. Changes to the assumptions could result in either higher or lower lcvels of optimal bank capital. The paper is a staff working paper that does not represent the views of other Federal Reserve staff or the Board.

Through various post-crisis reforms, including strengthened regulatory capital rules that improved the quality and quantity of regulatory capital as well as supervisory stress testing, regulatory capital at large banks is at its highest level in decades. Additionally, the largest and most complex U.S. and foreign banks are required to maintain sufficient amounts of long-term debt, which can be converted to equity during resolution, thereby further increasing their loss absorbing capacity. The 2017 supervisory stress test projections suggest that, in the aggregate, the U.S. banks subject to the stress test would experience substantial losses under a hypothetical stress scenario but could continue lending to businesses and households. This speaks to the resiliency of the current U.S. regulatory regime and financial system.

4. As a response to questions from several senators you said that you support changes to the Volcker rule. That said, the Treasury Report recommends changes to the Volcker Rule and changes to capital and liquidity requirements, stress tests, and other enhanced prudential standards. What would be the impact on financial stability if changes were made to weaken both rules to limit proprietary trading in bank holding companies and

enhanced prudential standards, including capital and liquidity rules, stress tests, and others, applicable to the largest bank holding companies?

Material weakening of the post-crisis regulatory framework would not support a strong and stable banking system or economy. However, there may be some targeted changes to streamline regulations and reduce burdens that can be made without compromising the underlying goals and benefits of the regulations. For example, the Board is pursuing further tailoring of regulations, including the Volker Rule and capital regulations, to reduce burdens for smaller firms while maintaining the benefits of the regulations for U.S. financial stability and safety and soundness. The Volcker Rule seeks to prevent financial institutions with access to the federal safety net – FDIC insurance and the Board discount window – from engaging iu proprietary trading and to limit their ability to invest in hedge funds and private equity funds. The goal of capital and liquidity regulation is to ensure the safety and soundness of the banking system and to protect financial stability for the whole economy. The crisis revealed that the pre-crisis capital and liquidity regulatory framework was insufficient. The regulatory changes to this framework that have been made post-crisis are critical to the safety and soundness of the financial system as well as broader financial stability.

5. This week, the House approved the FY 2018 Financial Services and General Government Appropriations bill. Included in this bill is the provision from the CHOICE Act to bring all independent financial regulatory agencies' budgets under the appropriations process. What would be the impact on the Federal Reserve System if its budget for non-monetary policy activities were appropriated?

The impact of this change could be quite serious. Congress wisely led the way in establishing political independence as a cornerstone of central bank independence.

The Board should be and is accountable to the American people and their elected representatives. The Board is a prudent steward of taxpayer resources, and is transparent about our operations.

The Board's monetary policy, supervisory, and financial stability functions have always been closely connected and have become even more tightly connected following the financial crisis. Robust supervisory and financial stability programs, with steady and reliable funding, are a crucial support for the Board's monetary policymaking. During the financial crisis, the deep knowledge and expertise of banking supervisors was critical to the Board's efforts to assess and address the challenges facing the financial system. Our examiners at the major banking firms, coupled with extensive data collection, provide critical insights relevant to the judgments of policy makers on many questions that are extremely important in the conduct of monetary policy, such as the assessment of overall conditions in credit markets, evidence of imbalances in particular sectors or markets, signs of emerging liquidity pressures or indications of a withdrawal from risk-taking. Accurate and early readings on such issues are very useful to the Board in determining the appropriate stance of monetary policy.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Ranking Member Sherrod Brown:

1. Governor Powell, in a speech in April, and echoed in your written testimony for this hearing, you have suggested changes that "allow boards of directors and management to spend a smaller portion of their time on technical compliance exercises and more time focusing on the activities that support sustainable economic growth." The issues at Wells Fargo seem to indicate that bank boards do need to play a more active oversight role, and compliance is especially important to ensure that activities aren't happening in the bank that can cause consumer, employee and reputational harm.

   Do you think the lesson from the Wells Fargo episode is that the Board should have been *less* involved in Bank oversight?

2. The Treasury Report released on June 12 recommended that the FDIC be removed from the process to approve banks' living wills. Governor Powell, do you believe that the FDIC should remain part of this process?

3. A working paper by Federal Reserve Board economists concluded that "optimal [tier 1] bank capital levels in the United States range from just over 13 percent to over 26 percent [relative to risk-weighted assets]." Current capital ratios for the largest U.S. GSIBs are between 8 and 11.5 percent. In your oral testimony, you said,

   > Higher capital requirements increase bank costs, and at least some of those costs will be passed along to bank customers and shareholders. But in the longer term, stronger prudential requirements for large banking firms will produce more sustainable credit availability and economic growth through the cycle. Our objective should be to set capital and other prudential requirements for large banking firms at a level that protects financial stability and maximizes long-term, through-the-cycle credit availability, and economic growth. And to accomplish that goal, it is essential that we protect the core elements of these reforms for our most systemic firms in capital, liquidity, stress testing, and resolution.

   To get optimal results, it seems that capital requirements should be increased further. Do you agree?

4. As a response to questions from several senators you said that you support changes to the Volcker rule. That said, the Treasury Report recommends changes to the Volcker Rule *and* changes to capital and liquidity requirements, stress tests, and other enhanced prudential standards. What would be the impact on financial stability if changes were made to weaken ***both*** rules to limit proprietary trading in bank holding companies and enhanced prudential standards, including capital and liquidity rules, stress tests, and others, applicable to the largest bank holding companies?

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

5. This week, the House approved the FY 2018 Financial Services and General Government Appropriations bill. Included in this bill is the provision from the CHOICE Act to bring all independent financial regulatory agencies' budgets under the appropriations process. What would be the impact on the Federal Reserve System if its budget for non-monetary policy activities were appropriated?

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, DC 20510-6075

June 30, 2017

The Honorable Jerome H. Powell
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Governor Powell:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs on June 22, 2017 at our hearing entitled, "*Fostering Economic Growth: Regulator Perspective*".

In order to complete the hearing record, we would appreciate your answers to the enclosed questions by Thursday, July 20, 2017. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo

Mike Crapo
Chairman

MC/dr

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

September 20, 2017

The Honorable Thom Tillis
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Tillis:

1. I'm a proponent of tailoring regulations based off of the risk profiles of financial institutions, as opposed to having strict asset thresholds that do not represent what I believe is the smart way to regulate. But, my question here is really about the importance of ensuring that we have a system that is rooted in fundamental, analytical, thoughtful regulation so that we can achieve and execute on goals, whether balancing safety and soundness with lending and growth, or encouraging more private capital in the mortgage market to protect taxpayers and reform the GSEs.

a) Do you think that we should use asset thresholds as a way to regulate – yes or no? If no, can you provide me with the metrics or factors by which a depository institution should be evaluated? If yes, please explain.

b) Section 165 of Dodd-Frank requires enhanced supervision and prudential standards for banks with assets over $50 billion. This applies to any bank that crosses the asset threshold, without regard to the risks those banks pose based upon the complexity of the business model. This includes heightened standards on liquidity and capital under the Liquidity Coverage Ratio (LCR) and the Comprehensive Capital Analysis and Review (CCAR) which have a various assumptions built in that may drive business model.

i) I understand under these two regulatory regimes, banks have changed certain lending behaviors because of the assumptions federal regulators have made regarding certain classes of assets and deposits. Can you provide some examples of how the LCR and CCAR have changed the types of loans, lending, and deposits your institution holds?

ii) Construction lending by banks over the $50 billion threshold has been a source of concern, namely because these enhanced prudential standards have treated construction loans punitively. This includes construction lending for builders of apartments, warehouses, strip malls, and other projects that may have varying risk profiles associated with them. However, under the CCAR and DFAST assumptions, the regulators have assigned all these categories of lending the same capital requirements. The result is an overly broad capital requirement for varying loans that have different risks, a capital requirement that may be greater for some loans and lower for others, influencing the decision of many banks over the $50 billion threshold to hold less of these assets due to the punitive capital requirements associated with them. Have you seen a similar corresponding issue with construction loans because of the heightened prudential standards?

iii) Under the CCAR regulations, federal regulators routinely assign risk weights to certain assets that Bank Holding Companies have on their balance sheets. These risk weights often time changes the costs associated with holding certain investments, such as Commercial Real Estate. Has this changed the type of assets that institutions hold, or caused institutions to alter their business plans because of the regulatory capital costs? If so, can you provide examples of this?

iv) Do you think that regulators, on a general basis, get the risks weights right?

v) Fed Governor Tarullo, has argued that the $50 BB threshold is too low in terms of an asset threshold for enhanced prudential standards; does this number make

sense? Why do we need such arbitrary thresholds? Shouldn't we get away from these thresholds and move toward a regulatory system that evaluates substance and activities of an institution as opposed to an arbitrary number? Why can't we do that?

1) Does Title I allow the Fed to treat a $51 BB bank in a similar manner to a $49 BB bank for the purposes of enhanced prudential standards?

In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. The Federal Reserve has been working for many years to make sure that our regulation and supervision is tailored to the size and risk posed by individual institutions.

The failure or distress of a large bank can harm the U.S. economy. The recent financial crisis demonstrated that excessive risk-taking at large banks makes the U.S. economy vulnerable. The crisis led to a deep recession and the loss of nearly nine million jobs. Our regulatory framework must reduce the risk that bank failures or distress will have such a harmful impact on economic growth in the future.

The Federal Reserve Board (Board) has already implemented, via a regulation that was proposed and adopted following a period of public notice and comment, a methodology to identify global systemically important banking organizations (GSIBs), whose failure could pose a significant risk to the financial stability of the United States.[1] The "systemic footprint" measure, which determines whether a large firm is identified as a GSIB, includes attributes that serve as proxies for the firm's systemic importance across a number of categories: size, interconnectedness, complexity, cross-jurisdictional activity, substitutability, and reliance on short-term wholesale funding.

There are many large financial firms whose failure would pose a less significant risk to U.S. financial stability, but whose distress could nonetheless cause notable harm to the U.S. economy (i.e., large regional banks). The failure or distress of a large regional bank could harm the U.S. economy in several ways: by disrupting the flow of credit to households and businesses, by disrupting the functioning of financial markets, or by interrupting the provision of critical financial services, including payments, clearing, and settlement. Economic research has documented that a disruption in the flow of credit through banks or a disruption to financial market functioning can affect economic growth.[2] Some level of tailored enhanced regulation is therefore appropriate for these large regional banks.

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[1] Board of Governors of the Federal Reserve System (2015), "Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies," final rule, Federal Register, vol 80 (August 14), pp. 49082-49116.

[2] For evidence on the link between bank distress and economic growth, see Mark A. Carlson, Thomas King, and Kurt Lewis (2011) "Distress in the Financial Sector and Economic Activity," The B.E. Journal of Economic Analysis & Policy: Vol. 11: Iss. 1 (Contributions), Article 35. For evidence on the link between financial market functioning and economic growth, see Simon Gilchrist and Egon Zakrajšek (2012), "Credit Spreads and Business Cycle Fluctuations," American Economic Review, Vol. 102 (4): 1692-1720.

The application of tailored enhanced regulation should consider the size, complexity, and business models of large regional banks. The impact on economic growth of a large regional bank's failure will depend on factors such as the size and geographic distribution of the bank's customer base and the types and number of borrowers that depend on the bank for credit. Asset size is a simple way to proxy for these impacts, although other measures may also be appropriate. For large regional banks with more complex business models, more sophisticated supervisory and regulatory tools may be appropriate. For example, the Board recently tailored our Comprehensive Capital Analysis and Review (CCAR) qualitative assessment to exclude some smaller and less complex large regional banks, using asset size and nonbank assets to measure size and complexity, respectively.[3] In other contexts, foreign activity or short-term wholesale funding may be another dimension of complexity to consider. Any characteristics or measures that are used to tailor enhanced regulation for large regional banks should be supported with clear analysis that links them with the potential for the bank's failure or distress to cause notable harm to the U.S. economy.

The Board currently has only limited authority to tailor the enhanced prudential standards included in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). In particular, Congress required that certain enhanced prudential standards must apply to firms with $10 billion in total assets, with other standards beginning to apply at $50 billion in total assets.

I understand that Congress is currently considering whether and how to raise these statutory thresholds. The Board has supported increasing these thresholds. As an alternative to simply raising the thresholds, your question asks whether Congress should move away from an asset size threshold. As my answer above noted, I believe that it would be logical to use a wider range of factors than asset size to determine the application of tailored enhanced regulation for large regional banks. The Board stands ready to work with Members of Congress to pursue either approach: raising the dollar thresholds, or providing for the Federal Reserve to decide which firms are subject to enhanced prudential standards.

Several parts of your question concern the impact of enhanced prudential standards, including the liquidity coverage ratio (LCR) and CCAR, on commercial real estate lending at banks with assets greater than $50 billion. A recent study that evaluates pre-and post-crisis lending by large bank holding companies above and below the $50 billion asset threshold found no noticeable difference in commercial real estate loan growth since the implementation of enhanced prudential standards.[4] Commercial real estate lending has consistently grown faster at the smaller banks all the way back to 2001, perhaps reflecting a structural competitive advantage held by smaller banks. In addition, the study notes that banks' lending standards for commercial

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[3] Board of Governors of the Federal Reserve System (2017), "Amendments to the Capital Plan and Stress Test Rules; Regulations Y and YY," final rule, Federal Register, vol 82 (February 3), pp. 9308-9330.

[4] See Figure 6 from Cindy M. Vojtech (2017), "Post-Crisis Lending by Large Bank Holding Companies," FEDS Notes, Washington: Board of Governors of the Federal Reserve System, July 6, 2017. https://www.federalreserve.gov/econres/notes/feds-notes/post-crisis-lending-by-large-bank-holding-companies-20170706.htm.

real estate loans, as measured by the Federal Reserve's Senior Loan Officer Opinion Survey, are similar for banks above and below the $50 billion threshold.[5]

More broadly, post-crisis reforms to the supervision and regulation of the large banks were informed by the substantial body of research that has reached a consensus indicating that well-capitalized banks with strong liquidity positions are best able to support sustainable lending to creditworthy borrowers through the full business cycle. Indeed, overall bank lending has remained robust since post-crisis reforms began to be phased in--bank lending grew significantly faster than nominal GDP between 2013 and 2016.[6] As such, the strong capital and liquidity positions of U.S. banks could be said to have contributed to a stronger recovery from the financial crisis in the United States compared with other countries.

That said, it is difficult to isolate the effect that specific regulations have had on banks' business decisions from other factors that affect those decisions. For instance, an important determinant of bank lending is the amount of demand for loans, and banks undoubtedly would have altered their lending standards to reflect a better understanding of the riskiness of certain business lines that were incorrectly perceived to be lower-risk prior to the financial crisis. To be sure, changes in regulation and supervision were designed to incentivize the banking industry to become safer and less prone to the type of systemic risks that built up during the mid-2000s, and we believe that those intended effects are occurring. A relatively new and growing literature on bank responses to specific post-crisis regulations, like CCAR, is not yet comprehensive enough to fully understand how banks have adapted to the new regulatory environment, but it does provide some early evidence that banks are taking regulations into account when making business decisions.[7] We remain vigilant, however, in research and monitoring efforts to understand and address any unintended effects of regulatory changes, and welcome discussions with the public and the industry about ways to address those challenges without undermining the increased safety and resiliency of the financial system.

Finally, you ask whether risk weights, including those implied by the Federal Reserve's CCAR supervisory stress test, are generally correct or whether they are overly broad, assigning the same capital requirement to loans with different risks. It is traditional risk weights, not CCAR, that group loans into broad categories. Those traditional risk weights do create an incentive for a bank to prefer the riskiest loans in a particular category, if a bank's only consideration were to minimize its regulatory capital requirement. However, in CCAR, the Federal Reserve's stress test models control for the most important risk drivers in a bank's portfolio, down to the level of the individual loan in some cases. For example, commercial real estate loans are treated differently depending on the remaining maturity of the loan, the loan-to-value ratio, and whether

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[5] See Figure 7 from Vojtech (2017).

[6] See, Vojtech (2017).

[7] For example, a study that finds that the 2011 CCAR had a negative effect on the share of jumbo mortgage originations and approvals at banks subject to that exercise is Calem, Paul S. and Correa, Ricardo and Lee, Seung Jung, Prudential Policies and Their Impact on Credit in the United States (2017). BIS Working Paper No. 635. Available at SSRN: https://ssrn.com/abstract=2967129. Another recent study that finds that the stress tests have led to a reduction in bank lending to riskier borrowers is Acharya, Viral V. and Berger, Allen N. and Roman, Raluca A., Lending Implications of U.S. Bank Stress Tests: Costs or Benefits? (2017). Journal of Financial Intermediation, Forthcoming. Available at SSRN: https://ssrn.com/abstract=2972919.

the loan is collateralized by an income-producing property or is a construction loan. In addition, unlike traditional risk weights, stress tests account for the income generated by the loans as well as the potential losses under stress. Of course, traditional risk weights, stress tests, and any other individual measure of risk will necessarily be imperfect. Assessing capital using multiple perspectives--from traditional risk weights and stress tests--should produce a more stable and reliable treatment of risk over the various stages of the credit cycle.

2. Governor Powell: Given the importance of international standards to both the US and the global financial stability, would you agree with the US Treasury Department's recommendation that there should be more transparency for the public into the agenda of the Basel Committee? If so, do you think the Federal Reserve Board could be leading voice at the Basel Committee to shine some light into the agenda of that body and its proposed standards? And if, as goes the old adage says, 'there's no time like the present', do you see any reason why we can't start with more transparency on the proposal on the table relating to the finalization of the Basel III reforms?

The Board strongly supports transparency in the international standard setting process. Over the years, the Board has led efforts to increase transparency in the context of the Basel standards, and is generally pleased with the progress that has been made to date.

More remains to be done, however, and the Board will continue to use its influence to heighten openness around Basel standard setting, including the process for consideration of comments received through consultations and meeting agendas. The Basel Committee on Banking Supervision currently is studying approaches to increase external communication of work that is underway. The Board supports this effort and will be an active contributor to the deliberations.

3. Governor Powell: A number of President Obama's regulators who helped devise the Volcker after the passage of Dodd-Frank have come out and called for additional legislative and regulatory changes to the law. Your former colleague Governor Tarullo has called for statutory changes and said the law is too complicated. Former Fed Governor Stein, again an Obama appointee, has called for its outright repeal. The Federal Reserve staff have concluded in a report that the rule is negatively impacting market liquidity. These are just a few of the calls for changes from respected Democratic regulators. Would you agree that we should revisit this provision of Dodd Frank, which most people agree had nothing to do with the financial crisis and clarify that the statute does not impact legitimate market making? Can you provide me with specific legislative suggestions for how Congress can assist with your efforts to change Volker to cure its implementation issues?

a) There are many unintended consequences from Volker, and in the recent Treasury report, one of those consequences that was highlighted is the prohibition on a covered fund sharing the name of a bank-affiliated manager—even if the manager and the fund do not use the name of the bank. As the report stated:

> **i) "Although the prohibition on depository institutions sharing a name with the funds they sponsor is appropriate to avoid customer confusion as to whether the fund is insured, banking entities other than depository institutions and their holding companies should be permitted to share a name with funds they sponsor provided**

that the separate identity of the funds is clearly disclosed to investors." – Last Congress, H.R. 4096 was introduced to address this issue. Do you think that Congress should take up this measure, or are there ways by which the Fed or another regulatory body can address this issue?
ii) Chair Yellen has indicated she has "some sympathy" for some of the changes that Treasury has proposed. Will the Fed address this technical, unintended consequence in what seems to be an over-broad application of the Volcker Rule? And soon—as I understand the compliance date is July 21st?

The core premise of the Volcker Rule is relatively straightforward: that financial institutions with access to the federal safety net–Federal Deposit Insurance Corporation insurance and the Board discount window–should not engage in proprietary trading. The Volcker Rule's statutory provisions, however, are complex, which has led to a complex rule. While many changes to the Volcker Rule would require amendment to the statute, there may be ways to streamline and simplify the interagency Volcker Rule regulation to reduce burdens without sacrificing key objectives, and the Board is exploring possibilities.

The Board is working with the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Commodities and Futures Trade Commission (CFTC), and Securities and Exchange Commission (SEC) (together, the agencies) to identify areas of the implementing regulations that could be simplified. There are, however, limits to addressing inefficiencies of the Volcker Rule through amendments of the implementing regulations. For example, a change to the statute to exempt smaller firms would be a cleaner and more comprehensive way to reduce burdens for smaller firms. Additional examples are the treatment of foreign excluded funds and the name-sharing restriction, discussed further below, which may require statutory changes to be addressed more fully than through regulatory amendment.

You also ask about the name-sharing restriction of the Volcker Rule. This provision is imposed by the statute. The statute prohibits a banking entity from sponsoring a covered fund and defines "sponsor" to mean "to share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name." The statute also prohibits a banking entity from sharing the same name or variation of the same name with a covered fund that the banking entity organizes and offers. In particular, the statute provides as a requirement to permissibly organize and offer a covered fund that "the banking entity does not share with the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name."[8] The statute also defines the scope of the prohibition by defining the term "banking entity" to generally include any affiliate or subsidiary of an insured depository institution or any company that controls an insured depository institution. A change to the statute thus would be required to modify the scope of the name-sharing provision, and any legislation is ultimately up to Congress to decide.

Finally, you ask whether the Federal Reserve will address the technical, unintended consequences in the Volcker Rule. While we are restricted from granting burden relief that is in contravention of the requirements of the statute, we have provided relief for some provisions. Most recently, certain foreign non-covered funds organized and offered outside the United States

[8] 12 U.S.C. 1851(d)(1)(G)(vi).

may have become subject to the Volcker Rule by virtue of typical corporate governance structures for funds sponsored by a foreign banking entity in a foreign jurisdiction or by virtue of investment by the foreign banking entity in the fund. In July, the agencies, in consultation with the SEC and the CFTC, issued a statement of policy that indicates the agencies would not propose to make a finding that a banking entity is out of compliance with respect to the provisions of the rule that may apply to such foreign non-covered funds for one year while the agencies consider available avenues to address this issue. This issue could potentially be solved either through regulatory or legislative action. We will explore potential regulatory solutions to this issue in the context of the broader regulatory changes that we are working on.

4. Governor Powell: Like community banks, there are a number of savings & loan holding companies that include small and medium sized insurance companies that serve the interests and needs of small farmers and businesses of all kinds. And, like community banks they provide critical financial services, in this case security from loss and loss prevention advice, that make it possible for small farms and other small businesses to exist, thrive and employ. And, like community banks they are well regulated by their primary supervisor and are not systemically risky. Considering these facts, what are you doing to prevent and reduce unproductive regulatory burden on these insurers whose groups you supervise?"

The Board recognizes the importance of community banks and insurance companies in providing services to small businesses and farmers. As you know, the Dodd-Frank Act mandates that the Board supervise the consolidated entity of any insurance savings and loan holding company (ISLHC). In doing so, the unique characteristics, risks, and activities of each ISLHC are considered in the supervisory approach.

In order to mitigate regulatory overlap and burden in supervising these firms, the Board has been relying to the greatest extent possible on state insurance regulators' work related to the business of insurance. The Board has information sharing Memorandums of Understanding with every state insurance regulator. Supervision staff from Reserve Banks and the Board regularly meet with state insurance regulators to coordinate examination and inspection activities and share information relative to supervision. The Board and the National Association of Insurance Commissioners continue to discuss state and federal supervision, any ongoing enhancements to the respective supervisory programs, potential for coordination, and possible areas of overlap.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator Thom Tillis:

1. I'm a proponent of tailoring regulations based off of the risk profiles of financial institutions, as opposed to having strict asset thresholds that do not represent what I believe is the smart way to regulate. But, my question here is really about the importance of ensuring that we have a system that is rooted in fundamental, analytical, thoughtful regulation so that we can achieve and execute on goals, whether balancing safety and soundness with lending and growth, or encouraging more private capital in the mortgage market to protect taxpayers and reform the GSEs.
    a. Do you think that we should use asset thresholds as a way to regulate – yes or no? If no, can you provide me with the metrics or factors by which a depository institution should be evaluated? If yes, please explain.
    b. Section 165 of Dodd-Frank requires enhanced supervision and prudential standards for banks with assets over $50 billion. This applies to any bank that crosses the asset threshold, without regard to the risks those banks pose based upon the complexity of the business model. This includes heightened standards on liquidity and capital under the Liquidity Coverage Ratio (LCR) and the Comprehensive Capital Analysis and Review (CCAR) which have a various assumptions built in that may drive business model.
        i. I understand under these two regulatory regimes, banks have changed certain lending behaviors because of the assumptions federal regulators have made regarding certain classes of assets and deposits. Can you provide some examples of how the LCR and CCAR have changed the types of loans, lending, and deposits your institution holds?
        ii. Construction lending by banks over the $50 billion threshold has been a source of concern, namely because these enhanced prudential standards have treated construction loans punitively. This includes construction lending for builders of apartments, warehouses, strip malls, and other projects that may have varying risk profiles associated with them. However, under the CCAR and DFAST assumptions, the regulators have assigned all these categories of lending the same capital requirements. The result is an overly broad capital requirement for varying loans that have different risks, a capital requirement that may be greater for some loans and lower for others, influencing the decision of many banks over the $50 billion threshold to hold less of these assets due to the punitive capital requirements associated with them. Have you seen a similar corresponding issue with construction loans because of the heightened prudential standards?
        iii. Under the CCAR regulations, federal regulators routinely assign risk weights to certain assets that Bank Holding Companies have on their balance sheets. These risk weights often time changes the costs associated with holding certain investments, such as Commercial Real Estate. Has this changed the type of assets that institutions hold, or caused institutions to alter their business plans because of the regulatory capital costs? If so, can you provide examples of this?

iv. Do you think that regulators, on a general basis, get the risks weights right?

v. Fed Governor Tarullo, has argued that the $50 BB threshold is too low in terms of an asset threshold for enhanced prudential standards; does this number make sense? Why do we need such arbitrary thresholds? Shouldn't we get away from these thresholds and move toward a regulatory system that evaluates substance and activities of an institution as opposed to an arbitrary number? Why can't we do that?

1. Does Title I allow the Fed to treat a $51 BB bank in a similar manner to a $49 BB bank for the purposes of enhanced prudential standards?

2. Governor Powell: Given the importance of international standards to both the US and the global financial stability, would you agree with the US Treasury Department's recommendation that there should be more transparency for the public into the agenda of the Basel Committee? If so, do you think the Federal Reserve Board could be leading voice at the Basel Committee to shine some light into the agenda of that body and its proposed standards? And if, as goes the old adage says, 'there's no time like the present', do you see any reason why we can't start with more transparency on the proposal on the table relating to the finalization of the Basel III reforms?

3. Governor Powell: A number of President Obama's regulators who helped devise the Volcker after the passage of Dodd-Frank have come out and called for additional legislative and regulatory changes to the law. Your former colleague Governor Tarullo has called for statutory changes and said the law is too complicated. Former Fed Governor Stein, again an Obama appointee, has called for its outright repeal. The Federal Reserve staff have concluded in a report that the rule is negatively impacting market liquidity. These are just a few of the calls for changes from respected Democratic regulators. Would you agree that we should revisit this provision of Dodd Frank, which most people agree had nothing to do with the financial crisis and clarify that the statute does not impact legitimate market making? Can you provide me with specific legislative suggestions for how Congress can assist with your efforts to change Volker to cure its implementation issues?

   a. There are many unintended consequences from Volker, and in the recent Treasury report, one of those consequences that was highlighted is the prohibition on a covered fund sharing the name of a bank-affiliated manager—even if the manager and the fund do not use the name of the bank. As the report stated:

      i. "Although the prohibition on depository institutions sharing a name with the funds they sponsor is appropriate to avoid customer confusion as to whether the fund is insured, banking entities other than depository institutions and their holding companies should be permitted to share a name with funds they sponsor provided that the separate identity of the funds is clearly disclosed to investors." – Last Congress, H.R. 4096 was introduced to address this issue. Do you think that Congress should take up this measure, or are there ways by which the Fed or another regulatory body can address this issue?

ii. Chair Yellen has indicated she has "some sympathy" for some of the changes that Treasury has proposed. Will the Fed address this technical, unintended consequence in what seems to be an over-broad application of the Volcker Rule? And soon—as I understand the compliance date is July 21st?

4. Governor Powell: Like community banks, there are a number of savings & loan holding companies that include small and medium sized insurance companies that serve the interests and needs of small farmers and businesses of all kinds. And, like community banks they provide critical financial services, in this case security from loss and loss prevention advice, that make it possible for small farms and other small businesses to exist, thrive and employ. And, like community banks they are well regulated by their primary supervisor and are not systemically risky. Considering these facts, what are you doing to prevent and reduce unproductive regulatory burden on these insurers whose groups you supervise?"

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

August 11, 2017

The Honorable Tom Cotton
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the June 22, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on June 30, 2017.

<u>Questions for The Honorable Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System from Senator Cotton:</u>

1. President Trump issued an Executive Order in February establishing Core Principles for Regulating the United States Financial System. One of the principles is to prevent taxpayer-funded bailouts. Presumably that includes considering what could cause a disruption to the financial system. One potential cause is a requirement that banks publicly publish granular details of a complex liquidity regnlatory metric called the Liquidity Coverage Ratio (LCR). Regulators already receive information daily to monitor a firm's liquidity position, but now the Fed is requiring banks to publicly disclose these complex and technical liquidity details. If misunderstood, the disclosure could destabilize markets.

1. How is this requirement in keeping with the President's core prineiples? And how will the Fed manage through the next financial crisis and get banks to meet the funding needs of households and small business when meeting such needs will hurt banks' LCR?

The purpose of the Liquidity Coverage Ratio (LCR) public disclosure requirements is to provide market participants broad information about the liquidity risk profile of large banking organizations to support market discipline and encourage covered companies to take adequate steps to appropriately manage their liquidity positions. In addition, during times of stress, public disclosures can enhance stability by providing relevant information about firms. Without information about the liquidity strength of their counterparties, market participants may assume the worst about their counterparties and draw back from the market, exacerbating the problem. Thus, the LCR public disclosure requirements are consistent with enhancing financial stability and the principle of preventing taxpayer-funded bailouts.

To serve this purpose, the information disclosed must be sufficiently informative and timely. In order to mitigate potential financial stability and firm-specific risks related to the disclosure of real-time liquidity information, the LCR public disclosure rule requires covered companies to disclose average values of broad categories of liquidity sources and uses over a quarter, with a 45 day lag after the end of the quarter. In addition, as part of its LCR disclosures, a covered company is required to disclose a qualitative discussion of its LCR results to facilitate the public's understanding of its liquidity risk profile and ensure that the LCR disclosures are not misunderstood by the public. The Federal Reserve Board (Board) will carefully monitor the implementation of these requirements going forward. If warranted, I would be willing to revisit aspects of the LCR disclosures that result in significant undesirable or unintended consequences.

The LCR rule is designed to ensure that large banking organizations can withstand idiosyncratic or market liquidity stress without pulling back from meeting the funding needs of households and small business or resorting to fire sales of illiquid assets. The LCR rule requires covered companies to hold a minimum amount of high quality liquid assets to meet outflows over a 30 day stress scenario. It encourages banking organizations to fund extensions of credit with longer term debt or relatively stable deposits rather than short-term wholesale funding. In addition, the calibration of the LCR rule treats transactions with retail clients and wholesale counterparties favorably relative to transactions with financial sector entities. Importantly, the LCR rule is designed to allow banking organizations to use high quality liquid assets when needed to meet liquidity stresses and does not require a company to reduce lending if it depletes its liquid assets.

A company must notify its supervisor when it has an LCR shortfall, and the supervisor will monitor and respond appropriately to the unique circumstances that are giving rise to the company's shortfall.

2. How do the required data points for Liquidity Coverage Ratio (LCR) disclosure compare in both quantity and granularity to other mandatory public disclosures?

Consistent with the Board's longstanding commitment to public disclosure, firms are required to provide the public with various disclosures and reports that provide insight on their financial condition and risk management. The requirements of each report or disclosure are tailored to its purpose.

The LCR public disclosures have quantitative and qualitative risk management components. The quantitative LCR public disclosures are quarterly average amounts of broad categories of sources and uses of liquidity under the LCR rule. The LCR disclosures are contained in one summary-level table that includes three categories for a firm's high quality liquid asset holdings, 11 categories of outflows, and seven categories of inflows, and the covered company's LCR ratio. The LCR disclosures are less granular than disclosures of borrowing from the Board's discount window, which includes transaction-specific information about a bank's business decision to borrow at the window including the amounts borrowed and the collateral provided to secure each loan.

The LCR public disclosures are both less numerous and less granular than the qualitative and quantitative disclosures that bank holding companies with total assets greater than $50 billion are required to make about their capital adequacy and risk profile.[1] These disclosures address the composition of capital, measures of capital adequacy, and specific information about a range of granular exposure types, such as general credit risk, securitization, equity risk, and interest rate risk. They are described in ten tables in the regulatory capital rule and typically require quarter-end values rather than quarterly averages. In addition, bank holding companies that must calculate risk-weighted assets for market risk must disclose a range of risk measures for each material portfolio of covered positions on a quarterly basis, as well as more granular information about specific risks and qualitative risk management information.[2]

The LCR public disclosures are also less numerous and less granular than the Board's FR Y-9C Consolidated Financial Statement for Holding Companies, which collects basic financial data and requires firms to provide a balance sheet, an income statement, and detailed supporting schedules.[3] Typically this data is as of quarter-end.

3. The Basel III capital requirements increase the risk-weighting of Mortgage Service Rights (MSR) held by banks from 100% to 250%. Mortgage servicing is a stable and important revenue stream, especially for smaller banks, and allows banks to preserve a

[1] See 12 CFR 213.61. Certain large and internationally active bank holding companies must make the public disclosures described in 13 tables in 12 CFR 217.173.

[2] See 12 CFR 217.212.

[3] See https://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYJ+5BzDal8cbqnRxZRg==.

vital customer interface after they have sold the originated mortgage on the secondary market.

Basel III increases the risk-weighting for MSRs by a factor of 2.5 can you please justify this significant increase in capital required of banks to hold mortgage servicing assets, and detail the methodology used to quantify the risk associated with MSRs?

The Board recognizes community banks' concerns with respect to the burden and complexity of certain aspects of the U.S. regulatory capital framework, including the current treatment of mortgage servicing assets (MSAs). As described in the report on the review of the Economic Growth and Regulatory Paperwork Reduction Act, the federal banking agencies are jointly developing a proposal to simplify certain aspects of the regulatory capital framework, including the treatment of MSAs, while maintaining safety and soundness of the banking system.

The Board and the other federal banking agencies have long limited the inclusion of MSAs in regulatory capital due to the high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions. These limitations help protect banks from sudden fluctuations in the value of MSAs and from the inability to quickly divest these assets at their full estimated value during periods of financial stress. In developing the current regulatory capital rule, the federal banking agencies took into consideration statutory limitations related to MSAs, invited public comment on the proposed regulatory capital treatment of MSAs, and addressed industry comments in the final rule. In addition, the federal banking agencies considered whether the capital rule appropriately reflects the risk inherent in banking organizations' business models. Prior to issuing the capital rule, the federal baking agencies conducted a pro-forma economic impact analysis that showed that the vast majority of small banking organizations would meet the rule's minimum capital requirements on a fully phased in basis, including the treatment of MSAs.

A study by the federal banking agencies, together with the National Credit Union Administration, similarly concluded that MSA valuations are inherently subjective and subject to uncertainty because they rely on assessments of future economic variables (see the July 2016 Report to the Congress on the Effect of Capital Rules on Mortgage Servicing Assets). The results of the study support a conservative treatment of MSAs for purposes of regulatory capital.

Committee on Banking, Housing, and Urban Affairs
Fostering Economic Growth: Regulator Perspective
June 22, 2017

<u>Questions for The Honorable Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, from Senator Tom Cotton:</u>

Questions for Mr. Powell on LCR-Disclosure

President Trump issued an Executive Order in February establishing Core Principles for Regulating the United States Financial System. One of the principles is to prevent taxpayer-funded bailouts. Presumably that includes considering what could cause a disruption to the financial system. One potential cause is a requirement that banks publicly publish granular details of a complex liquidity regulatory metric called the Liquidity Coverage Ratio (LCR). Regulators already receive information daily to monitor a firm's liquidity position, but now the Fed is requiring banks to publicly disclose these complex and technical liquidity details. If misunderstood, the disclosure could destabilize markets.

1. How is this requirement in keeping with the President's core principles? And how will the Fed manage through the next financial crisis and get banks to meet the funding needs of households and small business when meeting such needs will hurt banks' LCR?

2. How do the required data points for Liquidity Coverage Ratio (LCR) disclosure compare in both quantity and granularity to other mandatory public disclosures?

Questions for Mr. Powell on MSR Capital requirements

The Basel III capital requirements increase the risk-weighting of Mortgage Service Rights(MSR) held by banks from 100% to 250%. Mortgage servicing is a stable and important revenue stream, especially for smaller banks, and allows banks to preserve a vital customer interface after they have sold the originated mortgage on the secondary market.

1. Basel III increases the risk-weighting for MSRs by a factor of 2.5 can you please justify this significant increase in capital required of banks to hold mortgage servicing assets, and detail the methodology used to quantify the risk associated with MSRs?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

October 10, 2017

The Honorable Ben Sasse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the July 13, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on July 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Sasse:

1. Our financial system has become increasingly consolidated as community banks and credit unions either close their doors or merge with larger institutions.

a. Are you concerned about this pattern? Why?
b. What services can these smaller institutions provide that larger institutions cannot provide?

The Federal Reserve Board (Board) recognizes the vital role community banks play in local economies and closely monitors consolidation trends at community banks. The banking industry has been consolidating at a relatively steady pace for more than 30 years.[1] Despite this, community banks (defined as banks with assets totaling less than $10 billion) have continued to play a vital role in local economies and serve as a key source of financing to small businesses and small farms. While community banks accounted for 20 percent of all insured depository institution assets at year-end 2016, they accounted for nearly 50 percent of all dollars lent to small businesses by insured depositories and 88 percent of all dollars lent to small farms. The Board believes it is important to maintain a diversified and competitive banking industry that comprises banking organizations of many sizes and specializations, including a healthy community banking segment.

Research conducted over many years has concluded that community banks provide several distinct advantages to their customers compared to larger banks. For example, given their smaller size and less complex organizational structure, community banks are often able to respond with greater agility to lending requests than their large national competitors. In addition, reflecting their close ties to the communities they serve and their detailed knowledge of their customers, community banks are able to provide customization and flexibility to meet the needs of their local communities and small business/farm customers that larger banks are less likely to provide. Community banks are particularly important for rural communities, where the closing of a bank can be associated with a material decline in local economic activity.

2. As you know, the CFPB may be moving forward on a rulemaking for Section 1071 of Dodd-Frank, which grants the CFPB the authority to collect small business loan data. I've heard some concerns that implementing Section 1071 could impose substantial costs on small financial institutions and even constrict small business lending.

a. Are you concerned that a Section 1071 rulemaking could hurt small business access to credit?

Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended the Equal Credit Opportunity Act to require that lenders collect information on credit applications and outcomes for small businesses, and women-owned and minority-owned businesses. The purpose is to facilitate enforcement of the fair lending laws, and allow communities, governmental entities, and creditors to identify business and community development needs and opportunities.

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[1] https://www.federalreserve.gov/pubs/feds/2008/200860/200860pap.pdf.

Although the Consumer Financial Protection Bureau (CFPB) must issue rules to implement section 1071 for most creditors, the Board is responsible for issuing rules for certain motor vehicle dealers that use installment contracts to finance vehicle purchases by small businesses.

Because the CFPB is still considering how to implement the law and has not yet issued a proposed rule, the scope of the rule in terms of the type of creditors, transactions, or data that will be covered has not been established. We expect the rulemaking process to include consideration of the relative costs and benefits of the proposed rule to assess its impact.

CFPB and Board staff have recently started to coordinate efforts to conduct additional outreach and gather information to assist in developing their regulatory proposals. In May, 2017, the CFPB published a "Request for Information" outlining the major issues on which the CFPB is seeking data and information from stakeholders that will be affected by the rules. The CFPB is also required to conduct a small business review panel pursuant to the Small Business Regulatory Enforcement Fairness Act. The panel would meet with representatives of small businesses that can provide feedback on the impact of the proposed regulations and on regulatory options and alternatives that might minimize the impact.

b. Has the Federal Reserve coordinated with the CFPB to ensure that implementing these requirements does not constrict small business access to credit?

The CFPB has primary rule-writing authority and must issue rules to implement section 1071 for most creditors. The Board is responsible for issuing rules that would apply to certain motor vehicle dealers that originate installment contracts to finance vehicle purchases by small businesses, and routinely sell or assign the contracts to a third party.

The Board believes that the two agencies should jointly develop rules that use consistent definitions and standards to ensure data are collected and reported uniformly, whether the loans are made by depository institutions, motor vehicle dealers, or another type of creditor. The Board will also participate in the CFPB consultation process, along with the other prudential regulators, that is mandated for all CFPB rulemakings under section 1022 of the Dodd-Frank Act. The CFPB has yet to commence its rulemaking consultation process.

In May 2017, the CFPB held a public field hearing in Los Angeles on small business lending and published a "Request for Information" outlining the major issues on which the CFPB seeks data and information from stakeholders that will be affected by the rules. This information is expected to assist the CFPB and the Board as they consider the scope of their proposed rules. In addition, CFPB and Board staff have recently started to coordinate efforts on planning joint outreach efforts to gather additional information.

3. I am very disturbed by the most recently available data on job openings and hires. As you know there were a record number of job openings, 6 million, while job hires fell to 5.1 million. This problem manifests itself in Nebraska as many businesses tell me that they have extreme difficulties finding and retaining talent.

a. Does this mismatch between job openings and job hires represent a new normal? Or will economic growth eventually reduce this mismatch over time, without any major structural changes to our economy?

Data from the Job Openings and Labor Turnover Survey[2] show that the ratio of job openings to hires has moved up since the end of Great Recession and has surpassed its pre-recession level. There are likely several factors that are responsible for the increase in job openings relative to hiring:

- Most of the increase likely reflects typical cyclical behavior of the labor market, that is, the ratio of vacancies to hires goes up when the economy improves and down when the economy slows. In other words, in tightening labor markets there is an increasing scarcity of job seekers overall, which may eventually impede firms' ability to fill job openings.
- Another possibility is that there have been changes in the ways that firms post job vacancies and search for workers. For example, online recruitment and job search have become increasingly popular, making it cheaper for firms to post job vacancies and possibly resulting in an elevated level of vacancies relative to earlier times.
- A third possibility is the mismatch between the skills that job seekers have and the skills that employers want. For example, such mismatch might arise because firms are less willing to hire those who have suffered long spells of non-employment during and after the Great Recession because firms perceive that these potential workers have lost job-related skills (or their skills have become otherwise obsolete). Alternatively, there may be a mismatch between low-skill workers and high-skill jobs, or a mismatch between locations where unemployed job seekers reside and where workers are in greatest demand.

If this third type of mismatch were a significant concern for the broader labor market, we would eventually expect to observe a substantial rise in wages as firms compete to hire workers with scarce skills. To date, however, we have not seen wage acceleration in the aggregate that exceeds what might be expected given the historical relationship between wage growth and other economic conditions. That said, in the Federal Reserve's Beige Book a number of respondents noted worker shortages at all skill levels and a couple Districts reported that labor shortages were beginning to push up wages.

Significant mismatch, if it exists, may be alleviated somewhat if aggregate labor market conditions remain favorable. For example, it may induce some workers who left the labor force out of discouragement to re-enter, some of whom may have skills matching those sought by firms. It may also encourage firms to consider less qualified applicants, perhaps by offering such workers additional training or education on the job.

b. What are the most prominent causes of this mismatch?

As described above, an elevated level ratio of vacancies to hires does not necessarily indicate the emergence of significant mismatch, since factors such as advances in recruiting technology and usual cyclical improvement in the labor market may have also led to the increase. Nonetheless,

[2] https://www.bls.gov/news.release/jolts.htm.

it may also reflect specific factors, such as the increased use of information technology in many industries and jobs, leading to mismatch between the skills and attributes demanded by firms and the available job seekers.

c. In what industries is this mismatch most prominent?

The ratio of vacancies to hires varies substantially across industries, although this need not indicate varying degrees of mismatch and may instead reflect industry differences in hiring conventions. (For example, for a given level of vacancies, firms hire fewer workers in the health and education sector on average than they do in the construction sector). Even taking these differences into account, the ratio of vacancies to hires appears to have continued to increase in industries such as health care and education, professional and business services, and trade, transportation, and utilities. Consistent with this observation, some firms responding to the most recent Labor Shortage Index survey from The Conference Board[3] reported anticipating there would not be a sufficiently qualified supply of workers in "management, business, and financial service occupations" or "professional and related services occupations." That said, we have not seen significant wage growth in most of these sectors relative to other sectors, suggesting that factors other than mismatch may be boosting the ratio of vacancies to hires in these industries.

d. What demographic groups are most hurt by this mismatch?

It is difficult to assess with any precision which demographic groups are disproportionately affected by mismatch due to data limitations. That said, there are some groups whose employment rates have declined substantially relative to other groups, which may represent weak labor demand relative to other groups and possibly owe, in part, to mismatch. For example, the employment rate for prime-age males (especially less-educated prime-age males) has declined more steeply than other groups, which could be partially because manufacturing (which disproportionately employed prime-age men) has contracted, while newly created jobs have been in occupations with different skills requirements or in different areas of the country.

e. Today, many workers, including those late in their career, are forced to retool their skills to find a job in new fields. Can our economy's current ecosystem of education and job retraining programs adequately respond to this challenge? If not, what changes could better address this issue?

Some job retraining and education programs, such as WorkAdvance and Apprenticeship Carolina, have had success lately, though these types of programs are especially helpful for workers earlier in their career whose skills can more easily be matched to growing labor demand. In general, an expansion of career and technical education programs and apprenticeships may be effective in helping workers gain valuable skills and obtain a foothold in a labor market that increasingly requires technical proficiency. In addition, promoting entrepreneurship through programs that equip people with the management skills and knowledge they need to start and operate a successful small business could also be a fruitful approach for some workers.

4. I am concerned about the impact of our recent trade disputes on our economy, particularly with agriculture.

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[3] https://www.conference-board.org/labor-shortages2016/index.cfm?id=38314.

a. How dependent is the agricultural economy on exports with other countries?

As reported by the U.S. Department of Agriculture, the export share of U.S. agricultural production has averaged about 20 percent in recent history. However, some specific agricultural products have had higher export shares. For example, cotton and tree nuts have historically had export shares around 75 percent, while rice, wheat, and soybeans have had export shares around 50 percent.[4]

b. U.S. corn exports to Mexico from January through May of this year are down by 7% compared to last year. Unfortunately, this may be due to reported efforts by Mexico to reduce corn imports from the United States, including by opening up trade with Brazil or Argentina. Are there historic examples of countries exploring other import markets in response to trade disputes?

Although there has been much reporting of efforts to diversify Mexico's supply, actual government policy actions have not been implemented. In addition, U.S. corn exports to Mexico, after being weak earlier in the year, have stepped up in recent months. Corn exports to Mexico are now down only 1 percent relative to 2016.

That being said, Brazil and Argentina are major corn exporters, who compete worldwide with U.S. exporters for market share. Because of transportation cost advantages, Mexico currently buys most of its imported corn from the United States. If Mexico were to increase trade barriers, such as tariffs, trade diversion would likely occur. For example, when the United States has historically imposed tariffs on imports from one country, U.S. imports from other countries have increased (see Prusa 1996).[5] However, U.S. exporters would likely find other international markets, albeit less profitable for their corn.

c. How significant is the risk that NAFTA renegotiations will drive other countries to explore import markets, including with agriculture?

Because there are fixed costs in establishing trading relationships, existing trade relationships are likely to continue even if North American Free Trade Agreement renegotiations cause increased uncertainty. However, the uncertainty could lead foreigners to consider diversifying their sources of imports. As such, U.S. producers will likely continue to export to Mexico and Canada, but U.S. producers may lose some sales as foreigners diversify their sources. In the short run, U.S. producers may find it hard to make up lost sales elsewhere, because it takes time to find new customers. However, in the long run, U.S. producers would find other foreign customers to buy their products, although the costs of transporting products to these markets would likely be higher and the prices received may be lower.

d. The Trump Administration is considering imposing new trade barriers on steel imports. Some have argued that other countries typically target retaliatory trade measures at the

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[4] https://www.ers.usda.gov/data-products/chart-gallery/gallery/chart-detail/?chartId=58396.

[5] Prusa, Thomas J., "The Trade Effects of U.S. Antidumping Actions," NBER Working Paper No. 5440, January 1996.

agricultural sector. Are there historical instances where this has occurred? If so, how strong were these measures?

When the U.S. government levied tariffs on steel imports in 2002, the European Union initiated steps to retaliate on $2.2 billion of U.S. exports of products such as vegetables, fruits, nuts, motorcycles, textiles, paper products, and furniture. The United States withdrew these steel tariffs in 2003 before the European Union went through with its retaliatory tariffs.

As another example, in 2009, Mexico retaliated against the United States for the cancellation of the cross-border long-haul trucking program. Mexico raised tariffs on around 90 products, including agricultural products, with affected exports valued at around $2 billion. In 2011, retaliatory duties were removed after the United States agreed to allow Mexican trucks to operate in the U.S. as part of a pilot program.

e. If there have been retaliatory measures in the past, how did these measures hurt the agricultural economy?

As estimated in Zahniser et al. (2016),[6] the Mexican tariffs reduced U.S. sales of targeted agricultural products by 22 percent, a value of $984 million. Although they do not find that reduced exports to Mexico were offset by increased sales of these same goods to other countries, they look over only a two year horizon, which may be too short a time to establish new trading relationships.

f. Assume that similar agricultural retaliatory trade measures are imposed in response to new steel trade barriers. How would these measures impact the agricultural economy?

Similar to question (c), there may be lost agricultural sales in the short run. Eventually, U.S. agricultural producers likely would find other customers.

5. Many economists point to weak productivity growth as one of the major contributors to slower economic growth overall.

a. Do you agree with this assessment?

Yes. Economic growth reflects contributions from both changes in output per hour, or productivity, and changes in the total number of hours worked in the economy. The step-down in business sector productivity growth in recent years has been substantial: productivity growth averaged 1-1/2 percent in the ten-year period ending in 2016; over the previous ten years, its average was 2-1/2 percent. That being said, a secular decline in the growth of hours worked has reduced economic growth as well.

b. Do you believe productivity measurements accurately account for new technology?

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[6] Zahniser, Steven, Tom Hertz, and Monica Argoti, "Quantify the Effects of Mexico's Retaliatory Tariffs on Selected U.S. Agricultural Exports," Applied Economic Perspectives and Policy, Vol. 38, No. 1, 2016, pp. 93-112.

Most of the challenge in measuring productivity, especially with regard to new technology, is in measuring prices. For example, when "big box" retailers became prevalent in the 1980s and 1990s, they offered many items at lower prices than conventional stores. These lower prices were due in part to improvements in the technology used by retailers to manage their supply chain, but arguably also reflected changes in quality of service. Official statistics struggled with the challenge of how much of the big-box discount to attribute to a different shopping experience and how much to treat as a productivity improvement.

However, properly measuring the effects of new technology has always been a significant challenge. More recently, the same price measurement challenge mentioned above has emerged with the shift in the retail sector toward e-commerce. More generally, economists have not found that measurement problems have gotten worse, or that economic activity has shifted to more poorly measured sectors in a way that would suggest that recent readings on productivity are less credible than those in the past. Thus, there is no compelling evidence that the recent productivity slowdown is simply an artifact of problems measuring new technology. However, this is an area of active research, and substantial uncertainty remains.

c. How does current policy impede productivity growth?

Contributors to productivity growth include (1) technological innovation, (2) human capital, (3) business capital, and (4) reallocation (matching labor and capital resources to their best employment). Government policy can affect productivity through all four of these channels.

It would be inappropriate for the Federal Reserve to criticize or endorse specific government policies for their effect on productivity, but the most constructive policy interventions address failures of the market system to guide resources to their best use. For example, practical technological innovation can depend on the performance of basic research (oftentimes undertaken many years earlier) with no known commercial application, and private sector research and development will tend to underemphasize such things; so, policies that encourage basic research indirectly promote productivity growth. With regard to the labor force, government support for education is justified because the cost to society when young adults fail to prepare for the job market exceeds the private cost to the individual.

Policy uncertainty is an important consideration as well. To the degree that risk-averse firms adopt a more cautious approach to investment when the future path of government policy is unclear, such uncertainty can retard productivity growth.

d. How can the United States improve productivity?

There may be opportunities to influence productivity through the channels discussed above. For example, although private research and development (R&D) has recovered since the Great Recession, government R&D remains low by historical standards, raising the possibility that we are sowing fewer seeds that may yield future practical innovations. With regard to human capital, recent research has highlighted the lifelong impact of early childhood education for poor students who would not otherwise have been in a stimulating environment. And regarding business investment, as noted above, a stable and predictable policy regime may encourage capital spending. Also, the stock of capital employed by the private sector includes roads, bridges, and so forth that are provided by the government, and such investment has slowed in recent years. Finally, government policies should be evaluated critically with respect to their effects on the free flow of labor and capital.

6. According to research compiled by AEI scholar, Nicholas Eberstadt, in his book Men Without Work, the proportion of prime-age men out of the labor force more than tripled in the past 50 years, from only 3.4% in 1965 to 11.8% in 2015. In addition, eight times as many prime-age men were economically inactive and not pursuing education in 2014 than in 1965.

a. What priority should we give this measurement in our broader economic calculus?

One important indicator of the health of the labor market is the labor force participation rate (LFPR), defined as the fraction of the working-age (16 years and older) population that is working or looking for work. The LFPR increased from less than 60 percent in the early 1960s to about 67 percent by the late 1990s, with much of the rise reflecting an increase in women's labor force attachment. Since then, the LFPR has fallen to about 63 percent. Although much of this decline is attributable to population aging as members of the baby boom cohort (born 1946 to 1964) have begun to reach retirement age, some of the decline in the overall LFPR is also attributable to the continued decline in LFPR for prime-age (25-54 year old) men.

The decline in LFPR for prime-age men is especially notable because they have historically had high levels of labor force participation. Moreover, this decline has been particularly steep relative to trends in the LFPR for other demographic groups, and has been especially steep for prime-age men with no more than a high school education. Understanding why the LFPR for prime-age men has fallen, and how responsive the LFPR for this group may be to further economic expansion, is important for determining whether the LFPR for prime-age men can reverse some of its longer-run decline, and how much additional improvement in labor force participation overall is possible if broader economic conditions remain favorable. Of particular interest to monetary policymakers is assessing where the labor market stands in the aggregate relative to the full-employment benchmark.

b. To what do you attribute this decline in labor force participation?

One possibility is that there has been a change in the composition of the types of available jobs, which may have disproportionately reduced employment opportunities for prime-age men (especially men with no more than a high school degree). Researchers have highlighted at least two potentially significant changes in the labor market that may have led to diminished job availability for these men. The first is the increased use of automation in the production process and computers in the workplace more generally, which has likely resulted in the elimination of some jobs over the past few decades that are now more efficiently performed by machines. The second is increased globalization, which is likely reinforcing the effects of automation. Though trade is generally beneficial, increased competition from lower-priced imports in some industries, according to some researchers, may be contributing to the decline in manufacturing employment. Both of these changes may have contributed to the decline in jobs that were particularly common for prime-age men, especially in manufacturing, and some of the workers who have been displaced by these changes may have opted to drop out of the labor force.

Another possibility is that prime-age men's ability to work or desire to work given available employment opportunities has diminished. For example, evidence suggests that significant health limitations may inhibit many individuals from participating in the labor force, and opioid use may also be an increasingly important barrier to employment for some individuals. Also, the severity and length of the Great Recession, and the sluggishness of the recovery, may have degraded somewhat the skills of individuals who experienced long spells of non-employment, or caused some employers to believe that such individuals' skills have decayed. Consequently, some individuals who lost their jobs during or after the Great Recession may have come to believe that they were unlikely to find suitable employment, and responded by dropping out of the labor force.

c. What types of policies could be effective in improving labor force participation among prime-age men?

Most broadly, it seems likely that policies supportive of continued economic expansion would improve job opportunities and encourage labor force attachment among all workers, including prime-age men.

Designing policies that aim to improve the labor force attachment for prime-age men can be challenging but should probably focus on some of the previously mentioned issues. For example, workforce development programs targeted to individuals displaced from jobs in shrinking industries and occupations could provide information on the current needs of local employers, provide re-training or additional education to meet those demands, and perhaps offer relocation assistance for moving to areas where job opportunities are most abundant. These programs may be particularly effective for younger workers (who are more geographically mobile and have more of their career remaining to benefit from the new skills provided by re-training), and may be most productively targeted at areas of the country where the decline in job opportunities has been most significant (such as locations that specialized in certain manufacturing industries). Another potentially fruitful approach may be promoting entrepreneurship as a path to a productive career, by offering education in the management and business skills necessary for operating a successful small business.

7. According to research from the Economic Innovation Group, the new startup rate is near record lows, dropping by "half since the late 1970s." The total number of firms in the U.S. dropped by around 182,000 from 2007 – 2014.

a. Are you concerned about this decline in new startups and broader economic consolidation?

The decline in new startups has been attracting a lot of attention, including within the Federal Reserve System, partly out of concern that some of the more recent decline might have played a role in the slow recovery after the Great Recession.

The startup rate (defined as the share of firms that are new in a given year) fell from 12.5 percent in 1980 to 8.0 percent in 2014 (the latest year for which data are available). The decline in startup activity is worth studying for several reasons. Research has shown that new firm entry is a significant driver of aggregate job gains and of productivity growth. Moreover, changes in employment at new and young firms tend to account for a large share of job growth during recoveries.

Economists have found that the decline in startup activity since 2000 looks somewhat different from the decline between 1980 and 2000. Two factors can account for much of the decline in the startup rate prior to 2000, neither of which is believed to have reduced American living standards broadly.

- Due to demographic changes, particularly birth rate patterns during the late-20th century, the U.S. labor force has grown more slowly in recent decades than previously. This slowing is believed to have reduced firm entry rates because new firm formation is typically highly responsive to labor force growth.
- Substantial consolidation to the retail trade sector in the 1980's and the 1990's, which was a slow growth sector that had historically been characterized by high rates of entrepreneurship.

While the demographic and industrial patterns described above have continued to affect startup rates after 2000, the sources of the decline in startup activity appear to have expanded and may be cause for concern.

- The decline in activity of young and startup firms spread to the information and high tech sectors after 2000, and across most industries rapid growth in employment, revenue, and value among young firms became less common. Falling startup activity in highly innovative sectors, along with the decline in high-growth outcomes among startups more broadly, may have negative implications for productivity and, therefore, American living standards.
- Reduced competition from high-performing new entrants may also be contributing to increased concentration in many industries in the U.S. Whether rising concentration reflects a consumer-harming decline in the intensity of competition is still an open question, and the causes of the post-2000 decline in high-growth startup activity remain unknown. Researchers in the Federal Reserve System and elsewhere are actively investigating this topic.

b. What, if any, policy solutions should be explored in order to respond to these challenges?

The underlying causes of the post-2000 decline in high-growth entrepreneurship are still not well understood, so identifying policy remedies for these patterns is difficult. However, there is a large body of research on the policy determinants of entrepreneurship generally. It would be inappropriate for the Federal Reserve to criticize or endorse specific government policies in this area, but a number of academic studies have explored these issues and can be summarized here.

In some cases, lack of access to financing can inhibit the formation and growth of new firms. In the wake of the financial crisis, credit markets were severely impaired, though functioning has largely recovered. Research suggests that entrepreneurship may also be supported by efforts to: reduce barriers to starting a firm more broadly (including policies that implicitly subsidize wage-earning work over self-employment); maintain a robust education system to ensure potential entrepreneurs (particularly women and minorities, a partially untapped pool of potential entrepreneurs) and their potential employees can acquire crucial technical skills; ensure an equal playing field between incumbents and potential entrants; and preserve competition and the mobility of labor.

8. In 2007 you stated that the Phillips curve, the inverse relationship between unemployment and inflation, "is a core component of every realistic macroeconomic model." Is this still true? If so, how does the current trend of low inflation and low unemployment fit into this model? If not, what new models are in place to give the American people confidence in the Federal Reserve's ability to manage inflation?

The evidence does suggest that labor market conditions (as summarized by the unemployment rate for example) influence inflation, and in my view this Phillips curve relationship is an important component of macroeconomic models. However, the magnitude of this influence seems to be modest, and especially over short periods of time, the effect can easily be overshadowed by other factors influencing inflation. For example, the drop in oil prices and the strengthening exchange value of the dollar that began around mid-2014 held down inflation appreciably over the following couple of years, and those influences far outweighed the effect of a tightening labor market.

Moreover, given the limits of our knowledge and noise in the data, those "other factors" are not always readily identifiable. As I said in my recent testimony, the softening of inflation this past spring appeared to reflect unusual reductions in certain categories of prices, and I would expect those not to be repeated. In the Summary of Economic Projections from June, the median inflation projection from Federal Open Market Committee (FOMC) policymakers calls for inflation to reach 2 percent over the next two years, as recent softness is not repeated and as the labor market strengthens further. Policymakers certainly recognize the risks around their projections, and with inflation having run below the FOMC's 2 percent objective for most of the period since the last recession, the FOMC has emphasized that we are carefully monitoring progress toward our symmetric inflation goal.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
July 13, 2017

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Ben Sasse:</u>

1. Our financial system has become increasingly consolidated as community banks and credit unions either close their doors or merge with larger institutions.
    a. Are you concerned about this pattern? Why?
    b. What services can these smaller institutions provide that larger institutions cannot provide?

2. As you know, the CFPB may be moving forward on a rulemaking for Section 1071 of Dodd-Frank, which grants the CFPB the authority to collect small business loan data. I've heard some concerns that implementing Section 1071 could impose substantial costs on small financial institutions and even constrict small business lending.
    a. Are you concerned that a Section 1071 rulemaking could hurt small business access to credit?
    b. Has the Federal Reserve coordinated with the CFPB to ensure that implementing these requirements does not constrict small business access to credit?

3. I am very disturbed by the most recently available data on job openings and hires. As you know there were a record number of job openings, 6 million, while job hires fell to 5.1 million. This problem manifests itself in Nebraska as many businesses tell me that they have extreme difficulties finding and retaining talent.
    a. Does this mismatch between job openings and job hires represent a new normal? Or will economic growth eventually reduce this mismatch over time, without any major structural changes to our economy?
    b. What are the most prominent causes of this mismatch?
    c. In what industries is this mismatch most prominent?
    d. What demographic groups are most hurt by this mismatch?
    e. Today, many workers, including those late in their career, are forced to retool their skills to find a job in new fields. Can our economy's current ecosystem of education and job retraining programs adequately respond to this challenge? If not, what changes could better address this issue?

4. I am concerned about the impact of our recent trade disputes on our economy, particularly with agriculture.
    a. How dependent is the agricultural economy on exports with other countries?
    b. U.S. corn exports to Mexico from January through May of this year are down by 7% compared to last year. Unfortunately, this may be due to reported efforts by Mexico to reduce corn imports from the United States, including by opening up trade with Brazil or Argentina. Are there historic examples of countries exploring other import markets in response to trade disputes?
    c. How significant is the risk that NAFTA renegotiations will drive other countries to explore import markets, including with agriculture?
    d. The Trump Administration is considering imposing new trade barriers on steel imports. Some have argued that other countries typically target retaliatory trade

measures at the agricultural sector. Are there historical instances where this has occurred? If so, how strong were these measures?

e. If there have been retaliatory measures in the past, how did these measures hurt the agricultural economy?

f. Assume that similar agricultural retaliatory trade measures are imposed in response to new steel trade barriers. How would these measures impact the agricultural economy?

5. Many economists point to weak productivity growth as one of the major contributors to slower economic growth overall.
   a. Do you agree with this assessment?
   b. Do you believe productivity measurements accurately account for new technology?
   c. How does current policy impede productivity growth?
   d. How can the United States improve productivity?

6. According to research compiled by AEI scholar, Nicholas Eberstadt, in his book Men Without Work, the proportion of prime-age men out of the labor force more than tripled in the past 50 years, from only 3.4% in 1965 to 11.8% in 2015. In addition, eight times as many prime-age men were economically inactive and not pursuing education in 2014 than in 1965.
   a. What priority should we give this measurement in our broader economic calculus?
   b. To what do you attribute this decline in labor force participation?
   c. What types of policies could be effective in improving labor force participation among prime-age men?

7. According to research from the Economic Innovation Group, the new startup rate is near record lows, dropping by "half since the late 1970s." The total number of firms in the U.S. dropped by around 182,000 from 2007 – 2014.
   a. Are you concerned about this decline in new startups and broader economic consolidation?
   b. What, if any, policy solutions should be explored in order to respond to these challenges?

8. In 2007 you stated that the Phillips curve, the inverse relationship between unemployment and inflation, "is a core component of every realistic macroeconomic model." Is this still true? If so, how does the current trend of low inflation and low unemployment fit into this model? If not, what new models are in place to give the American people confidence in the Federal Reserve's ability to manage inflation?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 1, 2017

The Honorable Heidi Heitkamp
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 1 that you submitted following the July 13, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on July 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Heitkamp:

Macroeconomic Policy

1. Today we have the strongest labor market in a decade, a 4.4 percent unemployment rate, yet wages are rising barely faster than inflation. Many economists have pointed to low productivity growth as the driving factor for why Americans haven't seen significant growth in real wages.

- **Do you believe productivity is the biggest factor holding back wage growth?**
- **Is slow productivity growth in part the result of businesses that have failed to pass on the gains from a growing economy by training and investing in their workers?**
- **What can we do to help turn the tide on productivity growth and boost wages for American workers?**

It is true that wage gains have been disappointing, and while this is not the only factor, sluggish productivity growth has been an important reason that wage growth has not been higher. Productivity in the business sector has increased only 1-1/4 percent per year since 2006, compared with its average of 2-1/2 percent from 1949 to 2005. And over the past five years, productivity rose less than ¾ percent per year, on average. Over time, sustained increases in productivity are necessary to support rising household incomes and living standards.

Economists do not fully understand the exact causes of the slowdown in productivity growth. To some extent, the slowdown may reflect the aftermath of the global financial crisis and recession. For example, research and development spending, an important source of innovation, fell sharply during the recession. To the extent such factors are at play, we may expect productivity growth to improve as the economy strengthens further. However, some analyses emphasize factors that predate the financial crisis and recession. For example, evidence suggests that the effects of the information technology revolution were fading by the early 2000s. Moreover, some see recent technological advances, including in information technology (IT), as less revolutionary than earlier technologies like electricity and the internal combustion engine. These more structural explanations might portent a longer period of slow productivity growth; though it certainly is possible that IT-related innovations, such as robotics and genomics, will eventually produce significant advances.

While there is disagreement about what policies would most effectively boost productivity, a variety of policy initiatives would likely contribute. More investment, both through improved public infrastructure and more encouragement for private investment, would likely play a meaningful role. More effective regulation likely could contribute as well. And better education, at all grade levels and including adult education, could both promote productivity growth and contribute to higher incomes not just on average, but throughout our society.

- **How proactive are you going to be able to be during the unprecedented unwinding of the fed's portfolio, should the impact of balance normalization deteriorate financial conditions to a point where the real economy is adversely impacted?**

Provided that the economy evolves broadly as anticipated, the Federal Open Market Committee (FOMC) expects to begin implementing a balance sheet normalization program this year. Consistent with the Policy Normalization Principles and Plans released in 2014, this program would gradually decrease reinvestments and initiate a gradual and largely predictable decline in the Federal Reserve's securities holdings.

For both Treasury and agency securities, we will reinvest proceeds from our holdings only to the extent that they exceed gradually rising caps on the reductions in our securities holdings. Initially, these caps will be set at relatively low levels--$6 billion per month for Treasuries and $4 billion per month for agency securities. Any proceeds exceeding those amounts would be reinvested. These caps will gradually rise over the course of a year to maximums of $30 billion per month for Treasuries and $20 billion per month for agency securities, and will remain in place through the normalization process. By limiting the volume of securities that private investors will have to absorb as we reduce our holdings, the caps should guard against outsized moves in interest rates and other potential market strains. The FOMC announced the details of this plan in advance so that when it goes into effect, no one is taken by surprise and market participants understand how it will work.

The FOMC expects this plan for reducing the Federal Reserve's securities holdings will run quietly in the background. Of course, the FOMC will be monitoring the process of balance sheet normalization over time and its effects in financial markets. The FOMC has noted that it would be prepared to resume reinvestments if a material deterioration in the economic outlook were to warrant a sizable reduction in the federal funds rate. More generally, the FOMC would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 18, 2017

The Honorable Heidi Heitkamp
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2 and 3 that you submitted following the July 13, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On September 1, 2017, I provided a response to question 1. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your questions submitted..

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on July 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Heitkamp:

Asset Thresholds for Systemically Important Financial Institutions

2. On several occasions before this Committee Governor Tarullo stated that the dollar asset thresholds in Dodd Frank such as the $50 billion threshold for SIFI designation, is far too high.

- **Do you believe regulators could effectively address systemic risk if the threshold were raised above $50 billion?**
- **Are there specific provisions in Dodd Frank which you believe are particularly costly or unnecessary for a certain subset of banks above the $50 billion threshold?**
- **Are there specific provisions in Dodd Frank which you believe are necessary for all banks above $50 billion in assets that should be retained in order to mitigate systemic risk?**
- **What concerns do you have with having a purely qualitative test for identifying systemic risk?**

In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. The Federal Reserve Board (Board) has been working for many years to make sure that our regulation and supervision is tailored to the size and risk posed by individual institutions.

The failure or distress of a large bank can harm the U.S. economy. The recent financial crisis demonstrated that excessive risk-taking at large banks makes the U.S. economy vulnerable. The crisis led to a deep recession and the loss of nearly nine million jobs. Our regulatory framework must reduce the risk that bank failures or distress will have such a harmful impact on economic growth in the future.

The Board has already implemented, via a regulation that was proposed and adopted following a period of public notice and comment, a methodology to identify global systemically important banking organizations (GSIBs), whose failure could pose a significant risk to the financial stability of the United States.[1] The "systemic footprint" measure that determines whether a large firm is identified as a GSIB includes attributes that serve as proxies for the firm's systemic importance across a number of categories: size, interconnectedness, complexity, cross-jurisdictional activity, substitutability, and reliance on short-term wholesale funding.

There are many large financial firms whose failure would pose a less significant risk to U.S. financial stability, but whose distress could nonetheless cause notable harm to the U.S. economy (large regional banks). Some level of tailored enhanced regulation is appropriate for these large regional banks. The failure or distress of a large regional bank could harm the U.S. economy in

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[1] Board of Governors of the Federal Reserve System (2015), "Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies," final rule, Federal Register, vol 80 (August 14), pp. 49082-49116.

several ways: by disrupting the flow of credit to households and businesses, by disrupting the functioning of financial markets, or by interrupting the provision of critical financial services, including payments, clearing, and settlement. Economic research has documented that a disruption in the flow of credit through banks or a disruption to financial market functioning can affect economic growth.[2]

The application of tailored enhanced regulation should consider the size, complexity, and business models of large regional banks. The impact on economic growth of a large regional bank's failure will depend on factors such as the size of the bank's customer base and how many borrowers depend on the bank for credit. Asset size is a simple way to proxy for these impacts, although other measures may also be appropriate. For large regional banks with more complex business models, more sophisticated supervisory and regulatory tools may be appropriate. For example, the Board recently tailored our Comprehensive Capital Analysis and Review qualitative assessment to exclude some smaller and less complex large regional banks, using asset size and nonbank assets to measure size and complexity, respectively.[3] In other contexts, foreign activity or short-term wholesale funding may be another dimension of complexity to consider. Any characteristics or measures that are used to tailor enhanced regulation for large regional banks should be supported with clear analysis that links them with the potential for the bank's failure or distress to cause notable harm to the U.S. economy.

The Board currently has only limited authority to tailor the enhanced prudential standards included in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). In particular, Congress required that certain enhanced prudential standards must apply to firms with \$10 billion in total assets, with other standards beginning to apply at \$50 billion in total assets.

You asked whether regulators could effectively address systemic risk if these statutory thresholds were raised. The Board has supported increasing these thresholds. We believe that the risks to financial stability from large banks, as noted above, can be addressed with tailored enhanced regulation, including higher thresholds.

You also asked about the specific provisions in section 165 of the Dodd-Frank Act. The Board has not taken a position on the relative merits of these provisions. As noted above, some level of tailored enhanced regulation is appropriate for large banks, taking into account how a particular regulatory standard affects a bank's size, complexity, and business model. Among these many provisions, the Board believes that supervisory stress testing is one of the most valuable, providing a forward-looking assessment of the largest firms' ability to continue providing credit to the real economy in the event of a significant macroeconomic and financial stress.

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[2] For evidence on the link between bank distress and economic growth, see Mark A. Carlson, Thomas King, and Kurt Lewis (2011) "Distress in the Financial Sector and Economic Activity," The B.E. Journal of Economic Analysis & Policy: Vol. 11: Iss. 1 (Contributions), Article 35. For evidence on the link between financial market functioning and economic growth, see Simon Gilchrist and Egon Zakrajšek (2012), "Credit Spreads and Business Cycle Fluctuations," American Economic Review, Vol. 102 (4): 1692-1720.

[3] Board of Governors of the Federal Reserve System (2017), "Amendments to the Capital Plan and Stress Test Rules; Regulations Y and YY," final rule, Federal Register, vol 82 (February 3), pp. 9308-9330.

You asked whether I have concerns about using a qualitative test in place of the existing quantitative thresholds. As my answer above noted, I believe that it would be logical to use a wider range of factors than asset size to determine the application of tailored enhanced regulation for large regional banks. Such factors should include quantitative metrics.

Congress could usefully decide to pursue either raising dollar thresholds or giving authority to the Board to decide which firms are subject to enhanced prudential standards. The Board stands ready to work with Members on the design of either approach.

Liquidity Coverage Ratio

3. As watchdogs of the financial system, we know that the Fed, OCC, and FDIC focus on promoting safety and soundness, and support transparency. To that end, firms are required to disclose extensive information on their financial health to the public.

Like all things, balance is important and in drafting rules and regulations, the agencies consider what is useful information versus what can be misleading and inadvertently hurt the markets. We've seen the Federal Reserve be thoughtful about that -- for example, the Fed does not disclose to the public who accesses its discount window for at least 2 years, balancing transparency with risk of public misconception. The Fed has recognized in that case that immediate information could actually lead to a market stress.

In December, the Federal Reserve finalized a rule requiring banks to publicly disclose – within 45 days of the end of quarter - the details of a complex liquidity metric called the Liquidity Coverage Ratio.

- **Why does the Fed allow a 2 year disclosure period for the discount window and only 45 days for this complex metric when the risks of public misconception are the same?**
- **How is the Fed promoting safety and soundness by asking banks to disclose complicated liquidity information that could lead to a financial stress?**
- **Since the Fed is already monitoring firms' liquidity data every day, why do we need this additional disclosure requirement?**
- **Would the Fed find it beneficial to conduct further study on the rule before requiring disclosures?**

The different timelines required for discount window and Liquidity Coverage Ratio (LCR) disclosures reflect the different purposes of the disclosures.

The Dodd-Frank Act specified the content of the discount window disclosures as well as the two year disclosure period. The primary purpose of the discount window disclosure is to provide transparency and accountability to the public regarding the Board's lending activities. Eligible borrowers may choose to borrow from the discount window both under normal conditions and when they are experiencing a liquidity stress. The discount window disclosures require all borrowing institutions to disclose transaction-specific information about a bank's business decision to borrow at the window, including the amounts borrowed and the collateral provided to secure each loan. A key reason for the two-year lag in disclosing this information is to preserve the willingness of solvent institutions to use the discount window, ensuring the effectiveness of the discount window as a backstop liquidity facility and systemic liquidity shock absorber for solvent institutions. In passing the Dodd-Frank Act, the Congress weighed the need for greater transparency about the Board's lending operations and the need to maintain the discount window as an effective liquidity backstop, and concluded that a two-year lag in disclosing transaction-level information on discount window borrowing appropriately balanced these two policy objectives.

In contrast, the primary purpose of the LCR public disclosure requirements is to promote safety and soundness by providing market participants high-level information about the liquidity risk profile of large banking organizations to support the ability of market participants to understand and constrain bank risk-taking. This sort of market discipline can usefully complement the Board's supervisory practices and policies. During times of stress, public disclosures can also enhance stability by providing relevant and sufficiently timely information that assures counterparties and other market participants regarding the resilience of covered companies. Without information about the liquidity strength of their counterparties, market participants may assume the worst regarding banking institutions and draw back from the entire market, exacerbating the problem.

The LCR public disclosures must be sufficiently informative and timely to serve their intended purpose. In order to mitigate potential financial stability and firm-specific risks related to disclosing real-time liquidity information, the LCR public disclosure rule requires covered companies to disclose average values of broad categories of liquidity sources and uses over a quarter, with a 45-day lag after the end of the quarter. Unlike event-driven discount window disclosures, the LCR public disclosure rule requires a set of firms to make regular periodic disclosures and does not require disclosure of transaction-specific information. They are more analogous to the Board's quarterly capital public disclosure requirements, which also focus on a firms' financial condition and risk management practices.

Given the fundamentally different purposes of the discount window and LCR disclosures, the Board did not provide for a common timeframe for the disclosures. While I do not believe it is necessary to conduct further study on the LCR public disclosure rule at this time, the Board will carefully monitor the implementation of these requirements going forward. If warranted, I would be willing to revisit aspects of the LCR disclosures that result in significant undesirable or unintended consequences.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
July 13, 2017

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Heidi Heitkamp:

Macroeconomic Policy

Today we have the strongest labor market in a decade, a 4.4 percent unemployment rate, yet wages are rising barely faster than inflation. Many economists have pointed to low productivity growth as the driving factor for why Americans haven't seen significant growth in real wages.

- Do you believe productivity is the biggest factor holding back wage growth?

- Is slow productivity growth in part the result of businesses that have failed to pass on the gains from a growing economy by training and investing in their workers?

- What can we do to help turn the tide on productivity growth and boost wages for American workers?

- How proactive are you going to be able to be during the unprecedented unwinding of the fed's portfolio, should the impact of balance normalization deteriorate financial conditions to a point where the real economy is adversely impacted?

Asset Thresholds for Systemically Important Financial Institutions

On several occasions before this Committee Governor Tarullo stated that the dollar asset thresholds in Dodd Frank such as the $50 billion threshold for SIFI designation, is far too high.

- Do you believe regulators could effectively address systemic risk if the threshold were raised above $50 billion?

- Are there specific provisions in Dodd Frank which you believe are particularly costly or unnecessary for a certain subset of banks above the $50 billion threshold?

- Are there specific provisions in Dodd Frank which you believe are necessary for all banks above $50 billion in assets that should be retained in order to mitigate systemic risk?

- What concerns do you have with having a purely qualitative test for identifying systemic risk?

Liquidity Coverage Ratio

As watchdogs of the financial system, we know that the Fed, OCC, and FDIC focus on promoting safety and soundness, and support transparency. To that end, firms are required to disclose extensive information on their financial health to the public.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
July 13, 2017

Like all things, balance is important and in drafting rules and regulations, the agencies consider what is useful information versus what can be misleading and inadvertently hurt the markets. We've seen the Federal Reserve be thoughtful about that -- for example, the Fed does not disclose to the public who accesses its discount window for at least 2 years, balancing transparency with risk of public misconception. The Fed has recognized in that case that immediate information could actually lead to a market stress.

In December, the Federal Reserve finalized a rule requiring banks to publicly disclose – within 45 days of the end of quarter - the details of a complex liquidity metric called the Liquidity Coverage Ratio.

- Why does the Fed allow a 2 year disclosure period for the discount window and only 45 days for this complex metric when the risks of public misconception are the same?
- How is the Fed promoting safety and soundness by asking banks to disclose complicated liquidity information that could lead to a financial stress?
- Since the Fed is already monitoring firms' liquidity data every day, why do we need this additional disclosure requirement?
- Would the Fed find it beneficial to conduct further study on the rule before requiring disclosures?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 1, 2017

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the written question that you submitted following the July 13, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on July 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Rounds:

1. Chair Yellen:

During your appearance before the Banking Committee in February, you mentioned that commercial and industrial or C and I lending has grown by over 75 percent since the end of 2010. This statistic was also mentioned in a hearing our colleagues in the House Financial Services Committee held in April when Mr. Peter Wallison from the American Enterprise Institute explained that the 75 percent increase in C and I lending is somewhat misleading. According to Mr. Wallison, the banking sector as a whole has yet to reach the lending level it was at in 2008 aside from a few of the very largest banks.

In addition, Mr. Wallison's written testimony cited two Fed researchers – Dean Amel and Traci Mach – who have found that there is a significant difference between the volume of loans made for amounts under 1 million dollars, which is oftentimes a proxy for lending from small institutions, and loans made for amounts over 1 million.

Can you please comment on the degree to which our banking sector, and our small banks in particular, have yet to make up the ground in C and I lending post-crisis? And what's your take on the research from Dr. Amel and Dr. Mach?

Total commercial and industrial (C&I) loans outstanding have grown since the end of 2010 for all commercial banking organizations -- including for large commercial banking organizations as a group and for small commercial banking organizations as a group. Although growth has been more rapid for the group comprised of larger banking organizations, smaller banks, in aggregate, have also experienced significant growth in C&I lending during this time period. For example, total C&I loan balances at banking organizations with less than $10 billion in consolidated assets (a commonly-used threshold for defining community banks) grew by more than 20 percent from 2010 to 2016, and the aggregate volume of C&I loans at these smaller banks was greater at year-end 2016 than at year-end 2007 or year-end 2008. The lower rate of growth in lending for the group comprised of smaller banks is, in part, attributable the fact that the number of banks in this size category has declined, while the number of banks with more than $10 billion in assets has increased. This shift in the size distribution of banks is due to the combined effects of the acquisition of some community banks by larger banks and the growth of some community banks beyond the $10 billion threshold by 2016.

The research by Dr. Amel and Dr. Mach[1], which is referenced in Mr. Wallison's testimony, notes that business loans under $1 million at origination are often used as a proxy for small business lending, not as a proxy for lending by community banks. Bank Call Reports filed by all commercial banks and thrift institutions provide data on their small loans to businesses. However, the Call Reports do not provide information on the size of the business obtaining the loan.

[1] Amel, Dean, and Traci Mach (2017). "The Impact of the Small Business Lending Fund on Community Bank Lending to Small Businesses," Economic Notes, vol. 46, no. 2, pp. 307–328.

Amel and Mach (2017) look specifically at small business lending by community banks. They note in their paper that following the financial crisis, total outstanding loans to businesses at commercial banks declined sharply. As of the third quarter of 2010, larger loans to businesses had begun to recover, but smaller loans to businesses were still in decline. The lack of recovery in smaller loans to businesses was a primary reason for the creation of the Small Business Lending Fund (SBLF) in 2010. Amel and Mach's work finds that the SBLF had little effect on small business lending by community banks. Although SBLF-participating community banks did increase their small business lending by a greater percentage than did non-participating community banks, this higher rate of growth in lending was already evident prior to the implementation of the SBLF, and did not change following the introduction of the SBLF.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
July 13, 2017

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Mike Rounds:</u>

Chair Yellen:

During your appearance before the Banking Committee in February, you mentioned that commercial and industrial or C and I lending has grown by over 75 percent since the end of 2010. This statistic was also mentioned in a hearing our colleagues in the House Financial Services Committee held in April when Mr. Peter Wallison from the American Enterprise Institute explained that the 75 percent increase in C and I lending is somewhat misleading. According to Mr. Wallison, the banking sector as a whole has yet to reach the lending level it was at in 2008 aside from a few of the very largest banks.

In addition, Mr. Wallison's written testimony cited two Fed researchers – Dean Amel and Traci Mach – who have found that there is a significant difference between the volume of loans made for amounts under 1 million dollars, which is oftentimes a proxy for lending from small institutions, and loans made for amounts over 1 million.

Can you please comment on the degree to which our banking sector, and our small banks in particular, have yet to make up the ground in C and I lending post-crisis? And what's your take on the research from Dr. Amel and Dr. Mach?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 1, 2017

The Honorable Sherrod Brown
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the July 13, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on July 24, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Ranking Member Brown:</u>

1. I believe the full employment part of the dual mandate has served the economy well, including reducing disparities in labor market data.

Can you talk about why the full employment mandate is so important and what would be the impact on groups that have traditionally been disadvantaged in the labor market if the mandate were eliminated or altered?

Congress set forth the mandate for monetary policy in the Federal Reserve Act, which directs the Federal Reserve Board (Board) to conduct monetary policy so as to promote maximum employment and stable prices. My colleagues and I on the Federal Open Market Committee (FOMC) are fully committed to pursuing the goals that Congress has given us. Both objectives of the dual mandate are important in promoting the economic well-being of the United States. Furthermore, the dual mandate has served the country well. For the past quarter century or so, inflation has been generally low and stable, and while the Great Recession severely impacted households and businesses, the Board had a clear mandate to counteract the profound economic weakness of that time and exercised that mandate forcefully. As a result of policies implemented by the Board, unemployment has declined substantially and deflation has been avoided.

When the economy softens, all major demographic groups tend to experience higher rates of unemployment. However, a marked characteristic of recent business cycles is that groups that have traditionally been disadvantaged in the labor market have tended to experience a higher-amplitude version of the unemployment experience of whites. For example, during the period around the Great Recession, the unemployment rate for whites increased from about 4 percent to about 9 percent. At roughly the same time, the unemployment rate for blacks or African-Americans increased from about 8 percent to a little over 16 percent, a larger increase that started from a higher level. Similarly, the unemployment rate for Hispanics or Latinos increased from about 5 percent to nearly 13 percent. From the worst time of the Great Recession, all three groups have enjoyed substantial improvements in their respective unemployment rates. Most recently, these rates have been in the neighborhood of 3¾ percent for whites, 7½ percent for blacks, and 5 percent for Hispanics. It is important to note that all three rates have come down substantially, and that the rates for blacks and Hispanics have declined by more than the rate for whites in recent years. However, it is also important to point out that the rates for blacks and Hispanics remain well above the rate for whites. Overall, the relative labor market experience of these groups has not improved in recent years, and that is a matter of considerable concern. Still, an important consequence of success in achieving the maximum employment objective of the dual mandate is that the benefits of a strong economy are shared widely across the individuals and households that make up our nation.

2. I think the Federal Reserve Board and the Federal Reserve Bank of Atlanta made a great choice earlier this year of Raphael Bostic as the new President of the Atlanta Fed. The Richmond Fed is currently undergoing a search for their President. Are you satisfied with the search process currently underway and confident that it will result in a diverse pool of candidates for consideration by the Richmond Federal Reserve Bank Board of Directors and the Federal Reserve Board of Governors?

As you know, I have repeatedly expressed my personal commitment, and our institutional commitment, to advancing the objectives of diversity and inclusion throughout our organization, including at the level of presidents and other senior leadership. Our searches for candidates for Reserve Bank presidents are planned and conducted with a particular emphasis placed on identifying highly qualified candidates from diverse personal, academic, and professional backgrounds.

As you noted, the search for the next president of the Federal Reserve Bank of Richmond (Richmond) is currently underway. The Reserve Bank's search committee, which is comprised of directors who are not affiliated with commercial banks or other entities supervised by the Board, has engaged a highly-regarded, national executive search firm with a strong track record in identifying highly-qualified and diverse candidate pools for executive positions to assist in the search process.

As we did during the Federal Reserve Bank of Atlanta search, and consistent with the Board of Governors' responsibilities under the Federal Reserve Act, my colleagues, typically represented by the Chair of the Board's Committee on Federal Reserve Bank Affairs, are following the Richmond search process closely at every stage. We have emphasized to the executive search firm and the search committee the importance that the Board attaches to the identification of as large a pool as possible of highly-qualified candidates from diverse personal, academic, and professional backgrounds.

Indeed I am confident in the strength of these processes, and in the commitment of my colleagues here at the Board and in Richmond to our shared objectives for the search.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
July 13, 2017

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Ranking Member Sherrod Brown:</u>

1) I believe the full employment part of the dual mandate has served the economy well, including reducing disparities in labor market data.

   Can you talk about why the full employment mandate is so important and what would be the impact on groups that have traditionally been disadvantaged in the labor market if the mandate were eliminated or altered?

2) I think the Federal Reserve Board and the Federal Reserve Bank of Atlanta made a great choice earlier this year of Raphael Bostic as the new President of the Atlanta Fed. The Richmond Fed is currently undergoing a search for their President. Are you satisfied with the search process currently underway and confident that it will result in a diverse pool of candidates for consideration by the Richmond Federal Reserve Bank Board of Directors and the Federal Reserve Board of Governors?

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, DC 20510-6075

July 24, 2017

The Honorable Janet Yellen
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Madam Chair:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs at our hearing on Thursday, July 13 2017 entitled "*The Semiannual Monetary Policy Report to the Congress*." In order to complete the hearing record, we would appreciate your response to the enclosed as soon as possible. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a MS Word or .pdf attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo

Mike Crapo
Chairman

MC/dr

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 11, 2017

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the written question that you submitted following the July 13, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on July 24, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Tillis:

1. I am very concerned about the method the Board has implemented to make determinations about the systemic risk profile of bank holding companies. As noted in the final rule issued July 20, 2015, the Board developed an "expected impact" framework, which is a consideration of each firm's expected impact on the financial system, determined as a function of the harm it would cause to the financial system were it to fail multiplied by the probability that it will fail.

To determine this potential harm, which Board staff deemed the "systemic footprint" of a particular firm, a multi-factored assessment methodology was developed. This test uses five equally-weighted categories that the Board asserts are "correlated with systemic importance" – size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity. Covered firms are then "scored" using these factors and firms with the highest scores are deemed to present systemic risks.

I believe that tracking and addressing systemic risks to the financial system is one of the most important responsibilities delegated to the Board of Governors. Due to the considerable significance, it is essential for the Board to use thoughtful, robust, and ultimately predicative tests/criteria/methods in its efforts.

Please indicate why you believe the five factor test that is currently being used is the best manner to determine the systemic impact of firms. Additionally, I respectfully request that you share the background materials/information/analyses that lead you (and or the Board) to draw this conclusion.

In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. The Federal Reserve has been working for many years to make sure that our regulation and supervision is tailored to the size and risk posed by individual institutions.

The five-factor test for determining the systemic footprint of global systemically important banks (G-SIBs) is used by the Federal Reserve Board (Board) to determine which banking firms are G-SIBs and to determine the capital surcharge for each G-SIB. The Board believes that the five-factor measure is a meaningful, but approximate, measure of a banking firm's systemic importance. The Board realizes that any such measure should evolve over time. As a result, the methodology is regularly reviewed, and is in the process of being reviewed now.[1]

The five-factor measure reflects substantial research efforts by both the international community and the Federal Reserve System. The analytical background for the Board's approach to G-SIB capital surcharges is spelled-out in a Board white paper,[2] along with the discussion in the Federal Register notice of the final rule.[3] The Basel Committee also has provided an explanation of its

[1] See Basel Committee on Banking Supervision, "Consultative Document: Globally-Systemically Important Banks-revised assessment framework." Issued for comment by June 30, 2017. March 2017.

[2] "Calibrating the GSIB Surcharge," Board of Governors of the Federal Reserve System, July 20, 2015.

[3] 80 FR 49088 (August 14, 2015).

five-factor measure.[4] An in-depth study of the Basel Committee's G-SIB capital surcharge system found that the weights used by its systemic indicator system produced results that were consistent with other approaches to creating a G-SIB index.[5] Moreover, the surcharges that were assigned under the five-factor measure are consistent with a range of alternative parameterizations of key variables in the formula.

The selected indicators in the Board's G-SIB capital surcharge framework were chosen to reflect the different aspects of how G-SIBs generate negative externalities when they are in financial trouble, and the different aspects of what makes a G-SIB critical for the stability of the financial system. The Board recognizes that there is no perfect measure of systemic importance and, as a result, the G-SIB measure focuses on indicators where there is substantial supervisory agreement about their link to systemic importance.

Additionally, while not directly asked in your question, an important topic related to this is ensuring that the Board continually assess its approaches to regulation to ensure that rules are tailored as much as possible to the actual risk of a regulated entity.

The Board has been making efforts to do this in many areas, such as our recent changes to our Comprehensive Capitol Analysis and Review qualitative analysis. However, as my colleague Governor Powell and I have noted, the Board has limited authority in tailoring certain provisions, such as the thresholds applied in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Further tailoring in areas such as these would require congressional action.

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[4] Basel Committee on Banking Supervision, "Global systemically important banks assessment methodology and higher loss absorbency requirement," July 2013.

[5] Wayne Passmore and Alex H. von Hafften, "Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?" Finance and Economics Discussion Series, Working Paper 2017-021, Appendix 1.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to Congress
July 13, 2017

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Thom Tillis:

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To determine this potential harm, which Board staff deemed the "systemic footprint" of a particular firm, a multi-factored assessment methodology was developed. This test uses five equally-weighted categories that the Board asserts are "correlated with systemic importance" – size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity. Covered firms are then "scored" using these factors and firms with the highest scores are deemed to present systemic risks.

I believe that tracking and addressing systemic risks to the financial system is one of the most important responsibilities delegated to the Board of Governors. Due to the considerable significance, it is essential for the Board to use thoughtful, robust, and ultimately predicative tests/criteria/methods in its efforts.

Please indicate why you believe the five factor test that is currently being used is the best manner to determine the systemic impact of firms. Additionally, I respectfully request that you share the background materials/information/analyses that lead you (and or the Board) to draw this conclusion.

August 7, 2017

The Honorable Ben Sasse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the July 27, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on August 1, 2017.

Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Sasse:

1. Our financial system has become increasingly consolidated as community banks and credit unions either close their doors or merge with larger institutions.

a. Are you concerned about this pattern? Why?
b. What services can these smaller institutions provide that larger institutions cannot provide?

Community banks play a critical role in our financial system and economy. While the consolidation trend in the industry has continued over the past 30 years, I believe that a number of factors in the post financial crisis environment have exacerbated the challenges facing these institutions, including the substantially increased cost of regulatory compliance. Despite this trend, community banks continue to support local economies and serve as a key source of financing to households and small businesses.

Research conducted over many years has concluded that community banks provide several distinct advantages to their customers compared to larger banks. For example, given their smaller size and less complex organizational structure, community banks are often able to respond with greater agility to lending requests. In addition, reflecting their close ties to the communities they serve and their detailed knowledge of their customers, community banks are able to provide customization and flexibility to meet the needs of their local communities and small businesses. Community banks are particularly important for rural communities, where the closing of a bank can be associated with a material decline in local economic activity.

Recognizing the important role of community banks in our diversified banking industry, if confirmed, I will work with my colleagues at the Federal Reserve to supervise and regulate community banks in a way that fosters safe and sound operation without limiting their capacity to support the financial needs of their communities.

2. Constituents in my state tell me that the EGRPRA report inadequately highlighted concrete ways to reduce the regulatory paperwork burden. What more can the Federal Reserve do to reduce the regulatory burden on community banks?

As noted in my previous answer, community banks play a critical role in our financial system and economy. If confirmed, I will work with my colleagues at the Federal Reserve to supervise and regulate community banks in a way that fosters safe and sound operation without limiting their capacity to support the financial needs of their communities. I believe more can be done to better tailor regulation and supervision for community banks in a manner that is appropriate to their small size and simplicity. I look forward to working with Congress and others at the Federal Reserve to identify further ways to effectively reduce burden.

3. Multiple anecdotes from my constituents suggest that there are several Nebraska counties where mortgages are not originated because of over-regulation. What is the best way to address this problem from a regulatory standpoint?

I believe that we should make efforts to right-size regulations to reduce burden for community banks consistent with safety and soundness and consumer protection, so they can properly serve their communities. I understand that the financial regulators discuss compliance and supervisory issues related to the mortgage regulations on a regular basis. If confirmed, I look forward to participating in these interagency communications to seek ways to reduce burden and improve access to safe and appropriate mortgage loan products.

4. My understanding is that only two banks have opened since the passage of Dodd-Frank, including Bird in Hand Bank in Pennsylvania, which has a customer base that is around half Amish.

a. Why do you believe this is the case?
b. What potential impacts does this have on our financial system?
c. Is there anything more the Federal Reserve can do to encourage the opening of new banks?

Historically, new bank formations have been cyclical and have fallen after the financial crises in the 1980s and 1990s before recovering as economic conditions improved.[1] Recent research has supported this and has shown that a portion of the decline in new charters since the crisis can be explained by factors such as a weak economy, low interest rates, and weak demand for banking services.[2] Nonetheless, from my experience as an investor in community banks since the crisis, I know that the widely recognized increased cost of regulatory compliance is an important factor deterring many investors who might potentially contemplate the formation of a new institution.

Potential impacts of fewer de novo bank entrants include lack of innovation, reduced competition, lack of local lending, and reduced availability of credit.

The Federal Reserve does not have chartering authority for insured depository institutions, which is the responsibility of the states and the Office of the Comptroller of the Currency, nor does the Federal Reserve grant deposit insurance. If confirmed, however, I would expect to work with the other U.S. federal and state banking agencies to prudently explore ways to increase new bank formation.

5. I'm concerned that our federal banking regulatory regime relies upon arbitrary asset thresholds to impose prudential regulations, instead of relying on an analysis of a financial institution's unique risk profile.

a. Should a bank's asset size be dispositive in evaluating its risk profile in order to impose appropriate prudential regulations?

[1] https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum16/SI_Summer16.pdf.
[2] https://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf.

One of the important general themes of regulation is ensuring that the character of the regulation is adapted to the character of the institution being regulated, what has become referred to as tailoring. I fully support tailoring, and I think that it is not only appropriate to recognize the different levels of risk and types of risk that different institutions in the system pose, but that it also makes for better and more efficient regulation. Efficient regulation allows the financial system to more efficiently support the real economy.

I believe a variety of approaches could be taken to determine which prudential regulations should apply to which banks in the U.S. banking system. For some regulations or for some bank populations, a simple fixed asset threshold may work. For other regulations or bank populations, a more complex, multi-factor approach may be appropriate. If I were to be confirmed, I would stand ready to work with Congress and my colleagues at the Federal Reserve on appropriate tailoring thresholds.

b. If not, what replacement test should regulators follow?

Broadly speaking, I support tailoring regulations in such a way that reduces the risk that financial distress in the banking industry would cause substantial harm to the U.S. economy, without imposing undue burden on smaller community and regional banking organizations whose failure would not cause notable harm to the U.S. economy. I understand that Congress is currently considering whether and how to raise existing statutory thresholds in the Dodd-Frank Wall Street Reform and Consumer Protection Act, and that the Federal Reserve has expressed support for increasing these thresholds. I, too, would support these efforts. As noted above, I believe a variety of approaches could be taken, and I would stand ready to work with Congress and my colleagues at the Federal Reserve on the design of such an approach, if I were to be confirmed.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
July 27, 2017

<u>Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Ben Sasse:</u>

1. Our financial system has become increasingly consolidated as community banks and credit unions either close their doors or merge with larger institutions.
    a. Are you concerned about this pattern? Why?
    b. What services can these smaller institutions provide that larger institutions cannot provide?

2. Constituents in my state tell me that the EGRPRA report inadequately highlighted concrete ways to reduce the regulatory paperwork burden. What more can the Federal Reserve do to reduce the regulatory burden on community banks?

3. Multiple anecdotes from my constituents suggest that there are several Nebraska counties where mortgages are not originated because of over-regulation. What is the best way to address this problem from a regulatory standpoint?

4. My understanding is that only two banks have opened since the passage of Dodd-Frank, including Bird in Hand Bank in Pennsylvania, which has a customer base that is around half Amish.
    a. Why do you believe this is the case?
    b. What potential impacts does this have on our financial system?
    c. Is there anything more the Federal Reserve can do to encourage the opening of new banks?

5. I'm concerned that our federal banking regulatory regime relies upon arbitrary asset thresholds to impose prudential regulations, instead of relying on an analysis of a financial institution's unique risk profile.
    a. Should a bank's asset size be dispositive in evaluating its risk profile in order to impose appropriate prudential regulations?
    b. If not, what replacement test should regulators follow?

August 7, 2017

The Honorable Brian Schatz
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the July 27, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on August 1, 2017.

Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Schatz:

1. This administration's narrative is that Dodd-Frank is constraining lending because compliance is so costly. However, Federal Reserve data shows that banks' commercial lending is at an all-time high—far higher than pre-recession levels—and bank profits are also at an all-time high. The largest banks all passed their stress tests and were given the green light to increase dividend payments and stock buybacks. This is above the high levels we saw in 2016, when the largest banks had over $100 billion to spend on dividends.

a. Do you agree that these are signs that banks are thriving?

The stability of the U.S. financial system is supported by the safe and sound operation of banking institutions. One of the most important prudential measures for ensuring that stability is bank capital. Of course, there is a tradeoff between higher bank capital levels that increase the resiliency of individual institutions and the system as a whole, and the cost of that capital. A goal of regulation should be to balance to protection of financial stability in a way that promotes economic growth and business opportunity.

Since the financial crisis, banks have substantially improved their capital planning practices and their capital adequacy. Bank lending in the United States has grown steadily since the crisis and U.S. banks are providing significant support to U.S. economic activity.

If confirmed, I will work with Congress and my colleagues at the Federal Reserve to ensure we have in place a financial regulatory system that protects U.S. financial stability and maximizes long-term economic growth and credit availability.

b. Do you think the amount of capital that banks are devoting to dividends and stock buybacks is a problem for our long-term economic growth?

We need a resilient, well-capitalized, well-regulated financial system that promotes the safety and soundness of individual institutions, protects the stability of the U.S. financial system, and fosters economic growth and business opportunity.

Having sufficient capital is essential to the resiliency of the largest banking organizations, as undercapitalized firms may be unable to lend and act as a financial intermediary during stress. Such undercapitalization impeded the ability of banks to lend and was a key contributor to the weakness in economic activity following the financial crisis. Nonetheless, higher levels of capital – at least at some point – may increase the cost of capital to banks, reduce lending, and potentially affect long-term economic growth. If confirmed, I will work with Congress and my colleagues at the Federal Reserve to ensure that capital requirements are well-calibrated to the risks of the activities and exposures of the banking industry and are sensitive to the character of each institution.

2. In addition to the fake accounts scandal, we recently learned that Wells Fargo charged consumers for high priced auto insurance that they did not need, without their knowledge. The high cost of the auto insurance pushed roughly 274,000 Wells Fargo customers into delinquency and resulted in almost 25,000 wrongful vehicle repossessions.

a. What will you do to prevent these types of scandals from happening again?

As I mentioned during my confirmation hearing, the robust enforcement of the consumer rules is important. I understand that the Federal Reserve has authority to address violations of law and unsafe and unsound practices at the institutions it supervises, and, if confirmed, I am committed to taking whatever action is appropriate based on the facts and circumstances. This would extend to the Board's supervisory responsibilities for Bank and Financial Holding Companies, including for the governance structure and enterprise compliance risk management and controls of these holding companies.

b. At what point do these kinds of violations become a safety and soundness concern for the banks the Fed supervises?

I understand that the Federal Reserve has authority to address violations of law and unsafe and unsound practices at the institutions it supervises, and, if confirmed, I am committed to taking whatever action is appropriate based on the facts and circumstances of each situation. The Federal Reserve has taken enforcement actions against firms for compliance and other risk management failures that demonstrated overall weaknesses in a firm's risk management framework and internal controls. I consider robust and effective risk management, including compliance risk management, an essential aspect of safety and soundness.

c. Do you think banks' compensation practices are contributing to the problem of banks harming their consumers in order to increase profits?

While incentive compensation is an important tool in successful management of financial institutions and is critical to attracting qualified employees and executives, improperly structured incentive-based compensation arrangements may encourage inappropriate risk-taking at financial institutions. If confirmed, I look forward to engaging with Federal Reserve Board members and staff to better understand the impact of incentive compensation practices on the safety and soundness of financial institutions.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
July 27, 2017

Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Brian Schatz:

Question 1

This administration's narrative is that Dodd-Frank is constraining lending because compliance is so costly. However, Federal Reserve data shows that banks' commercial lending is at an all-time high—far higher than pre-recession levels—and bank profits are also at an all-time high. The largest banks all passed their stress tests and were given the green light to increase dividend payments and stock buybacks. This is above the high levels we saw in 2016, when the largest banks had over $100 billion to spend on dividends.

(a) Do you agree that these are signs that banks are thriving?

(b) Do you think the amount of capital that banks are devoting to dividends and stock buybacks is a problem for our long-term economic growth?

Question 2

For: Randy Quarles
Topic: Wells Fargo scandals

In addition to the fake accounts scandal, we recently learned that Wells Fargo charged consumers for high priced auto insurance that they did not need, without their knowledge. The high cost of the auto insurance pushed roughly 274,000 Wells Fargo customers into delinquency and resulted in almost 25,000 wrongful vehicle repossessions.

(a) What will you do to prevent these types of scandals from happening again?

(b) At what point do these kinds of violations become a safety and soundness concern for the banks the OCC supervises?

(c) Do you think banks' compensation practices are contributing to the problem of banks harming their consumers in order to increase profits?

August 7, 2017

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the July 27, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on August 1, 2017.

<u>Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Cortez Masto:</u>

1. Please describe the steps you took as a Public Governor on FINRA's Board of Governors to manage your conflicts of interest.

The Financial Industry Regulatory Authority (FINRA) asks all prospective governors to disclose board and corporate affiliations prior to service on its Board. Sitting governors also have an ongoing obligation to update those disclosures annually and as circumstances warrant; FINRA circulates an annual questionnaire to which all governors respond which identifies and records any changes to such affiliations.

FINRA's governance team (Office of the Corporate Secretary and Office of the General Counsel) reviews agendas prior to Board and Committee meetings to determine whether any items appear to be a conflict for a specific governor based on the standards set forth in the FINRA Board's Code of Ethics and Business Conduct (attached). If a potential conflict of interest is identified, the matter will be referred to the Board Conflicts Committee for consideration and determination of whether the matter requires recusal. If this review determines that there is an apparent conflict of interest, the Corporate Secretary will notify the governor of the need to recuse himself or herself and notify the Board Conflicts Committee, and ensure that the affected Board member is recused from the discussion and voting. Board members are also asked to notify the Conflicts Committee if they are aware of a need for recusal that has not been identified through the process described above.

During my tenure as a governor, there were no matters identified by FINRA or by myself as being an actual or apparent conflict of interest.

2. During your tenure on FINRA's Board of Governors, did you ever raise with FINRA ethics counsel any issues that may have raised the need to recuse yourself from Board decision-making? If so, how was that issue resolved?

No.

3. Please provide a copies of FINRA's corporate governance guidelines and Board Member code of conduct.

Attached is the Code of Ethics and Business Conduct and the Corporate Governance Guidelines.

4. Please identify and describe any board committees you served on while on FINRA's Board of Governors.

I serve on three Committees at FINRA: the Executive Committee, Management Compensation Committee, and the Regulatory Policy Committee.

Executive Committee

The Executive Committee is comprised of all Committee chairs and is authorized to exercise all the powers and authority of the Board in the management of the business and affairs of the Corporation between meetings of the Board. I began serving on this Committee effective July 15, 2016.

Management Compensation Committee

The Management Compensation Committee reviews and recommends changes to FINRA's Compensation Policy with the primary objective that it attract, develop and retain high performing individuals who are capable of achieving FINRA's mission of ensuring market integrity and investor protection. The Committee reviews the plans for the development, retention, succession and retirement of key executives of the Corporation and its subsidiaries. I began serving on this Committee effective November 10, 2015.

Regulatory Policy Committee

The Regulatory Policy Committee advises the Board with respect to the regulatory policies and strategy of FINRA programs. The Committee develops and/or adopts necessary or appropriate regulatory policies and strategy and makes recommendations to the Board on regulatory rule proposals. I began serving on this Committee effective November 10, 2015.

Code of Ethics and Business Conduct for the Board of Governors of FINRA and the Board of Directors of its Subsidiaries

[Adopted by FINRA Board on December 3, 2008; Amended September 19, 2013.]

INTRODUCTION

FINRA serves as the primary private-sector regulator of America's securities industry. Our focus and purpose is investor protection and market integrity.

Because integrity and excellence serve as the foundation for everything we do, we have adopted a Code of Conduct for FINRA's employees, including its officers. The Code explicitly applies to the activities of FINRA's employees; but it also defines our expectations of everyone who acts on our behalf, including the Governors of FINRA and the Directors of its subsidiaries. You, too, are ambassadors for FINRA, and should at all times demonstrate honesty, integrity, fairness and excellence.

We have provided each of you with a copy of our Code of Conduct. In addition, we have prepared this Code of Ethics and Business Conduct for the Board of Governors of FINRA and the Board of Directors of its Subsidiaries. This Code highlights those issues that are particularly relevant to your duties as Governors and Directors. Please review this Code and retain a copy where you can easily access and reference it.

RESPONSIBILITIES OF FINRA GOVERNORS AND DIRECTORS

All Governors and Directors have a responsibility to:

- Be familiar with, understand and comply with the expectations of all laws and regulations relevant to your duties as FINRA Governors and Directors.
- Be familiar with, understand and comply with the expectations of this Code, as well as with those expectations of FINRA's Employee Code of Conduct that are relevant to your ability to fulfill your obligations to FINRA.
- Seek guidance before taking action that you are uncertain about. Feel free to consult with FINRA's Office of General Counsel about any questions or concerns.
- Promptly notify FINRA's Office of General Counsel if you become aware of unethical conduct or violations of the law, FINRA's employee Code of Conduct, or this Code.
- Promote and encourage ethical leadership and a culture of integrity throughout FINRA.
- Embrace and advocate FINRA's mission of "Investor Protection, Market Integrity" when making decisions or acting on behalf of the organization — as a Governor or Director, your fiduciary duty runs to the corporation and all of its constituents, not to the members or parties responsible of your election or appointment to the Board.

CODE OF CONDUCT

A. Avoiding Conflicts of Interest

A conflict of interest exists when our private interests interfere, could interfere, or even *appear* to interfere with the interests of FINRA. We must act honestly and ethically in the handling of actual or apparent conflicts between our personal and/or professional interests and those of FINRA.

Broadly speaking, this means we may not have direct or indirect interests in, or relationships with, any organization where these interests or relationships could conceivably: (a) hinder our objectivity, independence of judgment or conduct in carrying out our responsibilities as FINRA Governors and Directors, or (b) embarrass FINRA because of the *appearance* of a conflict of interest.

Indeed, the appearance of a conflict can be as harmful as an actual conflict. Therefore, while we discuss below several specific situations that you may face as Governors or Directors, the goal of this policy is to avoid the *appearance* of impropriety, as well as situations where independence is actually impaired.

Some Helpful Definitions

"**Immediate family**" (hereafter "family") includes a Governor's or Director's spouse, parent, stepparent, child, or stepchild; a member of a person's household; an individual to whom a person provides financial support of more than 50 percent of his or her annual income; or a person who is claimed as a dependent for federal income tax purposes.

You are considered "**affiliated**" with a regulated entity if you:

- Currently act as an officer, director or employee of the entity; or
- Have been an officer, director or employee of the entity within the last year; or
- Have a "family" member or close business associate, i.e. a partner, who is currently an officer or director of the entity.

"Substantial financial interest" includes:

- Being employed by or holding stock or another ownership interest in a regulated entity or vendor which is equal to one percent or more of the outstanding stock of a publicly traded company or one percent or more of the total value of assets of the entity or which is equal to or greater than five percent of your total net worth. (In determining your ownership interest, you should consider not only your own holdings, but also the holdings of any affiliate and any family member.)
- A loan by you or a family member, equal to or greater than five percent of your total net worth, to a regulated entity or vendor.
- Accepting or allowing a family member or affiliate to accept a loan or other form of indebtedness equal to or greater than five percent of your total net worth from a regulated entity or vendor.

1. Examples of Potential Conflicts

a. Conflicts or Perceived Conflicts Involving Rules or Other Matters Presented to the Board

If you or a family member has a "substantial financial interest" in a FINRA member or are "affiliated" with a regulated entity, you may not participate in:

- Any regulatory matter, disciplinary action or investigation which involves the regulated entity; or
- Any decision regarding an application by that entity for an exemption or other special dispensation.

Participation by Governors or Directors who are affiliated with regulated entities is an inherent and valuable incident of FINRA's status as an SRO. The compositional requirements of the Boards of FINRA and its subsidiaries have been carefully developed to ensure that a broad spectrum of industry and public views are represented.

When you participate in the discussion related to and/or vote on a rule or a matter, which you believe may significantly and disproportionately impact an entity in which you or a family member has a "substantial financial interest" or with which you or a family member are affiliated, you should always reveal the nature of your interest to the members of the Board prior to the discussion or vote. Under such circumstances, you also should consider recusing yourself from the discussion and the vote. Such situations can give rise to concerns about fairness and objectivity, and can create a *perception* of a conflict of interest, even if there is no actual conflict.

b. Vendors, Potential Vendors and Other Business Partners

If you or a family member have a substantial financial interest in or are affiliated with a FINRA vendor or a potential vendor, you may not participate in the consideration of a contract or other agreement that would be material to the operating revenues of that vendor (five percent of more of the vendor's gross revenues). Similarly you should not encourage member firms or companies that do business with FINRA to buy supplies or services from family members or entities with which you or a family member have a substantial financial interest or are affiliated.

c. Outside Activities

You should be sensitive to other commitments or activities (i.e., your duties to another Board) that may interfere with your ability to act in the best interest of FINRA. If a situation arises where your commitments or other activities may conflict with your duties as a FINRA Governor or Director, you should consult with the Office of General Counsel.

d. Corporate Opportunities

You may not use FINRA property, information or position for personal gain unrelated to the performance of your duties as a FINRA Governor or Director. Prohibited activities include, for example, profiting from business opportunities that you learn about through your service as a FINRA Governor or Director.

e. Compensation

You may not accept compensation in any form for services performed for FINRA from any source other than FINRA. For example, you may not accept from others a finder's fee, commission or other remuneration for any business transaction in which FINRA is involved or for services rendered to FINRA.

2. Relationships with the SEC

Employees of the SEC are prohibited from soliciting or receiving gifts that have more than an incidental value from any entity they regulate, including FINRA and its member firms. With limited exceptions, SEC employees may not accept gifts from FINRA Governors or Directors. The exceptions include: (1) reasonable food or refreshments offered at a meeting; (2) gifts given as a result of personal relationships (i.e., family members or close personal friends); (3) advertising materials of incidental value; and (4) reasonable meals provided as part of an educational program. You should be familiar with, understand and comply with these restrictions.

3. Change or Prospective Change in Employment

If at any time during your tenure as a FINRA Governor or Director, you are changing or in the process of changing your place of employment, you should treat yourself as though the event has already occurred (i.e., consider yourself to be "affiliated" with that entity), and should comport yourself in accordance with the applicable provisions of this Code.

4. Participation in FINRA Adjudicatory Proceedings

FINRA has long-established policies governing participation by FINRA Governors and Directors in adjudicatory proceedings. (*Refer to* FINRA's Policy on Participation in Adjudicatory Proceedings, adopted on January 28, 1997, and NASD Regulation's Policy on Participation in Proceedings, adopted on January 27, 1997, and modified on March 21, 2000.) Pursuant to these policies, you may not appear as an expert or consultant in any FINRA hearing or arbitration proceeding on behalf of any party, other than yourself or the member firm with which you are currently associated. Under certain circumstances, former Governors and Directors may participate as panelists in FINRA disciplinary proceedings or FINRA arbitration proceedings. If you appear as a witness, expert or consultant in any FINRA hearing, any arbitration, any civil litigation, or any other adjudicative proceeding in connection with FINRA matters, you should make it clear to all parties, including the court or adjudicative panel, that you are not appearing on behalf of FINRA.

As a sitting Governor, Director, or member of the National Adjudicatory Council ("NAC"), you may not appear as a legal representative before any FINRA Adjudicator on behalf of any party other than yourself or the member firm with which you currently are associated. You may counsel clients up to the point at which you are required to file a Notice of Appearance, but may not file a Notice of Appearance to act in a representative capacity before an Adjudicator in any FINRA proceeding on behalf of any party other than yourself or the member firm with which you currently are associated. In addition, once you are elected or appointed Governor, Director or NAC member, and throughout your term, you may not appear before an officer or employee of FINRA in a representative capacity during on-the-record testimony, in negotiating any aspect of on-the-record testimony or in any subsequent stage of a FINRA examination, investigation or disciplinary action on behalf of any individual or firm, other than yourself or the member firm(s) with which you are currently associated and were associated before the firm was aware of the examination, investigation or disciplinary action.[1] This proscription does not apply to former Governors, Directors or NAC members, and also does not apply to another member of the law firm with which the Governor, Director or NAC member is associated.

5. Participation in Educational Programs or Speaking Engagements

FINRA recognizes that you may be invited to participate in educational programs. These activities are beneficial to investors, member firms and the general public. Such activities, however, may create real or apparent risks. In order to avoid this risk, FINRA expects you to follow these guidelines:

- Take care that the speech or materials used do not include confidential or non-public information or remarks concerning pending FINRA litigation or disciplinary proceedings.
- When you participate in educational programs or speaking engagements as a representative of FINRA's Board, FINRA's Office of Corporate Communications is available to assist you in preparing your remarks or speech.
- Except where you are stating a policy, position or rule that has been finally approved by FINRA, all speeches should contain a disclaimer indicating that you are expressing your own views and do not necessarily speak for FINRA. The General Counsel's office is available to review advance texts, riders, slides and other materials used for speaking engagements.
- If you are authorized by FINRA to appear as its representative at a public event or speaking engagement, FINRA will pay your expenses, as provided in the applicable FINRA travel policy.

[1] This provision applies to any governor starting a new term after September 19, 2013.

B. Business Gifts, Entertainment and Courtesies

Gifts, entertainment and hospitality (collectively referred to as business courtesies) can help build goodwill and working relationships. But while business courtesies are fairly common, they can also create serious ethical risks. For FINRA, this is particularly true of business courtesies from entities or individuals we regulate, and from current or potential vendors (though all business courtesies can give rise to ethical risks). Be aware, as well, that even if ethical concerns are not well founded, business courtesies can create the *appearance* of misconduct. Such perceptions alone, even if mistaken, can undermine your integrity and that of FINRA.

For this reason, FINRA has adopted the following limits on business courtesies for Governors and Directors. In order to avoid the appearance of any impropriety, you should be careful not to accept business courtesies from regulated entities or vendors if, in your best judgment, the gift is being offered to influence your actions as a FINRA Governor or Director.

We expect you to report to the Office of the Secretary the acceptance of any and all gifts, gratuities or other remuneration received in excess of $500 from a single regulated entity, vendor or potential vendor during any calendar year.

C. Safeguarding Confidential Information

FINRA Governors and Directors have access to a broad array of sensitive, confidential or proprietary information, including information about the firms FINRA regulates, investigates or otherwise has dealings with (as well as the firm's employees and customers), information about FINRA employees, and information about FINRA itself. Unless required by law or instructed by an appropriate member of FINRA's Board of Governors, you should maintain the confidentiality of any and all such information. You may never use such information for personal gain.

D. Protecting FINRA Assets

You may not use or seek to use FINRA's employees, supplies, equipment, buildings or other assets for your personal benefit except for legitimate business purposes or as part of an adopted or approved FINRA program or policy that is available to all Governors and Directors.

E. Honest and Fair Dealing

You should at all times deal fairly with investors, FINRA member firms, suppliers, employees and others with whom FINRA interacts. You should never take advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair practices.

F. Insider Trading

As FINRA Governors and Directors, you may have access from time to time to non-public, confidential or proprietary information about publicly traded companies. It is against FINRA policy for you to trade in the stock of any public company based on *any* non-public information obtained through your service as a FINRA Governor or Director. Moreover, much of this non-public information is *material*, meaning that a reasonable investor would consider it important in deciding to buy, sell, or hold onto a company's stock. It is against the law (as well as FINRA policy) for ***anyone*** to buy or sell the stock of any publicly traded company while in possession of material, non-public information about that company. This means you, but it also means your spouse, your best friend, and anyone else you might intentionally or inadvertently tip off about material non-public information relating to a publicly traded company.

WAIVERS

Any waiver from any part of this Code requires the express approval of the Board following disclosure of all relevant information.

ANNUAL REVIEW

FINRA's Board of Governors, or a committee of that Board or its designee, will review and reassess the adequacy of this Code annually, and the Board may make any amendments that it deems appropriate.

CERTIFICATION

Each Governor and Director is required to certify annually, as long as he or she serves in such capacity, that he or she has received, read and understands the Code, and agrees to comply with its expectations, as follows:

> I [____] hereby certify and acknowledge that (i) I am a member in good standing of the Board of Governors of FINRA and/or the Board of Directors of FINRA Regulation or FINRA Dispute Regulation; (ii) I have received, read and understood the Code of Ethics and Business Conduct for the Board of Governors of FINRA and the Board of Directors of its Subsidiaries; (iii) such Code has been and is applicable to my activities as a member of such the Board of Governors of FINRA or the Board of Directors of FINRA Regulation or FINRA Dispute Regulation; (iv) I have complied and am in compliance with such Code; and (v) I am not aware of any non-compliance with such Code by others.

Signed: ____

Name Printed: ____

Date: ____

Corporate Governance Guidelines

Prepared for the FINRA Board of Governors

Updated August 22, 2016

The Mission of the FINRA Board of Governors

The FINRA Board is vested with all powers necessary for the management and administration of FINRA and the promotion of its welfare. The Board has a function independent of management and is not responsible for the day-to-day affairs of the Corporation. It, however, does have the responsibility to oversee management and be informed, investigate and act as necessary to promote FINRA's welfare, objectives and purposes.

Board members need to have an understanding of the issues facing the organization and an ability to apply their knowledge and expertise to those issues. They must represent the best interests of FINRA and further FINRA's mission and stated positions, consistent with the Board's Code of Ethics and Business Conduct, and Board members need to have a full understanding of, and comply with, the FINRA's Restated Certificate of Incorporation and By-Laws that form the governance base of FINRA. Board members must have adequate working knowledge of FINRA, as well as its members and services. Board members must regularly attend Board and committee meetings; participate effectively and in a collegial manner, in all deliberations, and get enough information to make a reasonably informed decision. Board members must observe strict confidentiality of all matters presented to the Board or their appropriate committees. Any possible conflict-of-interest issues must be raised with the appropriate staff or the Chairman of the Board for prompt resolution.

Guidelines on Significant Corporate Governance Issues

Selection and Composition of the Board

Board Membership Criteria

It is the duty of the Governor to communicate and work professionally and effectively with all members of the Board. Board members are expected to be unbiased and objective, voting on matters for the good of investors, industry and marketplace, regardless of the interest of their specific organization, affiliation or classification, as required by applicable law.

The Board includes both Industry and Public Governors. The Corporate Secretary of FINRA collects from each nominee for Governor such information as is reasonably necessary to serve as the basis for a determination of the nominee's qualification as an Industry or Public Governor. Board members have a continuing obligation to notify the Corporate Secretary should such information change in any manner.

The exact size of the FINRA Board is determined by the Board within a range set forth in the By-Laws. There are 10 required Industry Governor seats on the Board comprising:

- three Small Firm Governors,
- one Mid-Size Firm Governor,

- three Large Firm Governors,
- a Floor Member Governor,
- an Independent Dealer/Insurance Affiliate Governor; and
- an Investment Company Affiliate Governor.

In addition, the By-Laws provide that the number of Public Governors on the board must exceed the number of Industry Governors on the board, which results in a minimum of eleven Public Governors. One seat on the Board is also reserved for FINRA's Chief Executive Officer.

Because of these restrictions the practical minimum number of Board members is 22. In April 2013, the Board authorized three additional Public Governor seats to increase the Board's size to the maximum number of 25 governors.

Selection and Orientation of New Governors

The Nominating and Governance Committee identifies and nominates candidates to run for election or be appointed to seats on the Board. Interested persons may submit a letter of interest and brief biography to the Corporate Secretary who will forward the information to the Committee.

Governors who are required to be elected by the members[1] must be elected by a plurality of the votes of the members of FINRA present in person or represented by proxy at the annual meeting of members of the Corporation and entitled to vote for such category of Governors. Quorum, as established in the Certification of Incorporation, is one-third of the members entitled to vote at the meeting of members of the Corporation (i.e., Annual or Special Meetings) and, likewise, with respect to elections for elected Governors, one-third of the members of the class or group entitled to vote.

Orientation of New Governors

As soon as practicable after being elected or appointed to the Board, new Governors receive a new board member orientation, at which they meet with senior management and receive an overview of FINRA's primary programs, departments and operations. New board members are also provided a FINRA Board Member Reference Manual, which summarizes Board member duties and responsibilities.

Board Composition

Definitions of Industry and Public Board Members

The definitions of Industry and Public are set forth in the FINRA By-Laws and provide:

- "Industry Governor" or "Industry committee member" means the Floor Member Governor, the Independent Dealer/Insurance Affiliate Governor and the Investment Company Affiliate Governor and any other Governor (excluding the CEO of the Corporation) or committee member who: (1) is or has served in the prior year as an officer, director (other than as an independent director), employee or controlling person of a broker or dealer, or (2) has a

[1] The Small Firm Governors, Mid-Size Firm Governor and Large Firm Governors are elected by members in the same firm-size category. However, vacancies with less than 12 months on the term may be filled by appointment.

consulting or employment relationship with or provides professional services to a self-regulatory organization registered under the Act, or has had any such relationship or provided any such services at any time within the prior year.

- "Public Governor" or "Public committee member" means any Governor or committee member who is not the CEO of the Corporation or who is not an Industry Governor and who otherwise has no material business relationship with a broker or dealer or a self-regulatory organization registered under the Act (other than serving as a public director of such a self-regulatory organization).

Governors Who Change Their Professional Affiliations

Changes to a Governor's professional affiliation may affect his or her eligibility to serve in the Board classification for which he or she was elected or appointed. A Governor who changes his or her job responsibilities must notify the Corporate Secretary and provide an update to his or her Board questionnaire. The Governor's eligibility to remain on the Board in his or her current seat will be determined following a thorough analysis of the new information.

Term Limits

FINRA Governors, other than the CEO who serves by virtue of his or her position, hold office for a term of not more than three years, or until a successor is elected or qualified, or until death, disqualification, resignation or removal. A Governor generally may not serve more than two consecutive terms on the FINRA Board.

Board Compensation Review

FINRA staff reports periodically to the Management Compensation Committee on the status of FINRA Board compensation in relation to other self-regulatory organizations and large U.S. companies. Additionally, the Board directed the Management Compensation Committee to re-evaluate the Board Compensation Schedule every five years taking into account appropriate cost of living adjustments and board pay comparators. Changes in Board compensation, if any, will be recommended first by the Management Compensation Committee to the Nominating and Governance Committee, and then by the Nominating and Governance Committee to the full Board for discussion and approval.

Board Operations and Conduct

Attendance and Participation

Board members are expected to attend and participate regularly in Board and Committee meetings consistent with the general fiduciary standards and governance needs of FINRA. Members should participate professionally and effectively, in a collegial manner, in all Board and committee deliberations and observe strict confidentiality of all matters presented to the Board or their appropriate committees.

Standard of Conduct

As a protector of investors and a guardian of market integrity, FINRA's Governors have a heightened duty to make certain that they act in the best interest of the company and that their conduct is beyond reproach. Pursuant to FINRA's By-Laws, the standard the Board uses to determine whether cause exists to remove a Board member is whether continued service affects the best interests of the corporation.

Under this standard, actions by a Governor in his or her individual capacity that may cast doubt upon his or her honesty, integrity, fairness and excellence and/or attract adverse publicity may undermine FINRA's stakeholders' confidence in the organization and may implicate this provision of the By-Laws. In order to maintain the respect and confidence of investors, member firms, business partners, regulators, employees and the public, it is Board policy that any Governor who finds him/herself facing personal, regulatory or legal issues that might implicate this standard must consult with the Chairman of the Board, Lead Director and/or CEO to discuss whether resigning from the Board is in the best interest of the organization.

Assessing Individual Governor's Performance

The effectiveness and credibility of the Board depends on an evaluation of the Board as a whole and of its individual members by the Nominating and Governance Committee. When evaluating Governors up for renomination, the Nominating and Governance Committee considers, among other things, adherence to the Board's mission, guidelines and policies, active engagement and effective interaction among Board members.

Review of Allocation of Powers

The Board periodically reviews the allocation of powers between management and the Board as delineated in the Certificate of Incorporation and the By-Laws, and determines whether these grants of authority are consistent with the changing needs of the business.

Board's Interaction with Interested Groups and the Media

The Board believes that Senior Management speaks for FINRA. If public comment from the Board is appropriate, these comments should, in most circumstances, come from the Chairman or the CEO. Individual Board Members may, from time to time, meet or otherwise communicate with members and various other constituencies that are involved with FINRA at their discretion, but in such circumstances they do so at their own expense and should make clear they do not formally represent FINRA or the FINRA Board.

Board members must not disclose Board information to the public and must observe the confidentiality guidelines. Sensitive, non-public policy and proprietary information should not be disclosed to anyone, including the media. This information may include FINRA internal personnel matters, investigations/examinations in progress, enforcement actions against members, deliberations and contemplated actions of the Board, and information on systems developments.

If a Board member is contacted by the media, the Board member should comport him/herself in a manner consistent with the preceding paragraphs. As a general matter, Board members should inform the FINRA Corporate Communications Department of any media inquiry or refer the inquiry to the FINRA Corporate Communications Department.

Travel Policy

Board members should ensure FINRA business travel conforms to the policy as outlined in the FINRA Board Travel Policy.

Interaction Among Board Members

Effective interaction among Board members ensures a well-functioning Board. Board members should exercise judgment when communicating with fellow Board members. Board members are asked to be respectful of business and other professional commitments of fellow Board members, and refrain from excessive and unnecessary electronic and hard-copy communications.

Board Relationship to Senior Management

Board Access to Senior Management

Board members have complete access to FINRA's Senior Management. Board members are requested to direct questions and issues to these individuals and/or the Corporate Secretary.

Individual Board members should not become involved in operational management, including regulatory matters and responsibilities of FINRA, except as requested by the CEO. The Board must focus on its role as a policy-maker within FINRA.

Board members are requested to use good judgment to ensure that contact is appropriate and non-disruptive to the business operation of FINRA. In order to ensure appropriate follow-up action, the Corporate Secretary should be copied on written communications. Board members should be conscious of the weight of their position and understand that contacts with staff members below the most senior level might be intimidating to such staff and might be interpreted as an attempt to unduly or improperly influence them.

Governors regularly meet in executive session outside the presence of the CEO and other FINRA officers or employees. The Chairman of the Board convenes and presides over these executive sessions and is responsible for communicating to the CEO issues discussed during such executive sessions.

Meeting Procedures

Selection of Agenda Items for Board Meetings

The Chairman and the CEO establish the agenda for each Board meeting. With respect to matters from which the Chairman and the CEO recuse themselves, the Lead Governor may include matters on the agenda of a meeting of the Board.

Each Board member is free to suggest the inclusion of item(s) on the agenda. Board members are requested to provide suggested agenda items to the Corporate Secretary at least three weeks in advance of the Board meeting.

Board Materials Distributed in Advance

Information and data that are important to the Board's understanding of operations will be distributed in writing to the Board sufficiently in advance of Board meetings to permit full review and consideration. FINRA management will make every effort to see that this material is as concise as possible while still providing the necessary information.

Providing materials to the Board in advance will generally conserve meeting time and focus discussion. On those occasions in which the subject matter is too sensitive to be presented in writing, the issue will be presented and discussed in person.

Board Meeting Order

The Chairman establishes the rules of order and procedure of the meeting to ensure the meeting is conducted in an orderly fashion. The Chairman retains the right, if necessary, to rule out of order any remarks or discussion. The Chairman may make additional meeting rules as appropriate or advisable.

The Lead Governor shall convene and preside at all meetings of the Board at which the Chairman is not present and all executive sessions if the Chairman is recused.[2]

Special Meetings

Special meetings of the Board may be called by the Board, the Chairman, the CEO, or the Lead Governor.

Committee Matters

Number, Structure, and Independence of Committees

The Board is authorized to appoint committees to facilitate and assist in the execution of the Board's responsibilities. At present, the committees of the Board include the:

- Audit Committee;
- Executive Committee;
- Finance, Operations & Technology Committee;
- Management Compensation Committee;
- Nominating & Governance Committee;
- Regulatory Policy Committee;
- Small Firm Governor Committee; and
- Large Firm Governor Committee.

The Management Compensation Committee exclusively comprises Public Governors. The Small Firm Governor Committee and the Large Firm Governor Committee comprise the Governors filling those respective seats on the Board.[3] For each of the other committee's listed

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[2] The "Lead Governor" is a member of the Board elected as such by the Board.

[3] The Large Firm Governor Committee and the Small Firm Governor Committees are convened in the event of a vacancy among the Large Firm Governors or the Small Firm Governors in which the term of office remaining is less than 12 months. Such vacancy is only filled by the Large Firm Governor Committee in the case of a Large Firm Governor vacancy, or the Small Firm Governor Committee in the case of a Small Firm Governor vacancy. Any such vacancy of the Mid-Size Governor is filled by the Board. In the event the remaining term of office of any Large Firm, Mid-Size Firm or Small Firm Governor position that becomes vacant is for more than 12 months, such vacancy is filled by the FINRA members entitled to vote for that category of Governorship. In all such instances, nominations are made by the Nominating Committee.

above, the number of Public Governors who serve on the committee must exceed the number of Industry Governors on the committee.

The Nominating & Governance Committee is responsible for recommending the creation and/or elimination of Board Committees, and periodically reviewing and recommending changes to committee charters.

Assignment and Rotation of Committee Members

Board members may indicate their preferred committee assignments. The selection process, however, is subject to various compositional requirements set forth in the FINRA By-Laws, the SEC-approved Plan of Allocation and Delegation of Functions by FINRA to FINRA Regulation, Inc., and the Board-approved committee charters. In nominating individuals to serve on Board Committees, consideration is given to each Governors' backgrounds, experience, and existing responsibilities as members of the FINRA Board.

Committee Meeting Order

The Chairman of the committee establishes the rules of order and procedure of the meeting to ensure the meeting is conducted in an orderly fashion. The Chairman of the committee controls the meeting agenda and the order of issues to be presented to the Board. The Chairman retains the right, if necessary, to rule out of order any remarks or discussion that does not comply with committee procedures. The Chairman may make additional meeting rules as appropriate or advisable.

Committee Agenda and Materials

The Chairman of the committee, in conjunction with the Chairman and the CEO, will establish a meeting agenda for each committee. Each committee member is free to suggest the inclusion of item(s) on the agenda. Committee members are requested to provide suggested agenda items to the Corporate Secretary at least three weeks in advance of the committee meeting. Committee materials will be distributed in writing before the committee meeting.

Leadership Development

Formal Evaluation of the Chief Executive Officer

Annually the Board, through the Management Compensation Committee, evaluates the CEO. This evaluation is communicated to the CEO by the Chairman of the Management Compensation Committee. The evaluation should be based on objective criteria including performance of the corporation, accomplishment of long-term strategic objectives and development of senior management. The evaluation will be used by the Management Compensation Committee when considering the compensation of the CEO.

Succession Planning

The Management Compensation Committee and the Nominating and Governance Committee are jointly responsible for developing and updating a plan of succession for the CEO.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
July 27, 2017

Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Catherine Cortez Masto:

- Please describe the steps you took as a Public Governor on FINRA's Board of Governors to manage your conflicts of interest.
- During your tenure on FINRA's Board of Governors, did you ever raise with FINRA ethics counsel any issues that may have raised the need to recuse yourself from Board decision-making? If so, how was that issue resolved?
- Please provide a copies of FINRA's corporate governance guidelines and Board Member code of conduct.
- Please identify and describe any board committees you served on while on FINRA's Board of Governors.

August 7, 2017

The Honorable Heidi Heitkamp
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the July 27, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on August 1, 2017.

<u>Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Heitkamp:</u>

1. Looking through your past statements, it's clear that you believe we need to have a financial system that takes on risk in order to get innovation and growth in our economy. However, as we saw during the financial crisis, too much risky behavior can lead to outright fraud and manipulation of markets, which ultimately led to widespread systemic harm. I strongly believe that criminal penalties for executives can deter the type of fraud and market manipulation that led to the 2008 crisis. If an executive acts recklessly and that recklessness results in substantial economic harm to the economy, he should be held criminally liable. Do you believe thoughtful changes to our white collar criminal standards and penalties would be an effective tool for protecting our financial system?

As the Federal Reserve has publicly stated, no individual and no institution should be exempt from prosecution when they commit a crime. The Justice Department has the sole authority to indict or seek federal criminal fines or other sanctions and to criminally prosecute individuals for their actions. The Federal Reserve may bring enforcement actions against and remove an institution-affiliated party in certain circumstances if they have violated a law or regulation or engaged in unsafe and unsound practices. When warranted, the Federal Reserve also has the authority to impose fines. I believe the Federal Reserve should take whatever action is appropriate to ensure individuals subject to the Federal Reserve Board's (Board) jurisdiction comply with the law and act consistently with safety and soundness principles.

2. As I'm sure you're aware the economy in North Dakota and rural America more generally is facing headwinds from a variety of factors including a strong dollar, potential trade restrictions and low commodity prices.

a. To take just the issue of trade, I'm interested to know how you would factor the Administration's trade policies into your monetary policy decisions and efforts to achieve economic growth at the Fed?

Monetary policy decisions should be based on an assessment of realized and expected progress toward the Federal Reserve's employment and price stability objectives. International trade is an important part of the U.S. economy, so trade developments should be an important aspect of that assessment. In addition to the current state of trade and trade policy, monetary policy should also consider several factors that could affect the outlook for trade, including movements in currency and commodity markets as well as prospects for economic growth abroad.

b. Do you believe that we can achieve economic growth at rates of 3% with a restrictive policy on trade?

With the economy now close to full employment, a step-up from recent growth rates of around 2 percent to a sustained 3 percent growth rate would require some combination of a sustained increase in productivity growth from its recent weak trend or an improvement in the trend in labor force growth despite the downward pressures being exerted by the aging baby-boom cohorts. An assessment of a trade policy's effect on growth would need to involve an assessment of its effect on these two factors.

c. Beyond regulatory changes and taxes, what steps should we be taking to increase productivity and achieve more robust GDP growth?

In my view, a combination of more encouragement for private investment, more-effective regulation, better education, and improved public infrastructure would contribute positively toward increasing productivity and improving GDP growth. I do not believe there is a single, unalterable combination of these proposals that would have to be followed to have a positive effect, and Congress could choose from a variety of specific policies addressing these issues in order to further this objective.

3. As part of the EGRPRA process, regulators identified access to timely appraisals – especially in rural America – as a major challenge for small lenders. Yet the report itself did little to address residential appraisal requirements.

a. Do you share my concerns that the appraisal system in rural America is broken?

As both my wife and I come from families involved in agriculture in the West, I am very aware of concerns about the availability of appraisers in rural areas. I understand that the Board, Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration recently issued an advisory addressing some of the ways institutions can address the issue of appraiser availability. If confirmed, I look forward to hearing from the industry stakeholders to understand their positions on this regulatory action. It is an issue I take very seriously.

b. What concerns would you have with raising the residential exemption threshold – which was last modified in 1994 – above its current limit of $250K?

I understand that the federal banking agencies are in the process of evaluating the current threshold. The Board, OCC, and FDIC recently issued a proposal to increase the transaction size threshold for requiring appraisals for commercial real estate transactions, and in that proposal have requested comments on many aspects of the appraisal regulations, including whether the appraisal threshold for residential transactions should be raised to reduce burden, consistent with safety and soundness and consumer protection. If confirmed, I look forward to hearing what the public has to say about that proposal and better understanding the issues involved. It is also my understanding that the bulk of the residential mortgage market is subject to the appraisal rules of other government entities, such as the government-sponsored enterprises or the Federal Housing Administration. If confirmed, I would support working with those other entities to harmonize appraisal rules for residential mortgages.

4. On several occasions before the Banking Committee Governor Tarullo testified that the dollar asset thresholds in Dodd Frank such as the $50 billion threshold for SIFI designation, is far too high.

a. Do you believe regulators could effectively address systemic risk if the threshold were raised above $50 billion?

One of the important general themes of regulation is ensuring that the character of the regulation is adapted to the character of the institution being regulated, what has become referred to as tailoring. I fully support tailoring, and I think that it is not only appropriate to recognize the different levels of risk and types of risk that different institutions in the system pose, but that it also makes for better and more efficient regulation. Efficient regulation allows the financial system to more efficiently support the real economy.

I believe a variety of approaches could be taken to determine which prudential regulations should apply to which banks in the U.S. banking system. For some regulations or for some bank populations, a simple, fixed asset threshold may work. For other regulations or bank populations, a more complex, multi-factor approach may be appropriate. If I were to be confirmed, I would stand ready to work with Congress and my colleagues at the Federal Reserve on appropriate tailoring thresholds.

b. Are there specific provisions in Dodd Frank which you believe are particularly costly or unnecessary for a certain subset of banks above the $50 billion threshold?

Broadly speaking, I believe that smaller community and regional banking organizations, whose failure would not cause notable harm to the U.S. economy, can be supervised in a way that promotes safe and sound banking without being subject to the enhanced regulations that apply to larger banking firms. I support efforts to consider whether and how specific regulations should be tailored in a way that reduces the risk that bank failures or distress will have a harmful impact on economic growth, without imposing undue burden. I support efforts to raise the $50 billion threshold in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to reduce regulatory burden on some regional banks, and, if confirmed, I am open to discussing the best way to accomplish that goal.

c. Are there specific provisions in Dodd Frank which you believe are necessary for all banks above $50 billion in assets that should be retained in order to mitigate systemic risk?

If confirmed, one of my first priorities will be to engage in a comprehensive review of rules to ensure we have a system in place that promotes the safety and soundness of individual institutions, protects the stability of the U.S. financial system, and fosters economic growth and business opportunity. In advance of such a review, I do not have a final view on any specific provisions that should remain in place for all banks over $50 billion. However, I support efforts to raise the $50 billion threshold in the Dodd-Frank Act to reduce regulatory burden on some regional banks with assets over $50 billion, and, if confirmed, I am open to discussing the best way to accomplish that goal.

d. What concerns do you have with having a purely qualitative test for identifying systemic risk?

I believe a variety of approaches could be taken to measure a firm's "systemic footprint." While there is merit to considering a qualitative test – since size is not a perfect proxy for risk – care would have to be taken in crafting such a test to ensure that measuring an institution's standing under the various qualitative elements did not itself become a burdensome compliance effort even for banks that ought clearly to be exempt. If I were to be confirmed, I would stand ready to work with Congress on the design of an approach to measuring firms' systemic importance.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
July 27, 2017

<u>Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Heidi Heitkamp:</u>

(1) Looking through your past statements, it's clear that you believe we need to have a financial system that takes on risk in order to get innovation and growth in our economy. However, as we saw during the financial crisis, too much risky behavior can lead to outright fraud and manipulation of markets, which ultimately led to widespread systemic harm. I strongly believe that criminal penalties for executives can deter the type of fraud and market manipulation that led to the 2008 crisis. If an executive acts recklessly and that recklessness results in substantial economic harm to the economy, he should be held criminally liable. Do you believe thoughtful changes to our white collar criminal standards and penalties would be an effective tool for protecting our financial system?

(2) As I'm sure you're aware the economy in North Dakota and rural America more generally is facing headwinds from a variety of factors including a strong dollar, potential trade restrictions and low commodity prices.

a. To take just the issue of trade, I'm interested to know how you would factor the Administration's trade policies into your monetary policy decisions and efforts to achieve economic growth at the Fed?

b. Do you believe that we can achieve economic growth at rates of 3% with a restrictive policy on trade?

c. Beyond regulatory changes and taxes, what steps should we be taking to increase productivity and achieve more robust GDP growth?

(3) As part of the EGRPRA process, regulators identified access to timely appraisals – especially in rural America – as a major challenge for small lenders. Yet the report itself did little to address residential appraisal requirements.

a. Do you share my concerns that the appraisal system in rural America is broken?

b. What concerns would you have with raising the residential exemption threshold – which was last modified in 1994 – above its current limit of $250K?

(4) On several occasions before the Banking Committee Governor Tarullo testified that the dollar asset thresholds in Dodd Frank such as the $50 billion threshold for SIFI designation, is far too high.

a. Do you believe regulators could effectively address systemic risk if the threshold were raised above $50 billion?

b. Are there specific provisions in Dodd Frank which you believe are particularly costly or unnecessary for a certain subset of banks above the $50 billion threshold?

c. Are there specific provisions in Dodd Frank which you believe are necessary for all banks above $50 billion in assets that should be retained in order to mitigate systemic risk?

d. What concerns do you have with having a purely qualitative test for identifying systemic risk?

August 7, 2017

The Honorable Jack Reed
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the July 27, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

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<u>Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Reed:</u>

1. The Federal Reserve, OCC, and FDIC in 2016 published a joint advance notice of proposed rulemaking (ANPR) on cybersecurity, asking for comment, among other things, on whether boards of directors should have adequate expertise in cybersecurity. Citing the ANPR: "a cyber incident or failure at one interconnected entity may not only impact the safety and soundness of the entity, but also other financial entities with potentially systemic consequences." Other than the solicitation of comments, we are not aware of any material progress on this ANPR. If confirmed, may I have a personal commitment from each of you that you will work with the FDIC and each other on advancing this cybersecurity ANPR?

Cybersecurity continues to be a major concern for the financial sector. If I were to be confirmed, I would be committed to finding ways to strengthen the resiliency of the financial sector against cyber risks.

One of my priorities would be to harmonize our supervisory expectations with those of other regulators in the financial sector as much as is practical. Therefore, an important step would be to reach a consensus on as many of the core elements of the advance notice of proposed rulemaking as possible.

2. The OCC and the Federal Reserve are each authorized to enforce the Military Lending Act (MLA), which is a bipartisan law enacted in 2006 that sets a hard cap of 36% interest for most loans to the military. On July 22, 2015, the Department of Defense finalized MLA rules that closed prior loopholes that allowed unscrupulous lenders to prey upon servicemembers and their families. Do you support these stronger MLA rules? If confirmed, will you support and enforce these strong MLA rules to the fullest extent possible?

The Military Lending Act (MLA) provides special consumer protections for service members and their dependents. In enacting the MLA, the Congress directed the Department of Defense to issue implementing regulations after consulting with the Federal Reserve and other agencies. I understand the Federal Reserve staff has worked with Defense Department staff to carry out that mandate and, if confirmed, I will support that effort and the Federal Reserve's full enforcement of the MLA at the institutions it supervises.

3. Half of the Federal Reserve's dual mandate is to achieve maximum employment. How would you support this part of the dual mandate to ensure that Rhode Islanders have more jobs?

The Federal Reserve System occupies a central position in our country's policy infrastructure for promoting a strong economy and the stability of the financial system, and supporting robust job growth in the context of price stability. I can assure you that if I were to be confirmed, I would be strongly committed to all these objectives. With respect to the employment mandate, I believe it is an important element of the Federal Reserve's obligation, and I would take it very seriously.

If I were to be confirmed, in my capacity as a Federal Reserve Board member and as Vice Chair for Supervision, I would work to refine and enhance regulations in ways that promote a safe and sound financial system and that support the flow of credit to households and businesses. As I have noted on previous occasions, I believe there are opportunities to simplify and streamline regulations, particularly for smaller financial institutions, which have a particular role in supporting the small businesses that are the engines of job creation. Easing regulatory burdens can help to foster improved access to credit, as well as more business and employment opportunities, without sacrificing the gains of recent years in strengthening the financial system.

If confirmed, I look forward to engaging with Federal Reserve Board members and staff to gain an accurate and complete picture as possible on overall and specific labor market conditions.

4. The White House has asked the Treasury Department to review the orderly liquidation authority (OLA) established by the Dodd Frank Wall Street Reform and Consumer Protection Act. The statutory purpose of OLA is "to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard." I would like to highlight some existing OLA provisions and ask you whether you support them.

In the case of a failure of a megabank, do you support the:

- **mandatory removal of the megabank's executives and board members responsible for the failure?**
- **FDIC's authority to claw back compensation from executives or directors substantially responsible for the failure?**
- **statutory mandate that "taxpayers shall bear no losses from the exercise of any authority" under OLA?**

Avoiding taxpayer loss and reducing moral hazard, which these provisions of Orderly Liquidation Authority (OLA) address, are important goals for the resolution of a large, systemically important financial company, and thus I fully support the objectives of these provisions. The Department of the Treasury is reviewing OLA, and if I am confirmed, I will give the resulting report serious review.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
July 27, 2017

Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Jack Reed:

Q: The Federal Reserve, OCC, and FDIC in 2016 published a joint advance notice of proposed rulemaking (ANPR) on cybersecurity, asking for comment, among other things, on whether boards of directors should have adequate expertise in cybersecurity. Citing the ANPR: "a cyber incident or failure at one interconnected entity may not only impact the safety and soundness of the entity, but also other financial entities with potentially systemic consequences." Other than the solicitation of comments, we are not aware of any material progress on this ANPR. If confirmed, may I have a personal commitment from each of you that you will work with the FDIC and each other on advancing this cybersecurity ANPR?

Q: The OCC and the Federal Reserve are each authorized to enforce the Military Lending Act (MLA), which is a bipartisan law enacted in 2006 that sets a hard cap of 36% interest for most loans to the military. On July 22, 2015, the Department of Defense finalized MLA rules that closed prior loopholes that allowed unscrupulous lenders to prey upon servicemembers and their families. Do you support these stronger MLA rules? If confirmed, will you support and enforce these strong MLA rules to the fullest extent possible?

Q: Half of the Federal Reserve's dual mandate is to achieve maximum employment. How would you support this part of the dual mandate to ensure that Rhode Islanders have more jobs?

Q: The White House has asked the Treasury Department to review the orderly liquidation authority (OLA) established by the Dodd Frank Wall Street Reform and Consumer Protection Act. The statutory purpose of OLA is "to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard." I would like to highlight some existing OLA provisions and ask you whether you support them.

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- mandatory removal of the megabank's executives and board members responsible for the failure?
- FDIC's authority to claw back compensation from executives or directors substantially responsible for the failure?
- statutory mandate that "taxpayers shall bear no losses from the exercise of any authority" under OLA?

August 7, 2017

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the July 27, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

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<u>Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Menendez:</u>

1. In January, the Minneapolis Federal Reserve published a report estimating that if the Federal Open Market Committee had been required to follow the Taylor Rule for the last five years, 2.5 million more Americans would be out of work today.

a. Do you accept the analysis that suggests strictly following the Taylor Rule would undermine the Federal Reserve's ability to achieve its full employment mandate?
b. Assuming this analysis is correct, and adhering to a strict Taylor Rule or other monetary policy rule would result in the loss of a large number of jobs, would you still argue in favor of following such a rule?

Of course, in general, it is difficult to say how the economy would have behaved in the past if the Federal Reserve or any other part of the government had followed a different set of policies. That basic difficulty is compounded many times over when examining the possible effects of alternative polices during a period that includes the aftermath of the most severe financial crisis since the Great Depression.

My commitment to a greater focus on rules in the conduct of policy, however, is not a back-door effort to reduce the Federal Reserve's commitment to its dual mandate. Rather, it is to acknowledge that there is still room for the Federal Reserve to do more in developing and explaining a clearly delineated and broadly measurable strategy that would improve current understanding and reduce future uncertainty concerning the expected course of monetary policy. In determining whether a particular policy rule or strategy is effective, an important element of that assessment is whether it supports the Federal Reserve's congressional mandates, including the full employment mandate. Thus, if the best analysis of a monetary policy rule's projected effects were that it would be inconsistent with the dual mandate, the Federal Reserve should not adopt that rule. And if experience over time demonstrated that the practical application of a rule was leading to outcomes that were inconsistent with the dual mandate, the rule should be refined or replaced.

The Federal Reserve has made substantial progress over the last 25 years in becoming both clearer and more consistent in explaining its monetary policy decisions. My commitment to a greater focus on rules in the conduct of monetary policy is neither inconsistent with that progress, nor a dramatic change in direction, nor a prioritization of one element of the dual mandate over another, but rather a recognition that the Federal Reserve can and should continue to improve the clarity and consistency of the framework in which it conducts monetary policy. This discipline can improve the policy itself, and improve the understanding of that policy by markets and by the public.

2. In the wake of the financial crisis, Congress enacted a provision, section 956 of Dodd-Frank, to require financial regulators to jointly issue rules to ban incentive pay practices at large financial institutions that encourage inappropriate risk-taking. In May of 2016, the

financial regulators including the Federal Reserve Board and the OCC proposed a rule to implement section 956. More than a year later, the rulemaking still has not been finalized. The Wells Fargo fraudulent account scandal uncovered last year, where senior executives were given bonuses for "successes in cross-selling," underscores the need for rules regarding incentive-based compensation agreements.

a. Will you commit to implementing section 956 of Dodd-Frank?

Incentive compensation is important to attract qualified employees and executives to financial institutions. It is also important that compensation programs do not distort incentives for employees to act in the long-term interest of the institution.

If confirmed, I would look forward to working with the other agencies to understand the issues raised in this rulemaking and fulfilling the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

b. Will you commit to implementing all congressionally-mandated rulemakings?

If confirmed, I am committed to fulfilling the requirements of all laws to which the Federal Reserve has been given authority by the Congress.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
July 27, 2017

Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Senator Robert Menendez:

1. In January, the Minneapolis Federal Reserve published a report estimating that if the Federal Open Market Committee had been required to follow the Taylor Rule for the last five years, 2.5 million more Americans would be out of work today.
    a. Do you accept the analysis that suggests strictly following the Taylor Rule would undermine the Federal Reserve's ability to achieve its full employment mandate?
    b. Assuming this analysis is correct, and adhering to a strict Taylor Rule or other monetary policy rule would result in the loss of a large number of jobs, would you still argue in favor of following such a rule?

2. In the wake of the financial crisis, Congress enacted a provision, section 956 of Dodd-Frank, to require financial regulators to jointly issue rules to ban incentive pay practices at large financial institutions that encourage inappropriate risk-taking. In May of 2016, the financial regulators including the Federal Reserve Board and the OCC proposed a rule to implement section 956. More than a year later, the rulemaking still has not been finalized. The Wells Fargo fraudulent account scandal uncovered last year, where senior executives were given bonuses for "successes in cross-selling," underscores the need for rules regarding incentive-based compensation agreements.
    a. Will you commit to implementing section 956 of Dodd-Frank?
    b. Will you commit to implementing all congressionally-mandated rulemakings?

August 7, 2017

The Honorable Sherrod Brown
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the July 27, 2017[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

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<u>Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Ranking Member Brown:</u>

1. While at the Treasury Department you negotiated the financial services provisions of six free trade agreements and described "liberalization of financial services" as "vital" to U.S. trade policy. Wall Street has sought to include financial regulation in trade agreements, most recently in the Transatlantic Trade and Investment Partnership (TTIP), as a backdoor way of weakening Wall Street reform. Secretary Lew, Governor Tarullo, and others pushed back on those efforts and argued that financial regulation should be addressed outside of trade policy. Do you agree that financial regulation should be negotiated outside of broader trade agreements?

I continue to believe that liberalization of financial services through increased market access and national treatment for U.S. financial firms in foreign markets is vital to U.S. trade policy. Traditionally, the financial services provisions of our trade agreements have been negotiated separately from the other provisions. Rather than being led by the Office of the United States Trade Representative (USTR), the negotiation of these provisions has been led by Treasury (which coordinates input from all the U.S. financial regulators), and the provisions are placed in separate chapters reflecting a recognition of all parties that the prudent and efficient operation of the financial sector has a foundational role for all other sectors of the economy and therefore should not be subject to compromises and tradeoffs with those other sectors. This insulation of the financial services provisions during the negotiating process also recognizes that discussions regarding financial regulation already occur regularly in various international bodies with financial services expertise, such as the Basel Committee, the Financial Stability Board, and the International Association of Insurance Supervisors.

The process I have described above was true of all the trade agreements for which I negotiated the financial services provisions, and this separation was scrupulously respected by USTR throughout the negotiating process. I support this bifurcation and believe it is well designed to ensure that the financial services provisions of trade agreements are calibrated to preserve financial stability while also providing a broader and fairer playing field for U.S. firms.

2. In September 2016, Governor Tarullo announced that the Board of Governors would be incorporating some modified form of the GSIB capital surcharge into the CCAR's minimum common equity ratio that apply to the U.S. GSIBs. When Senator Rounds asked you about your position on this change, you responded that you would want to look at the question in more depth, but that it is definitely worth looking at. Having had more time to consider the question, do you support this change for the 2018 CCAR process?

I understand that the Federal Reserve has previously committed that any change to incorporate the globally systemically important bank (GSIB) surcharge into the Comprehensive Capital Analysis and Review stress testing would have to go through the normal notice and public comment process of rulemaking. If I were to be confirmed, I look forward to studying the issue more in-depth and working with members of the Federal Reserve Board (Board) to further evaluate the benefits and costs associated with adoption of such a measure.

3. In your 2016 Wall Street Journal op-ed you said:

But the consequence of a dramatic increase in bank capital is an increase in the cost of bank credit, meaning higher interest rates across the board. Those who favor much higher bank capital argue this would not happen, because investors would accept lower returns if the banks they put their money in were safer. In the real world of capital markets, however, there are not enough natural investors in bank equity seeking utility-like returns.

a. Please provide all of the relevant literature upon which you are basing your assertion that a "dramatic increase in bank capital is an increase in the cost of bank credit[.]"
b. Do the prospective increased costs outweigh the associated benefits to increased financial stability, particularly when accounting for the cost of the recent financial crisis?
c. Please provide supporting evidence for your assertion that "there are not enough natural investors in bank equity" should capital requirements be increased substantially. What is a "natural" investor, and what distinguishes them from other types of investors?

The stability of the U.S. financial system is supported by the safe and sound operation of banking institutions. One of the most important prudential measures for ensuring that stability is bank capital. Of course, there is a tradeoff between higher bank capital levels that increase the resiliency of individual institutions and the system as a whole, and the cost of that capital. A goal of regulation should be to balance to protection of financial stability in a way that promotes economic growth and business opportunity.

Equity investors hold an institution's riskiest securities and as a consequence demand a return for that risk that is higher than the institution's debt holders in any given capital structure. Although in ideal conditions the return demanded on the equity should fall in proportion to increases in the firm's equity and reductions in its debt, actual capital markets differ from ideal conditions in a variety of ways: there is a tax preference for debt; there are higher direct and indirect transaction costs for issuing equity; a material portion of a bank's debt is insured (its deposits) and the insurance premium is not fully related to the risk covered; and both real and perceived asymmetries in information between an institution and its investors result in an underpricing of the riskiest securities and an overpricing of the less risky. As a result, equity financing is materially more expensive for a financial institution than debt financing, and there is persuasive literature that relates this higher cost of financing to a higher cost of credit provided by banks (e.g., Cosimano and Hakura 2011; ECB 2015; de Ramon, et al. (2012); Francis and Osborne (2009))[1].

Relatedly, there is a growing body of literature that analyzes the effect of bank capital levels on the quantity as well as the cost of credit. For example, Board governors have cited the following

[1] Cosimano, Thomas F. and Dalia S. Hakura (2009). "Bank Behavior in Response to Basel III: A Cross-country Analysis." IMF Working Paper WP/11/119; "Euro Area Bank Lending Survey" (January 2015); de Ramon, Sebastian J.A., et al (2012). "Measuring the Impact of Prudential Policy on the Macroeconomy: A Practical Application to Basel III and Other Responses to the Financial Crisis," Financial Services Authority Occasional Paper Series, No. 42; Santos, André Oliveira and Douglas Elliott (2012). "Estimating the Costs of Financial Regulation." IMF Staff Discussion Note SDN/12/11; Martin-Oliver, Alfredo et al (2013). "Banks' Equity Capital Frictions, Capital Ratios, and Interest Rates." International Journal of Central Banking, Vol. 9, No. 1, p.183.

studies. Furfine[2] analyzes data on large U.S. commercial banks between 1989 and 1997 and concludes that a one percentage point increase in capital standards reduces loan growth by 5.5 percent. Berrospide and Edge[3] find a more modest impact. Using U.S. bank holding company data from 1992 to 2009, the authors conclude that a one percentage point increase in capital requirements reduces loan growth by roughly 0.7 to 1.2 percentage points. Other studies tell a similar story using non-U.S. data. For instance, Francis and Osborne[4] find, using U.K. data, that a one percentage point increase in capital requirements reduces bank lending by approximately 1.2 percent. Finally, Martynova's[5] survey of the literature--mostly of studies using non-U.S. data--shows that an increase in capital requirements by one percentage point reduces loan growth by 1.2 to 4.6 percentage points.

As your question notes, however, whether the costs outweigh the benefits of higher capital is a separate issue. There is a growing body of research regarding the costs and benefits of bank capital that addresses the impact of capital standards on economic growth. A number of studies, also cited by Board governors, including the Basel Committee on Banking Supervision,[6] the Bank of England,[7] the Federal Reserve Bank of Minneapolis,[8] and Firestone et al.[9] suggest that higher bank capital requirements (up to a point) are good for long-term credit availability and economic growth, but that with levels of capital beyond that point, social welfare is decreased. While the optimal level of capital varies between studies, the basic framework is the same.

4. In the same op-ed, you said:

Focusing on bank size is politically appealing but diverts attention from the major source of systemic risk in the financial sector: a shortage of stable deposits. Banks are but one part of an interconnected financial sector providing over $40 trillion of credit to the economy, but that credit is supported by only about $11 trillion of bank deposits.

The gap must be closed largely with professionally managed, "wholesale" funding, such as short-term repurchase agreements. Wholesale funders are quick to pull their support by not rolling over short-term credit if they perceive those funds are at risk. This leads to periodic runs on financial institutions and the resulting demand for government intervention to prevent the failure of those institutions.

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[2] Furfine, Craig (2000). "Evidence on the Response of US Banks to Changes in Capital Requirements." BIS Working Papers No 88.

[3] Berrospide, Jose M. and Rochelle M. Edge (2010). "The Effects of Bank Capital on Lending: What Do We Know, and What Does It Mean?" Federal Reserve Board Finance and Economics Discussion Series 2010-44.

[4] Francis, William B. and Matthew Osborne (2012). "Capital Requirements and Bank Behavior in the UK: Are There Lessons for International Capital Standards?" Journal of Banking and Finance, 36, 803-816.

[5] Martynova, Natalya (2015). "Effect of Bank Capital Requirements on Economic Growth: A Survey." DNB Working Paper No. 467.

[6] Basel Committee on Banking Supervision (2010). "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements."

[7] Brooke, Martin et al. (2015). "Measuring the Macroeconomic Costs and Benefits of Higher U.K. Bank Capital Requirements." Bank of England Financial Stability Paper No. 35.

[8] Federal Reserve Bank of Minneapolis (2016). "The Minneapolis Plan to End Too Big To Fail."

[9] Firestone, Simon, Amy Lorenc, and Ben Ranish (2017). "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S." Federal Reserve Board Finance and Economics Discussion Series 2017-034.

Substantial wholesale funding is necessary to sustain the current level of financial-sector credit that supports the economy…

Whether there are 10 big banks in the country or 10,000 small ones, there will still be insufficient stable financing from deposits, and a resulting reliance on wholesale funds.

In 2013, Governor Tarullo told this committee that the "issue of short term, non-deposit, runnable funding" is "the one I think we should be debating in the context of Too Big to Fail, and in the context of our financial system more generally."

a. Do you agree with Governor Tarullo that more needs to be done to address the issue of short-term wholesale funding?

Since the time of Governor Tarullo's testimony, the Board has undertaken several efforts to address banking organizations' use of short-term wholesale funding. For example, the Board has implemented the liquidity coverage ratio and has proposed the net stable funding ratio to increase large banking organizations' resilience to disruptions in short-term wholesale funding. In addition, the Board adopted the GSIB surcharge rule, which takes U.S. GSIBs' reliance on short-term wholesale funding into account in the calibration of each GSIB's capital surcharge, and adopted a long-term debt requirement for U.S. GSIBs. If confirmed, I look forward to further evaluating the benefits and costs associated with adoption of such measures.

b. In 2013, the GAO found that "the use of programs by institutions of various sizes were driven in part by differences in how institutions funded themselves," and that large banks holding companies received a higher ratio of support relative to their total assets because they "relied less on deposits as a source of funding and more on short-term credit markets and participated more in programs created to stabilize these markets."

Do you agree that "focusing on size" may be an appropriate approach, to the extent that larger financial institutions (particularly bank holding companies) rely on more wholesale funding?

Large banking firms tend to have more complex risk and funding profiles relative to smaller firms. Accordingly, for some regulations it may be appropriate to use size-based thresholds to determine their scope of application. For other regulations, it may be appropriate to consider factors in addition to size in setting their scope of application, given the considerable variation in risk and funding profiles and systemic footprints across large firms.

c. Do you support the following measures that have been proposed to mitigate the risks posed by short-term wholesale funding:

i. The supplementary leverage ratio?
ii. The liquidity coverage ratio?
iii. The net stable funding ratio? If so, will you making finalizing the net stable funding ratio rule a priority?

Uniform margin requirements for securities financing transactions? If so, will you make proposing a rule for uniform margin requirements for securities financing transactions a priority?

As noted in the above response, the Board has undertaken several measures aimed at mitigating the risks of over-reliance on short-term wholesale funding, including the liquidity coverage ratio and the GSIB risk-based capital surcharges. The supplementary leverage ratio, while not specifically targeted towards short-term wholesale funding, also impacts firms' funding decisions. The net stable funding ratio and margin requirements for securities financing transactions could further mitigate potential risks to financial stability associated with different types of short-term wholesale funding. I have not had the benefit of the extensive review and analysis conducted by the Federal Reserve in the course of developing these measures, and thus, if confirmed, I look forward to further evaluating the benefits and costs associated with adoption of such measures.

5. In January 2014, the Board announced an Advanced Notice of Proposed Rulemaking on financial holding companies' commodities activities. In September 2016, the report released by the Board, the OCC, and the FDIC pursuant to section 620 of Wall Street Reform, on banks' securities activities recommended that Congress rescind two authorities under the Bank Holding Company Act – the merchant banking authority under section 4(k) and the grandfathered authority under section 4(o). Later that month, the Board released a proposed rule to limit some of the financial holding companies' commodities activities.

a. While at the Treasury Department, did you have any involvement in the 2003 joint report with the Board of Governors on Financial Holding Companies under the Gramm–Leach–Bliley Act or the 2005 Treasury Department report on the Impact of the Gramm-Leach-Bliley Act on Credit to Small Businesses and Farms?

These reports were prepared by the Office of Domestic Finance of the Treasury. During the periods of their preparation, I was serving in the Office of International Affairs (as Assistant Secretary in 2003, and as Assistant Secretary and Acting Under Secretary during the first part of 2005). The Office of International Affairs has no policy responsibility for the matters discussed in these reports, and I was not involved in their preparation.

b. Do you support the Board's recommendations in the section 620 report?

The Board's recommendations in the 620 report were the result of an extended review of the history and operation of the provisions under consideration. Having not had the benefit of that review, my views on the 620 report are not yet formed. If confirmed, I would look forward to understanding and exploring these issues with the other Board members.

c. Do you support the Board's proposed rule, and will you make finalizing the rule a priority?

The proposed rule invited public comment on additional prudential requirements and limitations on the physical commodities activities of financial holding companies (FHCs) to address the risks the activities may pose to FHCs and their subsidiary insured depository institutions. I understand that the Board received a wide range of comments from a variety of interested parties, including Members of Congress, academics, physical commodity end users and producers, public interest groups, and FHCs. I think it would be inappropriate for me to express a view in advance of reviewing all of these comments, and thus, if I am confirmed, I will review the proposal and comments to consider what future action may be appropriate.

6. In 2008, you editorialized in the Wall Street Journal against the restrictions on bank ownership imposed by the Board and the FDIC, and in 2009 you editorialized against aspects of the FDIC's proposed rule imposing additional restrictions on bank ownership by private equity funds. Did you have any contact with the Board concerning rules governing bank ownership? If so, please provide such contacts.

I spoke informally with Governor Randall S. Kroszner, at his request, in the fall of 2008 about potential safeguards to allow the safe expansion of the pool of bank capital given the need for such capital during the financial crisis, and had one formal meeting to discuss the issue with Governor Daniel Tarullo in March 2009.

7. As I mentioned during your hearing, in 2015 Bloomberg Television interview, you said:

The government should not be a player in the financial sector. It should be a referee. And both the practice and the policy and the legislation that resulted from the financial crisis tended to make the government a player. It put it on the field as opposed to simply reffing the game.

Please explain your views as to what distinguishes being a "player" from being a "referee," as it relates to financial regulation.

My approach to policy making, and particularly to regulation, has been that the discretion of policy makers, and particularly of regulators, should be as constrained as possible. Where discretion remains, regulators should be as clear as possible about how they will exercise it in the future so that their actions are predictable and there is less uncertainty as to what the policy will be.

8. In 2011, at an Atlantic Council event, you said:

I have come to believe that there is a fundamental problem with resolution mechanisms that allow substantial discretion for governments to act in particular cases, which Dodd-Frank…does. The consequence of that is that it multiplies uncertainty in a time of crisis because you're not going to act until you know what the government is going to do… I think ultimately the only really workable solution, which is to sort of have something that is like a bankruptcy regime—a rules-based approach as opposed to something that says, 'and then 'Mr. Wizard will decide what to do.'

a. Do you believe that Title II Orderly Liquidation Authority, as implemented by the FDIC's Single Point of Entry approach, allows "substantial discretion" to regulators in the event of an orderly liquidation?

The Department of the Treasury is reviewing the authorities of the Federal Deposit Insurance Corporation (FDIC) under the Orderly Liquidation Authority (OLA), and I will review the

Treasury report on OLA. Where the law provides regulators with discretion, regulators should be as clear as possible about how they will exercise their discretion. Since my 2011 statement, the FDIC has provided additional clarity regarding the single point of entry (SPOE) strategy it may employ under OLA. In addition, the Board has issued rulemakings to facilitate the resolution of global systemically important banking organizations, including an SPOE resolution under OLA. Regulators should continue their efforts to provide as much clarity as possible regarding the resolution of systemically important financial institutions.

b. Do you believe that some sort of bankruptcy regime for large, complex financial institutions is the only "rules-based approach" to the failure of such an institution?

Conceptually, there could be many ways to constrain the discretion of government actors to improve the certainty and predictability of their actions in the event of a financial institution's distress, of which bankruptcy is one but not the only one. An advantage of the bankruptcy process is that there is a long history of practice and interpretation that provides further clarity about how the system will operate in specific cases in the future. This is among the reasons it would be beneficial if the Bankruptcy Code could be amended so that a financial institution could fail in the same way that any other institution fails, and the rules surrounding that would be understood as they are for any other institution.

c. Do you believe that imposing different national bankruptcy regimes on the respective subsidiaries of a large, international financial institution multiplies uncertainty?

Whether the entry of a subsidiary of a large, international banking organization into a separate insolvency proceeding impedes the orderly resolution of the organization depends on a number of factors, including the structure of the organization, the functions of the subsidiary, and the circumstances that cause the failure. The Board and the FDIC (agencies) are responsible for reviewing the plans of many large, international banking organizations for their orderly resolution under the U.S. Bankruptcy Code. The agencies have provided guidance to the internationally-active firms that the firms should take steps to address resolvability obstacles related to their foreign subsidiaries. To further reduce uncertainty, large, international banking organizations and their domestic and foreign regulators should continue their efforts to plan for and coordinate the potential resolution of these organizations and should be as clear as possible as to how such resolutions may occur.

d. In your hypothetical scenario, is "Mr. Wizard" always a financial regulatory agency, or could such person also include a bankruptcy judge or trustee?

In my view, a critical issue in the resolution of financial firms is to improve the predictability and certainty of the course of resolution, and limiting the discretion of government actors is an important element of that process. Accordingly, improving the speed and certainty of outcomes in the bankruptcy process, including the predictability of decisions made by judges in that process, is central to the improvements that should be made to the Bankruptcy Code for the resolution of financial institutions. The Board and FDIC have made progress through the resolution planning, or "living will," review process to make the largest banking organizations easier to resolve under the current Bankruptcy Code. I support improving the Bankruptcy Code so that the rules surrounding the bankruptcy of a large financial company would be understood as they are for any other company with as little exercise of discretion as possible.

9. Related to monetary policy, do you agree with the "unconventional" steps taken by Federal Reserve Chairman Bernanke during the crisis? Since the crisis, do you think the Federal Open Market Committee has been on the right course of gradually increasing interest rates, and taking steps to begin to unwind their balance sheet later this year?

The financial panic and associated steep economic downturn in 2008/2009 was the most severe financial and economic crisis faced by the United States and the world since the Great Depression. In those circumstances, Congress, the Administration, and many federal agencies including the Federal Reserve took extraordinary steps to address the crisis. I am not in a position to judge the merits of every single action taken by the Federal Reserve over this period, but it is clear that the economy was in very serious trouble at the end of 2008.

Regarding the current trajectory of monetary policy, if confirmed, I expect to benefit from interactions with colleagues on the Federal Open Market Committee (FOMC) in assessing the appropriate course of policy. Broadly though, it does appear that the FOMC's approach to date in gradually raising the federal funds rate and preparing to reduce the size of its balance sheet in a gradual and predictable fashion has been effective in fostering the goals of maximum employment and stable prices while at the same time returning the stance of monetary policy to a more normal setting.

10. If confirmed, you will be a member of the Federal Open Market Committee. What experience will you bring to this role? Are there any changes in how monetary policy is currently conducted that you will advocate for?

Over the course of my career, I have gained broad experience in economic and financial issues, both from a private sector perspective in working with both large and small financial firms and from a policy perspective in serving in senior policy positions in two previous Administrations. Based on this experience, I have developed a mature understanding of the key monetary policy issues confronting the FOMC. Of course, if confirmed, I expect to add to this experience from interactions with colleagues on the FOMC.

I support the basic framework for the conduct of monetary policy established by the Congress. The Congress has directed the Federal Reserve to promote two basic goals--maximum employment and stable prices. The Federal Reserve has an important degree of operational independence in how it conducts policy to achieve these goals--but that operational independence comes with an obligation to be accountable and transparent to the public and the Congress.

The Federal Reserve has taken many steps over recent years to enhance transparency and accountability in the conduct of monetary policy. I would certainly support any additional steps in this area that would both enhance Federal Reserve transparency and support the effective conduct of monetary policy.

11. You have said in the past that Federal Reserve should adopt a monetary policy rule, like the Taylor rule. As you know, the Federal Reserve currently uses a variety of

monetary policy rules, including the Taylor rule, in its analysis and monetary policy decisionmaking, but does not rely solely on rules to determine interest rate adjustments. Do you agree with the Federal Reserve's current approach, or are you advocating that the Fed use a single rule?

The Federal Reserve has made substantial progress over the last 25 years in becoming both clearer and more consistent in explaining its monetary policy decisions. I believe, though, that there is still room for the Federal Reserve to do more in developing and explaining a clearly delineated and broadly measurable strategy that would improve current understanding and reduce future uncertainty concerning the expected course of monetary policy. My commitment to a greater focus on rules in the conduct of policy is not inconsistent with the Federal Reserve's progress in improving its transparency, nor a dramatic change in direction, but a recognition that the Federal Reserve can and should continue to improve the clarity and consistency of the framework in which it conducts monetary policy. This discipline can improve the policy itself, and improve the understanding of that policy by markets and by the public.

12. How important is it for the U.S. central bank to be independent?

I support the basic framework for the conduct of monetary policy established by the Congress. The Congress has assigned to the Federal Reserve the goals of monetary policy, and the Federal Reserve has an important degree of operational independence in how it conducts policy to achieve these goals. Independence of the central bank is critical in insulating the conduct of monetary policy from political pressures that can lead to ineffective policy and poor macroeconomic outcomes. Research has demonstrated that central banks that are subject to political pressures are generally less effective in achieving their macroeconomic objectives; for example, some historians have suggested that political pressures on the Federal Reserve may have contributed to policy mistakes and the "Great Inflation" of the late 1960s and 1970s.

While I am a strong supporter of the independence of the Federal Reserve, the Federal Reserve is a public institution and its independence comes with an obligation to be transparent and accountable to the Congress and the public in the conduct of monetary policy. Over time, the FOMC has made considerable strides in enhancing transparency. For example, it now issues statements following every meeting, the Chair holds a press conference four times each year, FOMC participants prepare quarterly economic projections, detailed minutes of FOMC meetings are published three weeks following each meeting, and full transcripts of meetings and supporting documents are released to the public with a five-year lag. These steps have significantly enhanced Federal Reserve transparency and have also supported the effectiveness of monetary policy by allowing the public to better understand and anticipate the Federal Reserve's policy decisions. If confirmed, I would support any additional steps that the Federal Reserve could take that would enhance both Federal Reserve transparency and the effective conduct of monetary policy.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
July 27, 2017

Questions for The Honorable Randal Quarles, nominee to be a Member of the Board of Governors of the Federal Reserve System; Reappointment as a Member of the Board of Governors of the Federal Reserve System; and Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, from Ranking Member Sherrod Brown:

1. While at the Treasury Department you negotiated the financial services provisions of six free trade agreements and described "liberalization of financial services" as "vital" to U.S. trade policy. Wall Street has sought to include financial regulation in trade agreements, most recently in the Transatlantic Trade and Investment Partnership (TTIP), as a backdoor way of weakening Wall Street reform. Secretary Lew, Governor Tarullo, and others pushed back on those efforts and argued that financial regulation should be addressed outside of trade policy. Do you agree that financial regulation should be negotiated outside of broader trade agreements?

2. In September 2016, Governor Tarullo announced that the Board of Governors would be incorporating some modified form of the GSIB capital surcharge into the CCAR's minimum common equity ratio that apply to the U.S. GSIBs. When Senator Rounds asked you about your position on this change, you responded that you would want to look at the question in more depth, but that it is definitely worth looking at. Having had more time to consider the question, do you support this change for the 2018 CCAR process?

3. In your 2016 Wall Street Journal op-ed you said:

   > *But the consequence of a dramatic increase in bank capital is an increase in the cost of bank credit, meaning higher interest rates across the board. Those who favor much higher bank capital argue this would not happen, because investors would accept lower returns if the banks they put their money in were safer. In the real world of capital markets, however, there are not enough natural investors in bank equity seeking utility-like returns.*

   a. Please provide all of the relevant literature upon which you are basing your assertion that a "dramatic increase in bank capital is an increase in the cost of bank credit[.]"

   b. Do the prospective increased costs outweigh the associated benefits to increased financial stability, particularly when accounting for the cost of the recent financial crisis?

   c. Please provide supporting evidence for your assertion that "there are not enough natural investors in bank equity" should capital requirements be increased substantially. What is a "natural" investor, and what distinguishes them from other types of investors?

4. In the same op-ed, you said:

   > *Focusing on bank size is politically appealing but diverts attention from the major source of systemic risk in the financial sector: a shortage of stable deposits. Banks are but one part of an interconnected financial sector providing over $40 trillion of credit to the economy, but that credit is supported by only about $11 trillion of bank deposits.*

> *The gap must be closed largely with professionally managed, "wholesale" funding, such as short-term repurchase agreements. Wholesale funders are quick to pull their support by not rolling over short-term credit if they perceive those funds are at risk. This leads to periodic runs on financial institutions and the resulting demand for government intervention to prevent the failure of those institutions.*
>
> *Substantial wholesale funding is necessary to sustain the current level of financial-sector credit that supports the economy...*
>
> *Whether there are 10 big banks in the country or 10,000 small ones, there will still be insufficient stable financing from deposits, and a resulting reliance on wholesale funds.*

In 2013, Governor Tarullo told this committee that the "issue of short term, non-deposit, runnable funding" is "the one I think we should be debating in the context of Too Big to Fail, and in the context of our financial system more generally."

a. Do you agree with Governor Tarullo that more needs to be done to address the issue of short-term wholesale funding?

b. In 2013, the GAO found that "the use of programs by institutions of various sizes were driven in part by differences in how institutions funded themselves," and that large banks holding companies received a higher ratio of support relative to their total assets because they "relied less on deposits as a source of funding and more on short-term credit markets and participated more in programs created to stabilize these markets."

   Do you agree that "focusing on size" may be an appropriate approach, to the extent that larger financial institutions (particularly bank holding companies) rely on more wholesale funding?

c. Do you support the following measures that have been proposed to mitigate the risks posed by short-term wholesale funding:

   i. The supplementary leverage ratio?

   ii. The liquidity coverage ratio?

   iii. The net stable funding ratio? If so, will you making finalizing the net stable funding ratio rule a priority?

   iv. Uniform margin requirements for securities financing transactions? If so, will you make proposing a rule for uniform margin requirements for securities financing transactions a priority?

5. In January 2014, the Board announced an Advanced Notice of Proposed Rulemaking on financial holding companies' commodities activities. In September 2016, the report released by the Board, the OCC, and the FDIC pursuant to section 620 of Wall Street Reform, on banks' securities activities recommended that Congress rescind two authorities under the

Bank Holding Company Act – the merchant banking authority under section 4(k) and the grandfathered authority under section 4(o). Later that month, the Board released a proposed rule to limit some of the financial holding companies' commodities activities.

a. While at the Treasury Department, did you have any involvement in the 2003 joint report with the Board of Governors on Financial Holding Companies under the Gramm–Leach–Bliley Act or the 2005 Treasury Department report on the Impact of the Gramm-Leach-Bliley Act on Credit to Small Businesses and Farms?

b. Do you support the Board's recommendations in the section 620 report?

c. Do you support the Board's proposed rule, and will you make finalizing the rule a priority?

6. In 2008, you editorialized in the Wall Street Journal against the restrictions on bank ownership imposed by the Board and the FDIC, and in 2009 you editorialized against aspects of the FDIC's proposed rule imposing additional restrictions on bank ownership by private equity funds. Did you have any contact with the Board concerning rules governing bank ownership? If so, please provide such contacts.

7. As I mentioned during your hearing, in 2015 Bloomberg Television interview, you said:

> *The government should not be a player in the financial sector. It should be a referee. And both the practice and the policy and the legislation that resulted from the financial crisis tended to make the government a player. It put it on the field as opposed to simply reffing the game.*

Please explain your views as to what distinguishes being a "player" from being a "referee," as it relates to financial regulation.

8. In 2011, at an Atlantic Council event, you said:

> *I have come to believe that there is a fundamental problem with resolution mechanisms that allow substantial discretion for governments to act in particular cases, which Dodd-Frank...does. The consequence of that is that it multiplies uncertainty in a time of crisis because you're not going to act until you know what the government is going to do... I think ultimately the only really workable solution, which is to sort of have something that is like a bankruptcy regime—a rules-based approach as opposed to something that says, 'and then 'Mr. Wizard will decide what to do.'*

a. Do you believe that Title II Orderly Liquidation Authority, as implemented by the FDIC's Single Point of Entry approach, allows "substantial discretion" to regulators in the event of an orderly liquidation?

b. Do you believe that some sort of bankruptcy regime for large, complex financial institutions is the only "rules-based approach" to the failure of such an institution?

c. Do you believe that imposing different national bankruptcy regimes on the respective subsidiaries of a large, international financial institution multiplies uncertainty?

d. In your hypothetical scenario, is "Mr. Wizard" always a financial regulatory agency, or could such person also include a bankruptcy judge or trustee?

9. Related to monetary policy, do you agree with the "unconventional" steps taken by Federal Reserve Chairman Bernanke during the crisis? Since the crisis, do you think the Federal Open Market Committee has been on the right course of gradually increasing interest rates, and taking steps to begin to unwind their balance sheet later this year?

10. If confirmed, you will be a member of the Federal Open Market Committee. What experience will you bring to this role? Are there any changes in how monetary policy is currently conducted that you will advocate for?

11. You have said in the past that Federal Reserve should adopt a monetary policy rule, like the Taylor rule. As you know, the Federal Reserve currently uses a variety of monetary policy rules, including the Taylor rule, in its analysis and monetary policy decisionmaking, but does not rely solely on rules to determine interest rate adjustments. Do you agree with the Federal Reserve's current approach, or are you advocating that the Fed use a single rule?

12. How important is it for the U.S. central bank to be independent?

United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510-6075

August 2, 2017

The Honorable Randal Quarles
Board of Governors of the Federal Reserve System
20th and C Street NW
Washington, D.C. 20551

Dear Mr. Quarles:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs on July 27, 2017 at our hearing to consider nominations.

In order to complete the hearing record, we would appreciate your answers to the enclosed questions by Monday, August 7, 2017 by 9:00AM. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo

Mike Crapo
Chairman

MC/dr

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

November 17, 2017

The Honorable Barry Loudermilk
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Loudermilk:

1. As you know, pursuant to Executive Order 13772, the Department of the Treasury released a report titled "A Financial System that Creates Economic Opportunities: Banks and Credit Unions" on June 12, 2017. This report contains numerous recommendations for regulatory relief for financial institutions, and I appreciate that you have indicated that you generally support these recommendations.

a. Specifically, the report recommends that the $50 billion threshold for application of enhanced prudential standards to institutions be more appropriately tailored to the risk profile of bank holding companies. Further, the report recommends that Federal Reserve update the threshold for applying CCAR stress tests and living wills to match that revised threshold. Do you agree with this recommendation?

b. The report also recommends that the Federal Reserve consider putting CCAR stress tests and living wills under a two-year cycle. Do you agree with this recommendation?

In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. The Federal Reserve has been working for many years to tailor our regulation and supervision to the size and risk posed by individual institutions.

The failure or distress of a large bank can harm the U.S. economy. The recent financial crisis demonstrated that excessive risk-taking at large banks can threaten the U.S. economy. The crisis led to a deep recession and the loss of nearly nine million jobs. Our regulatory and supervisory framework must aim to reduce the risk that bank failures or distress will have such a harmful impact on economic growth in the future.

The Federal Reserve Board (Board) has already implemented, via a regulation that was proposed and adopted following a period of public notice and comment, a methodology to identify global systemically important banking organizations (GSIBs), whose failure could pose a significant risk to the financial stability of the United States.[1] This "systemic footprint" measure, which determines whether a large firm is identified as a GSIB, includes attributes that serve as proxies for the firm's systemic importance across a number of categories: size, interconnectedness, complexity, cross-jurisdictional activity, substitutability, and reliance on short-term wholesale funding.

There are many large financial firms whose failure would pose a less significant risk to U.S. financial stability, but whose distress could nonetheless cause notable harm to the U.S. economy. The failure or distress of a bank of this nature could harm the U.S. economy in several ways: by disrupting the flow of credit to households and businesses, by disrupting the functioning of financial markets, or by interrupting the provision of critical financial services, including payments, clearing, and settlement. Economic research has documented that a disruption in the

[1] Board of Governors of the Federal Reserve System (2015), "Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies," final rule, *Federal Register*, vol 80 (August 14), pp. 49082-49116.

flow of credit through banks or a disruption to financial market functioning can affect economic growth.[2] Some level of enhanced, but appropriately tailored, standards are therefore appropriate for certain large, non-GSIB banks.

Any application of enhanced, but tailored standards to large, non-GSIB banks should consider their size, complexity, and business models. The impact on economic growth of a bank's failure will depend on factors such as the size and geographic distribution of the bank's customer base and the types and number of borrowers that depend on the bank for credit. Asset size is a simple way to proxy for these impacts, although other measures may also be appropriate. For banks with more complex business models, more sophisticated supervisory and regulatory tools may be appropriate. For example, the Board recently tailored our Comprehensive Capital Analysis and Review (CCAR) qualitative assessment to exclude some smaller and less complex large regional banks, using asset size and nonbank assets to measure size and complexity, respectively.[3] In other contexts, foreign activity or short-term wholesale funding may be another dimension of complexity to consider. Any characteristics or measures that are used to tailor enhanced standards for large, non-GSIB banks should be supported with clear analysis that links them to the potential for the bank's failure or distress to cause notable harm to the U.S. economy.

The Board currently has only limited authority to tailor the enhanced prudential standards included in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In particular, Congress required that certain enhanced prudential standards apply to firms with $10 billion or more in total assets, with different standards beginning to apply at $50 billion or more in total assets.

I understand that Congress is currently considering whether and how to raise these statutory thresholds. The Board has supported increasing these thresholds and is committed to continuing to work with Members of Congress on this issue.

With regard to the proposal to extend the timing of the CCAR assessment from annually to every two years, large banks continue to innovate and adapt their businesses, which is a normal practice for profit-making institutions. CCAR is designed to evaluate capital planning and positions relative to those changes, as well as any changes in a bank's balance sheet, and test for salient risks across the entire financial system. Given the dynamic nature of banks and the risks that they face, capital planning practices are most effective when they address the relevant risks of the firm, and therefore our current supervisory practice includes annual quantitative and qualitative assessments.[4]

With regard to resolution planning, the Government Accountability Office has recommended lengthening the current one-year resolution plan filing cycle to provide sufficient time for regulators to complete their plan reviews and feedback, and for firms to address and incorporate

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[2] For evidence on the link between bank distress and economic growth, see Mark A. Carlson, Thomas King, and Kurt Lewis (2011) "Distress in the Financial Sector and Economic Activity," The B.E. Journal of Economic Analysis & Policy: Vol. 11: Iss. 1 (Contributions), Article 35. For evidence on the link between financial market functioning and economic growth, see Simon Gilchrist and Egon Zakrajšek (2012), "Credit Spreads and Business Cycle Fluctuations," American Economic Review, Vol. 102(4): 1692-1720.

[3] Board of Governors of the Federal Reserve System (2017), "Amendments to the Capital Plan and Stress Test Rules; Regulations Y and YY," final rule, Federal Register, vol 82 (February 3), pp. 9308-9330.

regulators' feedback in subsequent plan filings. The Board and Federal Deposit Insurance Corporation continue to explore ways to improve the resolution planning process and believe it would be worthwhile to consider extending the cycle for living will submissions from annually to once every two years. Doing so would require amending the agencies' respective implementing regulations, which currently require annual plan submissions. In the meantime, I would note that the agencies have taken a number of steps in recent years to simplify the resolution plan filing process, for example by extending the plan submission deadline in a number of instances, and by reducing the plan content requirements for foreign banking organizations with a relatively small footprint in the United States. Also, resolution plan guidance provided to firms other than those that are largest and most systemically important has been tailored to reflect their smaller size and less-complex business models.

House Committee on Financial Services

Full Committee Hearing: "Monetary Policy and the State of the Economy"

July 12, 2017

Questions for the Record from Congressman Barry Loudermilk (GA-11)

The Honorable Janet Yellen, Chair, the Board of Governors of the Federal Reserve System

- As you know, pursuant to Executive Order 13772, the Department of the Treasury released a report titled "A Financial System that Creates Economic Opportunities: Banks and Credit Unions" on June 12, 2017. This report contains numerous recommendations for regulatory relief for financial institutions, and I appreciate that you have indicated that you generally support these recommendations.
    - Specifically, the report recommends that the $50 billion threshold for application of enhanced prudential standards to institutions be more appropriately tailored to the risk profile of bank holding companies. Further, the report recommends that Federal Reserve update the threshold for applying CCAR stress tests and living wills to match that revised threshold. Do you agree with this recommendation?
    - The report also recommends that the Federal Reserve consider putting CCAR stress tests and living wills under a two-year cycle. Do you agree with this recommendation?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

October 17, 2017

The Honorable Dennis Ross
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on August 14, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Ross:

1. Since the Federal Reserve Board (FRB) is a significant participant in the International Association of Insurance Supervisors (IAIS), which is attempting to develop a global group capital standard, can you provide any insight into the status of the Insurance Capital Standard (ICS) work at the IAIS and do you believe the 2019 deadline for IAIS adoption of ICS 2.0, the first version that member jurisdictions are expected to implement, will be kept? Will the FRB advocate that any version of the ICS should include recognition of U.S. state based capital standards and the capital standard currently under development by the FRB as at least one alternative for compliance?

The Insurance Capital Standard (ICS) aims to be the first international, group-wide capital standard broadly applicable to internationally active insurance groups. The International Association of Insurance Supervisors (IAIS) began work on the ICS in 2013, issued an initial consultative proposal in late 2014, and published a subsequent consultative proposal on an ICS version 1.0 in July 2016. A revised consultative proposal on an ICS version 2.0 is currently contemplated for the middle of 2018. Depending on the outcome of the consultation, stakeholder input, and data collection, as well as IAIS member review, appropriate subsequent steps will be determined. The ICS is scheduled to be adopted by the IAIS in late 2019. However, it is possible that ongoing discussions regarding the inclusion of other methods in the ICS, including possible aggregation approaches, result in the postponement of the IAIS' adoption. Importantly, standards developed at the IAIS are not self-executing or binding on the U.S. unless adopted by the appropriate lawmakers or regulators in the U.S. in accordance with applicable domestic laws and rulemaking procedures.

Together with the National Association of Insurance Commissioners (NAIC) and Federal Insurance Office, the Federal Reserve advocates for the development of international standards at the IAIS that would be appropriate for the U.S., including an implementable ICS. The Federal Reserve, along with its other U.S. colleagues, is advocating the ICS's inclusion of aggregation methods such as the NAIC's group capital calculation and the Federal Reserve's building block approach.

2. It appears that the "Building Block Approach" the FRB is developing as a capital standard for savings & loan holding companies that include insurers is similar in some basic respects to the "RBC (Risk-Based Capital) Aggregation Approach" being developed by the National Association of Insurance Commissioners (NAIC). If any capital standard proposed by the FRB differs from the NAIC's state-based standards, will the costs versus benefits of those differences be publicly assessed with regard to their effect on U.S. consumers and U.S. markets? How will that be done, with Congressional, state and stakeholder input?

The Federal Reserve Board (Board) remains mindful of the longstanding importance of the states' primary supervision of the insurance industry, which the Board's consolidated supervision complements and supplements. As stated in its advance notice of proposed rulemaking (ANPR) published in June 2016, a goal of the Board's proposed building block approach (BBA) is to efficiently use existing legal-entity-level regulatory capital frameworks, including those under state laws.

In its comment letter to the ANPR, the NAIC expressed its desire to work with the Board in its development of the BBA. The Board welcomes this interest, consistent with the Board's commitment to transparency and engagement with interested parties. Input from the NAIC would enhance the identification of commonality and ways to minimize inconsistency and burden upon the Board's supervised insurance firms. The proposed BBA is pursuant to the Board's statutory authority to set out capital standards for supervised insurance institutions as consolidated supervisor. It is not yet clear what form the NAIC's group capital calculation will take, though we note that the NAIC frequently produces model laws and regulations for states to evaluate and, if agreeable, adopt, potentially with tailoring. This differentiates the two capital frameworks structurally, and it is premature to say whether this will affect the content of the frameworks.

To the extent that technical or other considerations result in areas that reasonably may not be addressed identically between the two frameworks, the Board remains committed to transparency in its rulemaking process, engagement with congressional, state, and any other interested parties, and evaluation of costs, benefits, and economic impacts. In developing its proposed rules, the Board routinely considers a variety of alternatives and an initial balancing of costs and benefits of a proposal. As part of its rulemaking process, the Board seeks comment from the public on the burdens and benefits of our proposed approach in a rule as well as on alternative approaches. With respect to its insurance standards, and all other rulemakings, the Board follows the Administrative Procedures Act and other applicable administrative laws and practices that govern the various aspects of rulemakings, including the consideration of costs and benefits.

Questions for the Record

Hearing Title: Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System

Witness: The Honorable Janet Yellen, Chair of the Board of Governors of the Federal Reserve System

Member Requesting: Rep. Dennis A. Ross

1. Since the Federal Reserve Board (FRB) is a significant participant in the International Association of Insurance Supervisors (IAIS), which is attempting to develop a global group capital standard, can you provide any insight into the status of the Insurance Capital Standard (ICS) work at the IAIS and do you believe the 2019 deadline for IAIS adoption of ICS 2.0, the first version that member jurisdictions are expected to implement, will be kept? Will the FRB advocate that any version of the ICS should include recognition of U.S. state based capital standards and the capital standard currently under development by the FRB as at least one alternative for compliance?

2. It appears that the "Building Block Approach" the FRB is developing as a capital standard for savings & loan holding companies that include insurers is similar in some basic respects to the "RBC (Risk-Based Capital) Aggregation Approach" being developed by the National Association of Insurance Commissioners (NAIC). If any capital standard proposed by the FRB differs from the NAIC's state-based standards, will the costs versus benefits of those differences be publicly assessed with regard to their effect on U.S. consumers and U.S. markets? How will that be done, with Congressional, state and stakeholder input?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 1, 2017

The Honorable Ed Royce
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 1, 2, 3, and 6 that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Royce:

1. Today, the Fed's $4.5 trillion portfolio is made up of roughly 55% Treasury securities and 45% agency MBS. You and the F-O-M-C (Federal Open Market Committee) have announced your intentions to begin unwinding this historic portfolio. As that portfolio normalizes, do you expect the ratio of Agency MBS to Treasuries to remain the same over time?

Following its June meeting, the Federal Open Market Committee (FOMC) provided additional details regarding its plans for normalizing the size and composition of the Federal Reserve's securities portfolio over time.[1] Under this plan, the Federal Reserve will reduce its securities holdings in a gradual and predictable process by reducing the reinvestment of principal payments on existing securities holdings. Projections published by the Federal Reserve Bank of New York in July indicate that, under a baseline scenario, this gradual, passive runoff of securities holdings will result in the normalization of the size of the Federal Reserve's balance sheet by the end of 2021.[2]

Under these projections, the share of Treasury securities in the Federal Reserve System's securities holdings will decline slightly over the next few years because the runoff of Treasury securities is somewhat faster than the runoff of agency mortgage-backed securities (MBSs). However, as noted in the FOMC's Policy Normalization Principles and Plans document published in September 2014, the FOMC has indicated that in the longer run it expects to hold a portfolio that consists "primarily of Treasury securities, thereby minimizing the effect of the Federal Reserve's securities holdings on the allocation of credit across sectors of the economy."

2. As you know, many have criticized the Fed for placing their "thumb on the scale" for one sector of our economy, currently holding 29% of the total outstanding Agency MBS. There are others who want you to go even further and invest in infrastructure and municipal securities, etc. As this extraordinary episode in the Fed's history comes to an end – and we are also looking towards housing finance reform – do you think it makes sense to reassess whether or not the Fed should be in a position to support certain sectors over others?

The Federal Reserve conducts monetary policy to achieve the dual mandate objectives of maximum employment and stable prices. At the end of 2008, the federal funds rate had already been cut to near zero, and the economy was in dire circumstances with unemployment moving sharply higher and deflationary pressures mounting. Additional policy accommodation was clearly required to support the economy and keep inflation from moving much lower. Against this backdrop, the Federal Reserve conducted large scale purchases of longer-term Treasury and agency MBSs as a tool to put downward pressure on longer-term interest rates and to make financial conditions more accommodative. Purchases of agency MBSs helped to support the mortgage and housing markets. These markets were under severe stress during the crisis and the

[1] This information is available on the Board's website at https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm.

[2] https://www.newyorkfed.org/medialibrary/media/markets/omo/SOMAPortfolioandIncomeProjections_July2017Update.pdf.

strains in these markets posed significant downside risks to the U.S. economy. These policies were effective in helping to stabilize the economy and foster progress toward the Federal Reserve's goals of maximum employment and stable prices.

The conduct of monetary policy is focused on promoting maximum employment and stable prices and does not seek to support one sector over another. A joint statement of the Treasury and the Federal Reserve in 2009 noted that "Actions taken by the Federal Reserve should also aim to improve financial or credit condition broadly, not to allocate credit to narrowly-defined sectors or classes of borrowers. Government decisions to influence the allocation of credit are the province of the fiscal authorities."

It is important to note that the range of assets that the Federal Reserve can purchase is quite limited. The most important classes of assets by far that the Federal Reserve can purchase are Treasury and agency MBSs. The Federal Reserve's authority to purchase municipal securities is extremely limited and of little practical value as a policy tool. The Federal Reserve has no authority to purchase securities issued by the private sector.

3. In your submitted testimony you state that 'the longer-run normal level of reserve balances will depend on a number of as-yet-unknown factors...' But conclude that you 'anticipate' keeping the reserve balances at a level 'larger than before the financial crisis.' What is the reasoning behind keeping the portfolio above past 'normal' levels?

These issues are discussed at length in projections published by the Federal Reserve Bank of New York in an update to the Annual Report of the System Open Market Account.[3] The size of the portfolio over time is largely determined by two factors--the level of currency and other non-reserve liabilities and the level of reserve balances held by depository institutions. The level of currency and non-reserve liabilities is largely unrelated to the stance of monetary policy, and these liabilities tend to grow over time. The Federal Reserve generally increases its securities holdings slowly over time to match the growth of these liabilities. For example, the level of currency outstanding at the end of 2007 was about $800 billion and has risen to a level of about $1.6 trillion today. So even if the Federal Reserve had not engaged in large scale asset purchases, the size of the portfolio would have doubled in size since 2007 based on the expansion of currency alone.

The other key factor affecting the size of the balance sheet is the level of reserve balances held by depository institutions. This factor reflects the stance of monetary policy and the Federal Reserve's policy implementation framework. Just prior to the crisis, the level of reserve balances was quite small, on the order of $5 to $10 billion. Today, largely reflecting the expansion of the portfolio through asset purchase programs, reserve balances exceed $2 trillion. As the size of the Federal Reserve's balance sheet is normalized, the level of reserve balances will decline substantially. However, reserve balances may not decline to the very low levels that prevailed in the pre-crisis period because the level of reserve balances consistent with effective policy implementation may be higher than in past. For example, banks may demand significantly higher levels of reserve balances than in the past due to new liquidity regulations. Moreover, the scale transactions among banks has expanded over time, and this trend could lead

[3] https://www.newyorkfed.org/medialibrary/media/markets/omo/SOMAPortfolioandIncomeProjections_July2017Update.pdf.

banks to hold large precautionary levels of reserves. Although the level of reserve balances may ultimately be higher than in the pre-crisis period, as noted in the FOMC's Policy Normalization Principles and Plans, the FOMC intends to operate with the smallest balance sheet consistent with efficient and effective implementation of monetary policy.

6. Clearly one problem we face in this country that is difficult for us to address at the federal level alone is local zoning laws and ordinances which may unintentionally be a barrier to increasing our housing supply and notably a supply of affordable housing for mainstream Americans. Would you agree that having this Administration create a new council consisting of federal reserve officials, federal home loan banks, US mayors and other local officials, affordable housing advocates, academics and the private sector would be an important step towards a necessary dialogue on creating a housing market for all Americans?

Efficient regulation in all areas is an extremely important issue for the Congress and the Administration to address, and housing-related regulation is no exception. However, zoning laws and ordinances lie outside the purview of the Board.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 21, 2017

The Honorable Ed Royce
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 4 and 5 that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. On September 18, 2017, I provided responses to questions 7 and 8. Additionally, on September 1, 2017, I provided responses to questions 1, 2, 3, and 6. A copy of all responses has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Royce:</u>

4. Last week the G20 Leaders highlighted the importance of improving efforts on anti-money laundering and countering the financing of terrorism. As you know, this has been a focus of mine for some time. Rep. Velazquez and I sent a letter to Treasury Secretary last week on this issue, As we look at the effectiveness of our AML regime over time, it seems a 'compliance for the sake of compliance" approach has moved us away from the original intent of these rules. There have been a number of suggestions to both more effectively target bad actors and simplify the compliance regime.

- **Do you agree our AML regulatory regime deserves a fresh look?**

Elements of the Bank Secrecy Act/anti-money laundering (BSA/AML) regulatory requirements are several decades old. The Federal Reserve is constantly looking for ways to improve and maintain the effectiveness of the BSA and U.S. anti-money laundering (AML) regime as appropriate. In this regard, the Federal Reserve is an active member of the Bank Secrecy Act Advisory Group (BSAAG), a body established by Congress consisting of representatives from federal regulatory and law enforcement agencies, financial institutions, and trade groups, and participates in BSAAG's efforts to enhance the BSA.

I understand that Congress has recently enacted the "Countering America's Adversaries through Sanctions Act," which requires the President, acting through the Secretary of the Treasury to assess the effectiveness of, and ways in which, the United States is currently addressing the highest levels of risk of various forms of illicit finance. The Federal Reserve is committed to working with the Secretary of the Treasury in this regard.

- **Have you personally spoken with the Treasury Secretary about the need for reform of the AML regulatory requirements?**

The Federal Reserve is committed to continuing the close working relationships already in place with the Treasury Department, Financial Crimes Enforcement Network (FinCEN), law enforcement, and the other supervisory agencies to develop ways to improve the efficiency and effectiveness of the BSA/AML requirements. We look forward to working on these matters with the Treasury Secretary as well as the Treasury Undersecretary of Terrorism and Financial Intelligence.

- **Is it time for FinCEN to reclaim its exam authority for AML compliance, at least for the most complex, internationally active institutions?**

The Federal Reserve takes seriously its responsibility to provide ongoing, enhanced supervision of the largest, most complex banking organizations. Our examinations and evaluations of a banking organization's risk management and compliance practices related to anti-money laundering laws are an important part of our overall approach to ensuring the safety and soundness of the institutions we supervise. A more exclusive BSA examination role for FinCEN would be a fundamental re-alignment in how the federal government supervises for BSA compliance at large, complex banks and could potentially result in duplication of effort, lead to gaps between the supervision of small and large banks, and reduce flexibility for the federal banking agencies when addressing compliance issues that are relevant to safety and soundness.

5. In their Declaration, the G20 leaders raised the importance of "effective implementation of the international standards on transparency and beneficial ownership of legal persons and legal arrangements, including the availability of information in the domestic and cross-border context." I recently cosponsored legislation with Reps. Maloney and King, which would effectively ensure the beneficial owner of a corporation is known and readily verifiable. Given your role in AML supervision, from a "Know Your Customer" standpoint, do you think this would be a worthwhile step?

While the Federal Reserve does not have an official position on H.R. 3089, "Corporate Transparency Act of 2017," in general, it has supported past efforts to promote transparent incorporation practices and enhance information available to law enforcement. In addition, this step may complement the legal entity customer information that banks and other financial institutions are required to collect under FinCEN's Customer Due Diligence and Beneficial Ownership Final Rules.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 18, 2017

The Honorable Ed Royce
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 7 and 8 that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. On September 1, 2017, I provided responses to questions 1, 2, 3, and 6. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on August 14, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Royce:

7. As you know housing finance reform remains the biggest piece of unfinished business left from the financial crisis. In the past the Fed has played a constructive role in housing finance reform. I was pleased to see last week Governor Powell highlighted the role housing played in the crisis and the flaws within the existing system, which is still dominated by the duopoly of Fannie and Freddie. This duopoly is shouldering much of the risk in the market despite interest from the private sector. As you know the recent Treasury report highlighted the need to reassess the way mortgages are treated - from assignee liability being placed on investors who do not have control over the origination process to the risk-weighting and stress-testing of mortgage products vis-a-vis other asset classes. As we begin to contemplate GSE reform, is the Fed willing to take another look at these rules and the extent to which we are propping up this duopoly through potentially overly punitive measures on private markets?

Capital rules require banks to hold a percentage of their assets as capital to act as a financial cushion to absorb unexpected losses. Riskier assets require higher capital cushions and less risky assets require smaller capital cushions. For example, banks are required to have less capital when they hold mortgage-backed securities that have explicit government backing (e.g., Ginnie Mae securities), than when they hold securities that protect a government-sponsored enterprise (GSE) against credit losses that could occur during stressful macroeconomic conditions (e.g., subordinated securities that are included in so-called credit risk transfer transactions). Collateral matters as well, so mortgages held in bank portfolios are typically weighted favorably compared to other asset classes; therefore, no further reductions in risk-weights for such loans is likely necessary.

Analogously, stress test rules are designed to ensure that banks have effective capital planning processes and sufficient capital to absorb losses during stressful conditions, while meeting obligations to creditors and counterparties and continuing to serve as credit intermediaries. At the same time, liquidity stress tests are designed so that banks can meet their near-term payment obligations in the presence of contractual outflows and counterparty runs. In prescribing more stringent prudential standards, including stress test and liquidity requirements, the Federal Reserve Board (Board) may differentiate among bank holding companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board deems appropriate.

Because capital and stress test rules are risk-dependent, it is likely such rules will change as a result of GSE reform. On the one hand, if Congress decides to provide an explicit, transparent, guarantee to certain mortgage-backed securities, then less capital will need to be held when banks hold such securities than otherwise. On the other hand, if there is no government-backing for certain mortgage-backed securities, then banks will need to assess potential unexpected losses associated with the underlying mortgages for such securities and then hold sufficient capital to absorb losses in stressful conditions. This would also be the case when a bank holds mortgages, rather than mortgage-backed securities, on its balance sheet.

As Governor Powell noted in his July 6, 2017 remarks, a government guarantee should apply to securities, not to institutions. GSE reform should not leave us with any institutions that are so important as to be candidates for too-big-to-fail.

8. During prior statements you previously discussed in some detail fixed income liquidity. And while the Fed continues to say that the corporate debt and Treasury markets are robust in the wake of profound regulatory changes, we observe that not all markets are assessed equally. Asset-backed securities do not enjoy the same robust liquidity – principally due to regulatory pressures such as the Volcker Rule and others. You have previously eluded that the Volcker Rule could be well-suited to revisions. Just weeks ago, Governor Powell indicated these efforts are underway. Would you please tell our office what the Fed is doing to make sure the remedy fits the symptom? And, are you talking with stakeholder groups such as broker/dealers and large investors? Lastly, when might these efforts produce a revised product?

To help monitor fixed-income market liquidity, staff of the Federal Reserve Board (Board), Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Commodity Futures Trading Commission (agencies) prepare quarterly reports regarding liquidity in the corporate bond market, which are available on the Board's public website.[1] A number of other researchers have also performed analyses of fixed-income market liquidity. Although some studies have found evidence of somewhat reduced liquidity in a few pockets of the financial markets, most studies have concluded that market liquidity broadly is in good condition across the U.S. financial markets. Many factors simultaneously affect fixed-income market liquidity, including current financial market conditions, making it extremely difficult to separately identify the impact of the Volcker Rule with any degree of precision. The Board will continue to monitor and report on developments.

Regardless, there may be benefits to simplifying aspects of the Volcker Rule. The agencies are currently exploring possibilities to simplify and tailor regulations implementing the Volcker Rule, while fully implementing the statutory provisions. While it is difficult to predict the timing of any potential revisions with certainty, the Board is open to meeting with all relevant stakeholders and considering all input received throughout the revision process.

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[1] https://www.federalreserve.gov/foia/corporate-bond-liquidity-reports.htm.

QUESTIONS FOR THE RECORD – REP. ED ROYCE (CA-39)

Full Committee hearing: "Monetary Policy and the State of the Economy."

Wednesday, July 12, 2017 10:00 AM in 2128 Rayburn HOB

Witness: The Honorable Janet L. Yellen, Chair, Federal Reserve Board

Today, the Fed's $4.5 trillion portfolio is made up of roughly 55% Treasury securities and 45% agency MBS. You and the F-O-M-C (Federal Open Market Committee) have announced your intentions to begin unwinding this historic portfolio. As that portfolio normalizes, do you expect the ratio of Agency MBS to Treasuries to remain the same over time?

As you know, many have criticized the Fed for placing their "thumb on the scale" for one sector of our economy, currently holding 29% of the total outstanding Agency MBS. There are others who want you to go even further and invest in infrastructure and municipal securities, etc. As this extraordinary episode in the Fed's history comes to an end – and we are also looking towards housing finance reform – do you think it makes sense to reassess whether or not the Fed should be in a position to support certain sectors over others?

In your submitted testimony you state that 'the longer-run normal level of reserve balances will depend on a number of as-yet-unknown factors...' But conclude that you 'anticipate' keeping the reserve balances at a level 'larger than before the financial crisis.' What is the reasoning behind keeping the portfolio above past 'normal' levels?

Last week the G20 Leaders highlighted the importance of improving efforts on anti-money laundering and countering the financing of terrorism. As you know, this has been a focus of mine for some time. Rep. Velazquez and I sent a letter to Treasury Secretary last week on this issue, As we look at the effectiveness of our AML regime over time, it seems a 'compliance for the sake of compliance" approach has moved us away from the original intent of these rules. There have been a number of suggestions to both more effectively target bad actors and simplify the compliance regime. Do you agree our AML regulatory regime deserves a fresh look? Have you personally spoken with the Treasury Secretary about the need for reform of the AML regulatory requirements? Is it time for FinCEN to reclaim its exam authority for AML compliance, at least for the most complex, internationally active institutions? As you know, it ceded this authority over two decades ago to federal banking supervisors.

In their Declaration, the G20 leaders raised the importance of "effective implementation of the international standards on transparency and beneficial ownership of legal persons and legal arrangements, including the availability of information in the domestic and cross- border context." I recently cosponsored legislation with Reps. Maloney and King, which would effectively ensure the beneficial owner of a corporation is known and readily verifiable. Given your role in AML supervision, from a "Know Your Customer" standpoint, do you think this would be a worthwhile step?

Clearly one problem we face in this country that is difficult for us to address at the federal level alone is local zoning laws and ordinances which may unintentionally be a barrier to increasing our housing supply and notably a supply of affordable housing for mainstream Americans. Would you agree that having this Administration create a new council consisting of federal reserve officials, federal home loan banks, US mayors and other local officials, affordable housing advocates, academics and the private sector would be an important step towards a necessary dialogue on creating a housing market for all Americans?

As you know housing finance reform remains the biggest piece of unfinished business left from the financial crisis. In the past the Fed has played a constructive role in housing finance reform. I was pleased to see last week Governor Powell highlighted the role housing played in the crisis and the flaws within the existing system, which is still dominated by the duopoly of Fannie and Freddie. This duopoly is shouldering much of the risk in the market despite interest from the private sector. As you know the recent Treasury report highlighted the need to reassess the way mortgages are treated - from assignee liability being placed on investors who do not have control over the origination process to the risk-weighting and stress-testing of mortgage products vis-a-vis other asset classes. As we begin to contemplate GSE reform, is the Fed willing to take another look at these rules and the extent to which we are propping up this duopoly through potentially overly punitive measures on private markets?

During prior statements you previously discussed in some detail fixed income liquidity. And while the Fed continues to say that the corporate debt and Treasury markets are robust in the wake of profound regulatory changes, we observe that not all markets are assessed equally. Asset-backed securities do not enjoy the same robust liquidity – principally due to regulatory pressures such as the Volcker Rule and others. You have previously eluded that the Volcker Rule could be well-suited to revisions. Just weeks ago, Governor Powell indicated these efforts are underway. Would you please tell our office what the Fed is doing to make sure the remedy fits the symptom? And, are you talking with stakeholder groups such as broker/dealers and large investors? Lastly, when might these efforts produce a revised product?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 1, 2017

The Honorable Joyce Beatty
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 1 that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. The response to the remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Beatty:

1. While the economy has battled its way back from the deepest recession since the Great Depression, many Americans still have not felt the effects of this recovery. For instance, while the overall unemployment numbers have come down considerably since the depths of the Financial Crisis in 2008, wage growth has only recently begun to grow. While the cost of healthcare, housing, and everyday consumer products has increased, Americans wages have not kept pace. After the March FOMC meeting, you stated that "one of the things that has been holding down wage increases is very slow productivity growth." You also have stated in the past that slow productivity growth, along with the widening income gap, are long-term risks facing our economy, that only policymakers can address.

Why is the U.S. facing slow productivity growth and how do policymakers combat this problem, so that we can see wage growth for the average American?

In part, the weakness in productivity growth in recent years likely reflects the enduring effects of the Great Recession. For example, there is some evidence that the recession led to a long-lasting reduction in business investment, research and development spending, and new business formation, and that these factors have lowered productivity growth.[1] That said, productivity growth began to slow even before the Great Recession, and some research has suggested that the earlier deceleration was the result of economic effects of the 1990s IT revolution having largely run their course by the mid-2000s.[2,3]

While there is a range of opinions about what policies would effectively increase productivity and hence help to achieve more robust GDP growth, some combination of improved public infrastructure, better education, more encouragement for private investment, and more effective regulation would likely contribute positively toward those objectives.

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1 Reifschneider, Dave, William Wascher, and David Wilcox (2015). "Aggregate Supply in the United States: Recent Developments and Implications for the Conduct of Monetary Policy," *IMF Economic Review*, vol. 63, no. I, pp. 71-109.

2 Fernald, John G. (2014) "Productivity and Potential Output Before, During, and after the Great Recession," *NBER Macroeconomics Annual* 29(1), pp. 1-51.

3 It has also been argued that mismeasurement of real output could have contributed to the weakness in measured productivity growth. However, recent research by Byrne, Fernald, and Reinsdorf casts doubt on the ability of this hypothesis to explain the recent slowdown. Byrne, David M., J. Fernald, and Marshall Reinsdorf. (Spring-2016), "Does the United States Have a Productivity Slowdown or a Measurement Problem?" *Brookings Papers on Economic Activity*.

QUESTIONS FOR THE RECORD
CONGRESSWOMAN JOYCE BEATTY (OH-03)
FINANCIAL SERVICES COMMITTEE HEARING, JULY 12, 2017
"MONETARY POLICY AND THE STATE OF THE ECONOMY"

Question #1

While the economy has battled its way back from the deepest recession since the Great Depression, many Americans still have not felt the effects of this recovery. For instance, while the overall unemployment numbers have come down considerably since the depths of the Financial Crisis in 2008, wage growth has only recently begun to grow. While the cost of healthcare, housing, and everyday consumer products has increased, Americans wages have not kept pace. After the March FOMC meeting, you stated that "one of the things that has been holding down wage increases is very slow productivity growth." You also have stated in the past that slow productivity growth, along with the widening income gap, are long-term risks facing our economy, that only policymakers can address.

Why is the U.S. facing slow productivity growth and how do policymakers combat this problem, so that we can see wage growth for the average American?

Question #2

As you may know, thousands of my constituents work for several regional banks with significant operations in the Third Congressional District of Ohio and the Greater Columbus Metropolitan area. In April, former Governor Tarullo gave a departing speech at the Woodrow Wilson School at Princeton University where he discussed the post-crisis regulatory response. Within that speech, he offered some areas of bank regulation that he thought made sense to right-size, specifically, the $50 billion SIFI threshold, the $10 billion stress test threshold, and implementation of the Volcker rule.

Obviously, these are decisions for policymakers to make, but I wanted to give you the opportunity to address these remarks by your former colleague and offer any comments or thoughts you may have on some of the issues he addressed. Specifically, what is the appropriate asset threshold for SIFI designation, if there is one?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

October 17, 2017

The Honorable Keith Rothfus
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the written question that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Rothfus:</u>

1. The Financial Stability Board (FSB) and International Association of Insurance Supervisors (IAIS) conduct most of their activities behind closed doors, to the detriment of stakeholders and consumers affected by their activities. While the IAIS has made some improvements lately, its procedures still require significant improvement. Will you agree to additional transparency and accountability and more consultation with Congress before taking positions in international insurance regulatory discussions? If not, why not? And will you agree to use your influence at the IAIS and the FSB to improve their openness and accountability? If not, why not?

The Federal Reserve Board (Board) remains committed to transparency and accountability in the development of international insurance standards at the Financial Stability Board (FSB) and International Association of Insurance Supervisors (IAIS). We support building on the enhanced transparency at the FSB and IAIS with further steps to improve access and stakeholder engagement at these institutions. For instance, before the FSB recommends a particular policy action, the FSB typically goes through a public notice and comment process similar to that which would accompany rulemaking in the United States. At the IAIS, the Federal Reserve supports the continued publication for public comment of consultation documents with proposed approaches and frameworks for the supervision of internationally active insurance groups. The Board, along with our partners, the National Association of Insurance Supervisors (NAIC) and Federal Insurance Office (FIO), will also continue to actively seek out and engage U.S. insurance stakeholders to ensure an understanding of their perspectives. Indeed, the U.S. delegation routinely hosts meetings with U.S. insurance stakeholders for open dialogue and active working sessions regarding policy matters currently before the IAIS, a level of engagement that will continue. We remain open to additional suggestions on how to improve transparency at the IAIS and FSB through our participation.

In addition, it is important to note that none of the policy actions recommended by the FSB would take effect in the U.S. without being adopted by U.S. authorities through a public notice and comment process. Thus, the Federal Reserve would not implement any FSB or IAIS standards in the U.S. without going through the same process as we do for our rulemakings.

The Federal Reserve continues to work with other U.S. participants in international insurance standard-setting processes--including state insurance regulators, the NAIC, and FIO--to develop international insurance standards that are consistent with supervisory objectives under applicable federal and state laws, regulations, and policies. Excessive delays in the ability of U.S. participants to advocate positions in international standards negotiations could seriously diminish the ability of the U.S. to influence outcomes and ensure that international standards work for U.S. firms, U.S. consumers, and the U.S. financial markets.

Representative Keith Rothfus
Question for the Record

"Semi-Annual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System"
July 12, 2017; 10:00am
Witness: The Honorable Janet Yellen

The Financial Stability Board (FSB) and International Association of Insurance Supervisors (IAIS) conduct most of their activities behind closed doors, to the detriment of stakeholders and consumers affected by their activities. While the IAIS has made some improvements lately, its procedures still require significant improvement. Will you agree to additional transparency and accountability and more consultation with Congress before taking positions in international insurance regulatory discussions? If not, why not? And will you agree to use your influence at the IAIS and the FSB to improve their openness and accountability? If not, why not?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

November 2, 2017

The Honorable Scott Tipton
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 6 that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. On September 18, 2017, I provided responses to questions 1, 2 and 7. Additionally, on September 11, 2017, I provided responses to questions 3 through 5. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Tipton:</u>

6. The leverage capital ratio requires banks to hold capital against any and all assets, regardless of the risk of the assets. Recognizing the value of the leverage ratio as a backstop where risks can change, are hard to calculate, or where the risks are unknown, what is the purpose of holding leverage capital for riskless assets, such as Treasury securities and funds on deposit, at the Federal Reserve? Would there be economic or supervisory value in excluding these riskless assets from leverage ratio calculations?

The leverage ratio provides a backstop to risk-based capital requirements pursuant to which a firm must hold capital in accordance with the riskiness of its exposures. Risk-based measures generally rely on either a standardized set of risk weights that are applied to exposure categories or on models. In either case, there are opportunities for potential arbitrage. Standardized risk weights reflect the risk of a class of exposures rather than each particular exposure, and models are reliant on historical data and thus may understate risk. In contrast, a leverage ratio, by its nature, lacks this potential for arbitrage because it does not differentiate the level of capital required by exposure type. Excluding select categories of assets from the leverage ratio would be inconsistent with the leverage ratio's purpose as a risk-insensitive measure that simply measures how much a firm's assets are supported by leverage and with its goal of addressing the risk that a banking organization will fund itself with too much debt. In the Federal Reserve Board's experience, a banking organization can be vulnerable if its total leverage is high during stress periods because high leverage decreases the amount of equity a banking organization has available to absorb losses.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 11, 2017

The Honorable Scott Tipton
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 3 through 5 that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Tipton:

3. Under current interest rate policies, banks will receive from the Federal Reserve interest payments for the funds that banks have on deposit at the Fed. Former Fed Governor Don Kohn, discussing the importance of paying interest on these reserves, wrote that "the Fed will need to make good economic arguments to explain why paying interest to banks is necessary." What are the Federal Reserve's "good economic arguments" for this practice?

The payment of interest on excess reserves contributes to effective implementation of monetary policy by helping to manage the level of the federal funds rate and other short-term interest rates. Most major central banks have the authority to pay interest on excess reserves and have used this authority to help manage the level of short-term interest rates.

In the current circumstances, interest on excess reserves is essential to the Board's ability to manage the level of short-term interest rates even with a very elevated level of reserve balances in the system. Absent this tool, the Board would not have been able to raise the level of short-term interest rates until it had dramatically reduced its holdings of longer-term securities. As demonstrated in the so-called "taper tantrum" in the summer of 2013, markets can be very sensitive to information bearing on the Board's holdings of longer-term securities. It seems likely then that a program of rapid large scale sales of assets to reduce the level of reserve balances in the system would have been very disruptive to markets and counterproductive in fostering continued economic recovery and a return of inflation to 2 percent.

4. The Volcker Rule was written under the justification that banks should not be using insured deposits to fund inappropriate securities activities. To what degree is authority under Section 23A of the Federal Reserve Act not enough to keep banks from using insured deposits to engage in the securities activities that are the target of the Volcker Rule?

Section 13 of the Bank Holding Company Act, also known as the Volcker Rule, prohibits banking entities from engaging in proprietary trading of financial instruments or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with private equity funds or hedge funds (covered funds), subject to certain exceptions. Section 23A of the Federal Reserve Act limits the ability of a depository institution to engage in certain transactions with an affiliate, such as loans or extensions of credit to the affiliate.[1]

The Volcker Rule's activity restrictions generally apply to banking entities, which the statute defines to include insured depository institutions and their subsidiaries and affiliates, with limited exceptions.[2] Section 23A does not limit the proprietary trading and covered fund activities of a bank itself. Rather, it limits the ability of a bank to fund activities of an affiliate

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[1] By its terms, section 23A of the Federal Reserve Act applies to all Federal Reserve member banks. 12 U.S.C. 371c. Other statutes expanded the coverage of section 23A to apply to all insured depository institutions. *See, e.g.*, 12 U.S.C. 1828(j) and 12 U.S.C. 1468(a).

[2] Section 13 defines "banking entity" to include any insured depository institution, any company that controls an insured depository institution or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity, with limited exceptions. 12 U.S.C. 1851(h)(1).

through loans to or transactions with the affiliate. As such, section 23A may limit the direct exposure of a bank to risks associated with an affiliate's activities, as well as the direct transfer of any funding subsidy effects relating to deposit insurance and access to the Board's discount window. Other measures such as capital, liquidity, and risk management requirements applicable to the bank, affiliate, or consolidated firm may also serve as potential limitations. Any decision to remove the Volcker Rule's restrictions and rely on other measures such as these would be a matter for Congress.

5. Former Fed Chairman Paul Volcker, when recently asked about proposed revisions to the Volcker Rule, responded by saying, "Everybody wants to see it more simple . . . [and] if they can do it in a more efficient way, God bless them." Do you share the views of Chairman Volcker, that there is value in making implementation of the Volcker Rule simpler and more efficient? If so, what changes would you consider?

The statutory requirements of the Volcker Rule are very complex – the statute includes many detailed restrictions that have broad effect throughout a firm. Even without a statutory change, there may be ways to streamline, simplify, and tailor the interagency Volcker Rule regulation to reduce costs while continuing to ensure the statutory requirements are fully implemented. The Board is assessing opportunities for changes in coordination with the other agencies also responsible for the Volcker Rule's implementation under the statute.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

September 18, 2017

The Honorable Scott Tipton
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 1, 2 and 7 that you submitted following the July 12, 2017,[1] hearing before the Committee on Financial Services. On September 11, 2017, I provided responses to questions 3 through 5. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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[1] Questions for the record related to this hearing were received on August 14, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Tipton:

1. Last month the Treasury released their first report on the state of financial regulation and included in that report was a recommendation for regulators to expand coordination of their examination and data collection efforts. I recently sent a bipartisan letter to Secretary Mnuchin, with 31 other Financial Services Committee colleagues, on this very topic. In a press conference, you made remarks agreeing that there are burdens that can be simplified and reduced in the financial system. Do you support greater exam coordination and data collection efforts among regulators?

The Federal Reserve Board (Board) supports continuing and enhancing efforts to coordinate the agencies' examination and data collection activities. As the Treasury Department's report notes, the Board and other agencies already coordinate many of these activities through their participation on the Federal Financial Institutions Examination Council (FFIEC). Notable recent coordination efforts by the FFIEC have aimed to streamline the data collected from financial institutions on the quarterly Call Report, improve the consistency and coordination of agency efforts to assess the cybersecurity readiness of supervised banks, and identify and initiate changes to rules and regulations in order to eliminate unnecessary burdens on community banks, such as simplifying certain requirements of the agencies regulatory capital rules. Moreover, the FFIEC member agencies are currently engaged in an examination modernization project. This project is reviewing community bank examination processes used by the FFIEC members and is expected to result in recommendations for procedural changes that would make examinations more efficient and less burdensome to banks.

In addition to these efforts, the Board has consistently coordinated with and relied on the work of other bank regulators, to the greatest extent possible, in supervising bank and savings and loan holding companies. At community and regional bank holding companies where the Board is not the primary insured depository institution regulator (IDIR) and the majority of the consolidated assets are at the bank level, the Board's policy is to rely substantially on the work conducted by the primary IDIRs. These efforts include using existing examination reports and other supervisory information submitted to other regulatory agencies to reduce the scope and frequency of holding company inspections and closely coordinating with other agencies to avoid duplication of supervisory activities, reporting requirements, and information requests. Periodic reviews are conducted by the Board staff to ensure that Reserve Banks are coordinating with and appropriately relying on the work of primary regulatory agencies.

2. A recent survey conducted by Morning Consult found that 89% of the general public believes that it is important to the U.S. economy to have banks of all sizes. Tailoring of regulations, as it's commonly used, means adjusting regulations and supervision to fit and accommodate the variety of sizes, risk profiles, and business models in the banking industry. Without tailoring, financial institutions are driven to consolidate and adopt the same business model, homogenizing the industry. What is the Federal Reserve doing to promote variety in the banking industry?

The Board recognizes the importance of having a diversified and competitive banking industry that is comprised of banking organizations of many sizes and specializations. To promote this, the Board has, and continues to, tailor its regulations and supervisory program based on the risk profile, size and complexity of the organizations we supervise. Doing so allows the Board to achieve its goal of promoting a strong banking system and preventing or mitigating against the risk of bank failures, while minimizing a bank's regulatory compliance costs and accommodating the variety of sizes, risk profiles, and business models in the banking industry.

This tailored approach is reflected in our rulemaking, supervisory guidance, reporting requirements, and in the execution of supervision. Banking organizations with $50 billion or more in assets are subject to enhanced prudential requirements—including capital and capital planning, stress testing, and liquidity requirements—that increase in stringency, based on the size, complexity, and risk profile of the firm. The largest, most systemically important firms are subject to the Large Institution Supervision Coordinating Committee framework, which is a supervisory program designed to materially increase the financial and operational resiliency of systemically important financial institutions to reduce the probability of, and cost associated with, their material financial distress or failure.

In contrast, the Board has taken many steps to reduce regulatory burdens for the small and regional banking organizations. These include issuing guidance to encourage examiners to review loans off-site for banks with less than $50 billion in total assets, thereby reducing the number of examiners physically on-site; reducing the regulatory filing requirements for banks with less than $1 billion in consolidated assets by eliminating about 40 percent of the items in the required quarterly financial reporting form known as the Call Report; and improving examination planning efforts so that well-managed, lower risk banks receive less supervisory scrutiny.

To help further ease regulatory burdens for small banks, we routinely review our guidance and examination processes to insure they are appropriate. To that extent, we are looking at ways to develop a simplified regulatory capital regime for small banks, further simplify regulatory filing requirements for small banks, and have initiated efforts to ease the conditions under which an appraisal is required to support a commercial loan. We have also recommended that Congress consider exempting community banks from two sets of Dodd-Frank Wall Street Reform and Consumer Protection Act requirements--the Volcker Rule and the incentive compensation limits in section 956.

7. It is important with regard to governance and other matters that a bank's board of directors remains active and informed as well as set tone and policies for the bank. However, the accumulation of recent rules and regulations seems to be dragging boards into actual bank management and distracting them from the business plan and overall strategic policy-setting function of boards. Governor Powell has already talked about looking at restoring balance to the role of boards of directors. What is the Fed looking at in that regard, and what are the principles guiding your review?

The Board strongly agrees that boards of directors need to play an active, informed oversight role that is distinct from the role of senior management.

In that regard, on August 3, the Board announced that it is seeking public comment on a corporate governance proposal designed to enhance the effectiveness of boards of directors.

The Board's proposed guidance was informed by a multi-year review of the factors that make boards effective, the challenges that boards face, and how boards influence the safety and soundness of their firms and promote compliance with laws and regulations. The proposed guidance is intended to address three primary findings from the review:

- Many existing supervisory expectations do not clearly distinguish the roles and responsibilities of boards of directors from the roles and responsibilities of senior management.
- Boards often devote significant time satisfying supervisory expectations that do not directly relate to the board's core oversight responsibilities.
- Boards face significant information challenges that require active management of information flow.

The Board's proposed guidance consists of three parts:

- The Board Effectiveness Guidance (BE Guidance) that identifies the key attributes of effective boards of directors for the largest domestic bank and savings and loan holding companies and non-bank systemically important financial institutions. This proposed guidance is intended to better distinguish supervisory expectations for boards from that of senior management, and shift the supervisory focus to the board's core responsibilities. In particular, the proposal would emphasize a board's responsibilities to set clear, aligned and consistent direction, and to hold senior management accountable for, among other things, adhering to the firm's strategy and risk tolerance, and remediating material or persistent deficiencies in risk management and control practices.
- A proposal to eliminate or revise unnecessary, outdated, or redundant supervisory expectations for boards of directors included in certain existing Board Supervision and Regulation letters. This should allow board of directors to focus more of their time and resources on fulfilling their core responsibilities.
- A proposal to clarify expectations regarding the communication of supervisory findings by the Board to boards and senior management (revised SR 13-13/CA 13-10).

The Board's corporate governance proposal is currently out for public comment for a 60-day period ending October 10.

Hearing: Monetary Policy and the State of the Economy

Date: 7/12/17

Member Name: Rep. Scott Tipton

Witness to Respond: Chair Yellen

Question: Last month the Treasury released their first report on the state of financial regulation and included in that report was a recommendation for regulators to expand coordination of their examination and data collection efforts. I recently sent a bipartisan letter to Secretary Mnuchin, with 31 other Financial Services Committee colleagues, on this very topic. In a press conference, you made remarks agreeing that there are burdens that can be simplified and reduced in the financial system. Do you support greater exam coordination and data collection efforts among regulators?

Question: A recent survey conducted by Morning Consult found that 89% of the general public believes that it is important to the U.S. economy to have banks of all sizes. Tailoring of regulations, as it's commonly used, means adjusting regulations and supervision to fit and accommodate the variety of sizes, risk profiles, and business models in the banking industry. Without tailoring, financial institutions are driven to consolidate and adopt the same business model, homogenizing the industry. What is the Federal Reserve doing to promote variety in the banking industry?

Question: Under current interest rate policies, banks will receive from the Federal Reserve interest payments for the funds that banks have on deposit at the Fed. Former Fed Governor Don Kohn, discussing the importance of paying interest on these reserves, wrote that "the Fed will need to make good economic arguments to explain why paying interest to banks is necessary." What are the Federal Reserve's "good economic arguments" for this practice?

Question: The Volcker Rule was written under the justification that banks should not be using insured deposits to fund inappropriate securities activities. To what degree is authority under Section 23A of the Federal Reserve Act not enough to keep banks from using insured deposits to engage in the securities activities that are the target of the Volcker Rule?

Question: Former Fed Chairman Paul Volcker, when recently asked about proposed revisions to the Volcker Rule, responded by saying, "Everybody wants to see it more simple . . . [and] if they can do it in a more efficient way, God bless them." Do you share the views of Chairman Volcker, that there is value in making implementation of the Volcker Rule simpler and more efficient? If so, what changes would you consider?

Question: The leverage capital ratio requires banks to hold capital against any and all assets, regardless of the risk of the assets. Recognizing the value of the leverage ratio as a backstop where risks can change, are hard to calculate, or where the risks are unknown, what is the purpose of holding leverage capital for riskless assets, such as Treasury securities and funds on deposit, at the Federal Reserve? Would there be economic or supervisory value in excluding these riskless assets from leverage ratio calculations?

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable Ben Sasse
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the November 28, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on December 1, 2017.

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Senator Sasse:</u>

1. Is free trade always a net-gain for the U.S. economy? How would this view impact your tenure as Federal Reserve Chairman?

The Federal Reserve is entrusted to achieve its congressionally mandated objectives of price stability and maximum sustainable employment. Matters of trade policy are the responsibility of the Congress and the Administration.

In general, trade and access to global markets provide many benefits for businesses and firms, including larger and deeper markets for their products and a wider selection of inputs for production. Consumers also benefit in terms of greater variety of goods and more competitive prices. Because of these and other benefits, more open and globalized economies generally have been faster growing, more productive, and more dynamic. However, the economic shifts brought on by trade have costs, and the loss of jobs in some industries or professions has been very painful for those affected. Policymakers and economists alike are increasingly cognizant of the need to design policies to support workers and families so that the benefits of globalization and trade can be more widely and evenly shared.

2. Is the measure of the U.S.'s trade deficit with another country a useful metric to consult to evaluate whether trade with that country hurts or helps our economy? If not, what are some useful metrics?

The overall U.S. trade balance is the most useful measure for evaluating the impact of trade on the U.S. economy. That balance is affected by many factors, including savings and investment in the United States, economic conditions abroad, and movements in exchange rates. Bilateral trade deficits are less informative. For example, U.S. workers and businesses could benefit when the United States runs a deficit with one country by importing goods that we use as inputs to produce goods to sell to another country. In this example, a focus on the bilateral deficit would obscure the net effect on the U.S. trade balance and the overall benefit to the economy.

3. Is there any instance where the U.S. would benefit from a trade war with a large country like China? How should the Federal Reserve respond to such a trade war?

As noted in the answer to question 1, openness to trade has many benefits for the U.S. economy. A trade war with another large country could be quite disruptive and reduce the benefits we experience from trade.

China is an important U.S. trading partner. The Chinese economy is also an important source of demand for commodities and other products from the United States and other countries. What happens to China matters for the U.S. and global economies. At the same time, it is important for trade and financial relations to be arranged so that countries operate on a level playing field.

How the Federal Reserve would respond to these circumstances would depend on how it affected the U.S. economy and, in particular, progress toward the Federal Reserve's congressionally mandated objectives of price stability and maximum sustainable employment. It is difficult to predict those impacts and the appropriate monetary response.

4. How would you evaluate the economic impact of NAFTA's dissolution, all things being equal? How should the Federal Reserve respond to the dissolution of NAFTA?

If the United States were to withdraw from North American Free Trade Agreement (NAFTA), an earlier free-trade agreement with Canada would still be in force, while trade barriers between the United States and Mexico would revert to the moderate, Most Favored Nation (MFN), levels consistent with current international trade rules. Academic studies estimate that the effect of implementing NAFTA on U.S. output was positive, but small in magnitude, mostly because only a few sectors, like textiles, were highly protected in Mexico prior to the agreement. These studies could be interpreted to imply only a small, negative effect in the long run from leaving NAFTA and increasing tariffs to MFN levels.

Nonetheless, the near-term effects of a NAFTA withdrawal could be significant. In particular, North American automotive supply-chains have been built on tariff-free cross-border trade in automotive parts and could be disrupted. Additionally, U.S. agricultural exports to Mexico would likely face higher MFN import tariffs.

5. How would you evaluate the economic impact of the U.S. - South Korean Free Trade Agreement, all things being equal? How should the Federal Reserve respond to the dissolution of the U.S. - Korean Free Trade Agreement?

As noted in question 4, most of the academic literature studying the effects of trade agreements (such as NAFTA) has found modest positive effects for the United States, and the same would likely be true for the U.S. trade agreement with South Korea. In addition, South Korea accounts for a much smaller share of U.S. trade (about 3 percent) than does Canada and Mexico, so the direct effects of that agreement are likely even more limited.

As noted in question 3, monetary policy decisions should be based on an assessment of realized and expected progress toward the Federal Reserve's employment and price stability objectives. International trade is an important part of the U.S. economy, so trade developments should be one aspect of that assessment. However, trade policy is only one among several factors that could affect the outlook for trade, with other factors including movements in currency and commodity markets as well as prospects for economic growth abroad.

6. What were the economic impacts of the U.S.'s failure to ratify TPP?

Specific trade decisions are the province of Congress and the Administration. As a general rule, most research finds that open trade and capital flows provide benefits for U.S. businesses, including larger markets for U.S. products and a wider selection of inputs for production. Consumers also benefit from a greater variety of goods and more competitive prices. However, increased trade ean cause dislocations, including the loss of jobs in some industries. Policymakers and economists alike are increasingly cognizant of the need to design policies to support workers and families so that the benefits of globalization can be more widely and evenly shared.

7. How would you evaluate the economic impact of a 25% tariff on Mexican or Chinese goods, all things being equal? How should the Federal Reserve respond to such a tariff?

A higher tariff on either Chinese goods or Mexican goods would tend to shift demand both towards U.S.-produced goods and also to imports originating elsewhere. Although some U.S. businesses may benefit from increased domestic demand, U.S. firms would also likely have to pay more for imported intermediate inputs, increasing production costs. An additional effect would be to raise prices for goods consumed by U.S. households.

The benefits that U.S. business receive from increased domestic demand would also be reduced by lower demand from the targeted country. The targeted country's demand for U.S. exports would decline not only because a U.S. tariff would reduce the targeted country's own income, but also because the targeted country might retaliate by increasing its tariffs on U.S. goods.

In particular with regards to Mexico, the negative effects of higher tariffs on the Mexican economy could result in additional indirect spillovers to the U.S. economy, given the interconnected supply chains that currently tie together U.S. and Mexican production.

8. Has the U.S.'s threats to withdraw from NAFTA and failure to otherwise robustly defend free trade already damaged the economy? What about Mexico's efforts to find of other trading partners for goods like corn, in likely response to the U.S.'s threats to withdraw from NAFTA?

Market expectations about trade policy developments have, at times, affected some financial market variables, such as the exchange value of the dollar against the Mexican peso, but I am not aware of broader effects on the U.S. economy.

Mexico is the third-largest market for U.S. agricultural exports and the largest market for U.S. exports of corn, with U.S. corn exports to Mexico valued at $2.6 billion in 2016. Each year, the United States exports about 14 percent of its corn crop.

Although there have been reports of efforts by Mexico to diversify the sourcing of its imports of corn and other goods, actual government policy actions have not yet been implemented. In addition, U.S corn exports to Mexico, after being weak earlier this year, have stepped up in recent months. Through September, the value of corn exports to Mexico is now slightly higher than over the same time period in 2016.

A sizable reduction in Mexican demand for U.S. corn would force U.S. farmers to find other markets for their corn exports. Doing so could be difficult, especially in the short run, as other trading relationships would have to be developed or expanded. In addition, corn exports may become less profitable, after accounting for the increased shipping costs to reach farther away destinations. However, those same considerations raise questions over the ease with which Mexico could reduce its U.S. corn imports. That said, Brazil and Argentina are major corn exporters, who compete worldwide with U.S. exporters for market share, and are potential alternative sources for Mexican corn imports if the Mexican government were to enact to discourage demand for U.S. corn.

9. What economic sectors benefit the most from free trade and what - if any - sectors are hurt by free trade? For example, does free trade help the U.S.'s agricultural sector?

Sectors where the United States is particularly productive relative to its trading partners, such as agriculture, are ones that likely benefit most from openness to trade. For example, the value of U.S. agricultural exports has nearly tripled (increasing 182 percent) since 2002 as U.S. agricultural producers have exported a larger quantity of goods at higher prices.

Sectors that are likely to be hurt are those where our trading partners are particularly productive or low-cost, such that domestic production is displaced by growing imports from overseas. For example, there is a growing consensus among economists that the rise of China as an exporter contributed to job losses, higher unemployment, and lower wages for U.S. manufacturing workers in manufacturing industries that compete with imports from China, including apparel, furniture, and electronics. However, cheaper Chinese imports may have helped lower costs and boost employment in other industries, as well as providing cheaper goods to consumers.

10. It has been said that trade has destroyed large segments of the manufacturing-based economy. Is that true? How much of the damage to that sector has actually resulted from other factors such as automation?

Research suggests that, overall, increased trade has benefited the United States, both by expanding supply chains and access to new markets for U.S. exporters, and by providing U.S. households with a greater choice of goods at lower costs. That said, the U.S. manufacturing sector has been facing a number of long-term structural challenges, including the relative costs of labor and investment in producing domestically versus abroad. As a result, some industries within the U.S. manufacturing sector have experienced long-term declines stemming from globalization. It is very difficult to parse out with any precision responsibility for the decline of the manufacturing sector to the various possible underlying causes.

11. What - if anything - should be done to help those sectors that may be left behind by free trade and automation?

These are important issues that the Congress should consider. Technological change is inevitable, and in my view it would be a damaging mistake to stand in its way. And as I indicated earlier, the bulk of economic research suggests that, overall, increased trade has benefited the United States. However, research also indicates that automation and trade have tended to reduce the demand for lower-skilled workers, especially those in jobs that involve routine tasks, either physical or cognitive. This, in turn, has contributed to the increased inequality of incomes that has been in train for several decades, and it can help explain the ongoing decline in labor force participation of men 25-54 years old, which has been most concentrated among those with a high-school degree or less. Some communities have also suffered disproportionately because of the geographically concentrated nature of some of the job losses that have resulted from trade and automation. I have no prescription about exactly what an effective policy approach should be, but would broadly point to education and job training as among the things that the Congress could reasonably consider in trying to address these issues.

12. What risk does cybersecurity pose to the economy and what – if anything – should the Federal Reserve do about it?

As I stated during my confirmation hearing, cybersecurity risk is one of the most important risks faced by U.S. financial and government institutions. The U.S. economy has a heightened level of exposure to cyber risk due to the high degree of information technology (IT)-intensive activities and the ever-increasing interconnection between entities operating in its various sectors. In particular, firms in the financial services sector are highly interconnected and have considerable dependency on critical service providers. The presence of active, determined, and sometimes sophisticated adversaries means that malicious cyber attacks are often difficult to identify or fully eradicate, and may propagate rapidly through the financial sector, with potentially systemic consequences.

To reduce the threat to U.S. financial stability, the Federal Reserve has been taking steps to promote effective cybersecurity risk management at the institutions we supervise and strengthen their resilience to prepare for, withstand, and rapidly recover from a cyber-related disruption. The Federal Reserve evaluates the cyber and IT risk management practices of these institutions and provides critical feedback and guidance to better enable them to prepare for and rapidly recover from cyber-attacks. However, to combat the dynamic cyber threat and strengthen the resiliency of the financial sector, the Federal Reserve believes the public sector and private entities need to work closely together.

To this end, the Federal Reserve engages in interagency and industry collaboration with the Federal Financial Institutions Examination Council, Financial and Banking Information Infrastructure Committee (FBIIC), Financial Services Sector Coordinating Council (FSSCC), Financial Services Roundtable, and various other groups to improve the cyber and IT resiliency of the financial sector. In addition, the Federal Reserve established the Secure Payments Task Force, comprised of a diverse group of 170 industry participants, to collaborate on the industry's most pressing payments system security issues, including identity management, data protection, fraud, and risk information-sharing payment security.

We appreciate the perspective of these groups, which is complementary to achieving our safety and soundness and financial stability goals. We strongly believe that the continuation of these partnerships and their expansion into other areas is necessary to effectively combat the cyber threat.

13. What is the cause of the increasing geographic concentration of economic growth in larger cities? What - if anything – should the Federal Reserve do about it?

Since the end of the Great Recession, labor markets in larger cities have recovered substantially more than those in smaller cities and non-metropolitan (or rural) areas, and this divergence has become even more pronounced in the past few years. Several factors may help explain why larger cities have been growing more quickly in recent years. For example, larger cities tend to have more diversified economies, which contributes to greater resiliency in the face of adverse economic shocks. In contrast, rural areas tend to be more dependent on a single industry or employer, and have been hit harder by the loss of manufacturing jobs, perhaps prompted by technical change or greater exposure to international trade. As well, some highly-educated people and fast-growing high-technology and medical-science firms seem to be attracted to larger cities because of the greater opportunities and amenities they provide. Although the Federal Reserve is not well positioned to target particular industries or regions, pursuing our dual mandate of maximum employment and price stability can help foster broad-based economic growth, thereby improving prospects in all areas.

14. What is the cause of the increasing consolidation of the financial services sector? What are the downsides of this consolidation? What – if anything – should the Federal Reserve do about it?

The banking industry has been consolidating at a relatively steady pace for more than 30 years, resulting in a steady decline in the number of banks. The causes cited for this trend include changes in legislation that permitted interstate branching, demographic shifts in population from rural to urban centers, and rapid improvements in technology that have made it possible for banks to serve a broader geographic range of customers. Bankers also have increasingly cited an increase in regulatory burden as contributing to the decline in the number of small banks.

Research conducted over many years has concluded that community banks provide distinct advantages to their customers compared to larger banks. Because of their smaller size and less complex organizational structure, community banks are often able to respond with greater agility to lending requests than their large national competitors. In addition, community banks often have close ties to the communities they serve and detailed knowledge of their customers, which enables them to meet the needs of their local communities and small business and small farm customers in a more customized and flexible way than larger banks. Consequently, a decline in the number of community banks can adversely affect local and regional economic conditions.

The Federal Reserve believes it is important to maintain a diversified and competitive banking industry that comprises banking organizations of many sizes and specializations, including a healthy community banking segment. To help support this diversity, the Federal Reserve has taken a number of steps in recent years to reduce regulatory burden on community banks. These have included reducing the time devoted to the examination of lower-risk activities at supervised community banks, tailoring regulatory expectations depending on the size and complexity of banks, and completing more examination work off-site to reduce the disruption to day-to-day business that can be caused by the examination process. The Federal Reserve has also worked with the other banking regulators to streamline regulatory reporting requirements for small banks, increase the dollar threshold for commercial real estate loans requiring appraisals, and simplify certain aspects of the regulatory capital rules that community banks have found problematic. We will continue to work to identify further opportunities to adjust regulatory requirements to ensure that unnecessary regulatory burden is minimized for these banks.

15. I'd like to ask about the Federal Reserve's implementation of Section 165 of Dodd-Frank, which provides for enhanced prudential standards for banks with $50 billion in assets or higher. As you know, Congress is considering raising this threshold to $250 billion.

a. **Should a bank's asset size be dispositive in assessing a bank's risk profile for the purposes of imposing prudential regulations? For example, does a bank with less than $500 billion regional banks pose the same systemic risk and have the same complexity as large banks with around three times the asset size? According to Basel Systemic Risk Indicators from 2015, the systemic risk score of most banks with less than $500 billion in assets is 4 times less than banks with more than $500 billion in assets.**
b. **Are there costs to relying upon arbitrary asset thresholds to impose prudential regulations, instead of independently analyzing the risk profile of financial institutions?**
c. **If Congress raised the Section 165 threshold to $250 billion, should the Federal Reserve still tailor these prudential standards for banks above that that threshold? If so, how?**

You ask whether the Federal Reserve would continue to tailor enhanced prudential standards if the Dodd-Frank Wall Street Reform and Consumer Protection Act section 165 threshold is raised to $250 billion by Congress. It is important to note that the Federal Reserve already tailors its regulation and supervision of firms above this threshold. For example, firms with more than $250 billion in total assets, that are not considered to be global systemically important banks, are not subject to risk-based capital surcharges, the enhanced supplementary leverage ratio, or total loss-absorbing capacity and long-term debt requirements to facilitate orderly resolution. I fully expect that we would continue to tailor the application of regulations for such firms if Congress were to raise the threshold.

In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. The Federal Reserve has been working for many years to make sure that our regulation and supervision is tailored to the size and risk posed by individual institutions. I believe that it is not only appropriate to recognize the different levels of risk and types of risk that different institutions in the system pose, but that it also makes for better and more efficient regulation. Efficient regulation allows the financial system to more efficiently support the real economy.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Senator Ben Sasse:

- Is free trade always a net-gain for the U.S. economy? How would this view impact your tenure as Federal Reserve Chairman?

- Is the measure of the U.S.'s trade deficit with another country a useful metric to consult to evaluate whether trade with that country hurts or helps our economy? If not, what are some useful metrics?

- Is there any instance where the U.S. would benefit from a trade war with a large country like China? How should the Federal Reserve respond to such a trade war?

- How would you evaluate the economic impact of NAFTA's dissolution, all things being equal? How should the Federal Reserve respond to the dissolution of NAFTA?

- How would you evaluate the economic impact of the U.S. - South Korean Free Trade Agreement, all things being equal? How should the Federal Reserve respond to the dissolution of the U.S. - Korean Free Trade Agreement?

- What were the economic impacts of the U.S.'s failure to ratify TPP?

- How would you evaluate the economic impact of a 25% tariff on Mexican or Chinese goods, all things being equal? How should the Federal Reserve respond to such a tariff?

- Has the U.S.'s threats to withdraw from NAFTA and failure to otherwise robustly defend free trade already damaged the economy? What about Mexico's efforts to find of other trading partners for goods like corn, in likely response to the U.S.'s threats to withdraw from NAFTA?

- What economic sectors benefit the most from free trade and what - if any - sectors are hurt by free trade? For example, does free trade help the U.S.'s agricultural sector?

- It has been said that trade has destroyed large segments of the manufacturing-based economy. Is that true? How much of the damage to that sector has actually resulted from other factors such as automation?

- What - if anything - should be done to help those sectors that may be left behind by free trade and automation?

- What risk does cybersecurity pose to the economy and what – if anything – should the Federal Reserve do about it?

- What is the cause of the increasing geographic concentration of economic growth in larger cities? What - if anything – should the Federal Reserve do about it?

- What is the cause of the increasing consolidation of the financial services sector? What are the downsides of this consolidation? What – if anything – should the Federal Reserve do about it?

- I'd like to ask about the Federal Reserve's implementation of Section 165 of Dodd-Frank, which provides for enhanced prudential standards for banks with $50 billion in assets or higher. As you know, Congress is considering raising this threshold to $250 billion.

    - Should a bank's asset size be dispositive in assessing a bank's risk profile for the purposes of imposing prudential regulations? For example, does a bank with less than $500 billion regional banks pose the same systemic risk and have the same complexity as large banks with around three times the asset size? According to Basel Systemic Risk Indicators from 2015, the systemic risk score of most banks with less than $500 billion in assets is 4 times less than banks with more than $500 billion in assets.

    - Are there costs to relying upon arbitrary asset thresholds to impose prudential regulations, instead of independently analyzing the risk profile of financial institutions?

    - If Congress raised the Section 165 threshold to $250 billion, should the Federal Reserve still tailor these prudential standards for banks above that that threshold? If so, how?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable Brian Schatz
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the November 28, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on December 1, 2017.

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Senator Schatz:</u>

1. What are your views on whether climate change will have a material impact on our economy?

The potential impact of climate change on the U.S economy is an important issue that warrants further study. However, this issue is well outside of the remit of the Federal Reserve System. Moreover, as important as climate change may ultimately prove to be, it will play out over a much longer timeframe than the one that is most relevant for monetary policy decisionmaking; in our conduct of monetary policy, we are more concerned with short and medium term developments that may change materially over quarters and a relatively small numbers of years rather than the decades associated with the pace of climate change.

2. When the Federal Reserve Board formulates monetary policy, it takes a broad look at the economy and identifies short- and medium-run risks and trends. In the minutes from the FOMC's most recent meeting, there is a brief discussion of the economic impact of hurricane-related disruptions as well as dislocation from wildfires in California. But the minutes note that these sorts of severe weather events have only had a temporary impact in the past.

Our own government's data show that the intensity and frequency of major weather events are increasing. Hurricanes, flooding, droughts, wildfires—they are happening more often and they are causing more damage than ever.

a. **How many events do you think it would take to have a material impact on the economy?**
b. **Has the Federal Reserve considered what that number would be, in terms of number of events or the total cost of the damage?**

<u>Response to questions a and b:</u>

Each and every disaster of the kind that you describe represents a catastrophe for the individuals and communities that are directly affected. The most severe of these events can seriously damage the lives and livelihoods of many individuals and families, devastate local economies, and even temporarily affect national economic statistics such as GDP and employment. However, the historical regularity has been that events of this kind have not materially affected the business-cycle trajectory of the national economy, both because the disruptions to production have tended to be relatively short-lived and because such events tend to affect specific geographic areas rather than the United States as a whole. That said, the most severe of these events have imposed a significant drain on public resources. If such events become much more frequent or more severe, the fiscal cost would likely mount, and that would be an important issue for the Congress to consider.

c. **Have you or the Federal Reserve's staff been in communication with NOAA about the likelihood of the number of severe weather events increasing?**

d. **At what point should the Federal Reserve begin to factor into its analyses the downside risks of not having policies in place to combat climate change?**

Response to questions c and d:

As I indicated above, the pace of climate change--and the change in frequency of major weather events that might result--is commonly denominated in terms of decades or even longer, and thus is much slower-moving than is monetary policy decisionmaking. The issues of climate change and its associated effects on the economy are likely to be more relevant for various aspects of fiscal policy and the longer-run growth trend of the economy than they are for the short-term evolution of the business cycle.

3. The Treasury Department has put out a number of reports that detail its proposals for deregulating the financial industry. You have stated that Treasury's recommendations are a "mixed bag" and that there are "some ideas [you] would not support."

a. **What are the regulations you would not want to see undermined? Please be as specific as possible.**

The June 2017 Treasury report on financial regulation acknowledged that regulatory policies since the financial crisis have improved the safety and soundness of the financial system, and noted that the U.S. banking system is significantly better capitalized as a result of post-crisis regulatory capital requirements and stress testing. The report also made a series of recommendations for the U.S. regulatory agencies to consider in order to reduce regulatory burden on the banking system.

The Federal Reserve Board (Board) has not taken a position on many of the recommendations in the report. There are a number of recommendations in the report that I would support and that, in fact, the Board had already begun to implement before the report was published. For example, I believe that we should continue to further tailor statutory and regulatory requirements based on the risks presented by firms. I also believe that we should continue to streamline regulation of community banks, including simplifying capital requirements.

However, I also believe that we must maintain strong capital and liquidity requirements for large, complex financial institutions. Having strong capital and liquidity requirements for the global systemically important banks that constrain their leverage and risk-taking, for example, is an intended consequence of the post-crisis reforms and should be maintained. Any changes to the regulatory regime for these firms should be narrowly targeted at specific aspects of regulations that are having an unintended effect.

The Federal Reserve is committed to continuing to evaluate the effects of regulation on financial stability and on the broader economy, and to make adjustments as appropriate. As we do that, however, I would reiterate that we should preserve the core tenets of regulatory reform that were designed to significantly reduce the likelihood and severity of future financial crises. As I discussed in my testimony before the Senate Committee on Banking, Housing, and Urban Affairs on June 22, 2017, there are four key elements of the post-crisis regulatory reforms that I believe should remain substantially in place to achieve this aim: regulatory capital, stress testing, liquidity, and resolution planning. Moreover, I believe that we should continue to tailor our rules to the different risks of different firms and, in particular, work to reduce unnecessary burden on community banks.

In all our efforts, the Federal Reserve's goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. As we consider the recommendations in the Treasury report, that is the lens through which the Board would view any future regulatory changes. If I were to be confirmed, I look forward to continuing to work with our fellow regulatory agencies and with Congress to achieve these important goals.

b. As the Federal Reserve Chairman, how would you assess whether rolling back a particular regulation would introducc risks into the financial system?

The activities of financial firms can pose risks to the financial system. For example, an excessive reliance on short-term wholesale funding, excessive leverage, and deficiencies in risk management at large financial firms, as well as at many firms outside the regulated banking sector, led to a devastating financial crisis. The reforms to regulation and supervision that have been put in place are intended to help prevent another crisis. As we consider possible changes to the post-crisis structure of regulation and supervision, we should look at ways we might better tailor supervision and regulation to be more efficient while maintaining the resilience of the financial system. Changes to regulation should take into account a range of factors. When adopting regulations, we should consider our own analyses, as well as public comments, and aim to maximize the long-term net economic benefits, while taking account of regulatory burden.

4. At a hearing with the current CEO of Wells Fargo, I asked why the OCC should not review and possibly revoke the bank's charter because of its egregious violations of consumer protection laws. Mr. Sloan answered that Wells Fargo provides banking services to 1-in-3 households in America, which sounds to me like he thinks Wells Fargo is too big to be held accountable.

a. Do you think there are institutions that are too big to be held accountable?
b. Do you think there is a point at which a bank, regardless of how plain-vanilla it is, can be so big that its officers and board members are unable to manage risk and truly oversee all operations?
c. What should the Federal Reserve do in those cases?

I also have been very distressed to see large banking organizations with problems complying with consumer laws and preventing fraud. All banking organizations--regardless of their size--

are expected to comply with applicable laws and regulations and operate in a safe and sound manner. All banking organizations need to have effective, firm-wide compliance risk management programs that enable firms to identify, assess, and control their compliance risks. Banking organizations--especially the largest, most complex institutions--must appropriately design these programs for the activities in which they engage and ensure that they have sufficient systems and resources to effectively operate the programs on an ongoing basis.

The Federal Reserve's program for supervising large banking organizations is focused on whether the firms maintain sufficient capital to absorb stress and continue to operate, maintain sufficient liquidity to withstand an acute funding shock, conduct effective recovery and resolution planning, and maintain sufficient governance and controls to ensure all aspects of their business are well managed and operate in a safe and sound manner. Banking organizations that do not meet these standards or fail to comply with laws and regulations are subject to supervisory actions, including ratings downgrades and enforcement actions. The severity of an enforcement action is calibrated to the materiality of the legal violation or supervisory issue. Banking organizations that fail to address weaknesses over a prolonged period of time may be subject to restrictions or limitations on their business.

We expect to see robust policies and procedures in place to help ensure that employees are acting in a legal and ethical manner, and that the incentives that are put in place in these organizations are appropriate and do not foster behaviors that could harm consumers. This has been and will be a focus of our supervision for all banking organizations.

5. According to a letter that FDIC Vice Chairman Thomas Hoenig sent to this committee, "10 bank holding companies in the U.S. will distribute, in aggregate, 99 percent of their net income . . . [in the form of dividends and stock buybacks]." For 2017, these institutions will pay out over $116 billion. He goes on to note that "if the 10 largest U.S. bank holding companies were to retain a greater share of their earnings earmarked for dividends and share buybacks in 2017 they would be able to increase loans by more than $1 trillion, which is greater than 5 percent of annual U.S. GDP." In his view, "such massive distributions of capital provide no base for their future growth that would benefit our national economy."

a. **Do you think it is good or bad for the economy that banks are putting so much capital towards shareholder payouts?**
b. **This trend of aggressive shareholder payouts can be seen across major industries in our economy. Do you think the share of net income going to shareholder payouts, as opposed to other investments—such as R&D, wages, workforce development, and capital investments—plays any role in the disappointing productivity that the Federal Reserve has observed in the US economy?**

As a percentage of corporate earnings, payouts from U.S. corporations to shareholders in the form of share buybacks and dividends have been unusually high over the past couple of years. But establishing a direct connection between the strong shareholder payout activity and the lackluster capital investment and productivity growth of the economy is difficult. Indeed, prior to 2016, payouts to shareholders as a share of earnings had been running close to their average pace of the past three decades, including times with faster productivity growth. Moreover, economists tend to view the high payouts more as a consequence, rather than a cause, of the relatively modest pace of investment amidst high profitability.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Senator Brian Schatz:</u>

- What are your views on whether climate change will have a material impact on our economy?

When the Federal Reserve Board formulates monetary policy, it takes a broad look at the economy and identifies short- and medium-run risks and trends. In the minutes from the FOMC's most recent meeting, there is a brief discussion of the economic impact of hurricane-related disruptions as well as dislocation from wildfires in California. But the minutes note that these sorts of severe weather events have only had a temporary impact in the past.

Our own government's data show that the intensity and frequency of major weather events are increasing. Hurricanes, flooding, droughts, wildfires—they are happening more often and they are causing more damage than ever.

- How many events do you think it would take to have a material impact on the economy?

- Has the Federal Reserve considered what that number would be, in terms of number of events or the total cost of the damage?

- Have you or the Federal Reserve's staff been in communication with NOAA about the likelihood of the number of severe weather events increasing?

- At what point should the Federal Reserve begin to factor into its analyses the downside risks of not having policies in place to combat climate change?

The Treasury Department has put out a number of reports that detail its proposals for deregulating the financial industry. You have stated that Treasury's recommendations are a "mixed bag" and that there are "some ideas [you] would not support."

- What are the regulations you would not want to see undermined? Please be as specific as possible.

- As the Federal Reserve Chairman, how would you assess whether rolling back a particular regulation would introduce risks into the financial system?

At a hearing with the current CEO of Wells Fargo, I asked why the OCC should not review and possibly revoke the bank's charter because of its egregious violations of consumer protection laws. Mr. Sloan answered that Wells Fargo provides banking services to 1-in-3 households in America, which sounds to me like he thinks Wells Fargo is too big to be held accountable.

- Do you think there are institutions that are too big to be held accountable?

- Do you think there is a point at which a bank, regardless of how plain-vanilla it is, can be so big that its officers and board members are unable to manage risk and truly oversee all operations?

- What should the Federal Reserve do in those cases?

According to a letter that FDIC Vice Chairman Thomas Hoenig sent to this committee, "10 bank holding companies in the U.S. will distribute, in aggregate, 99 percent of their net income . . . [in the form of dividends and stock buybacks]." For 2017, these institutions will pay out over $116 billion. He goes on to note that "if the 10 largest U.S. bank holding companies were to retain a greater share of their earnings earmarked for dividends and share buybacks in 2017 they would be able to increase loans by more than $1 trillion, which is greater than 5 percent of annual U.S. GDP." In his view, "such massive distributions of capital provide no base for their future growth that would benefit our national economy."

- Do you think it is good or bad for the economy that banks are putting so much capital towards shareholder payouts?

- This trend of aggressive shareholder payouts can be seen across major industries in our economy. Do you think the share of net income going to shareholder payouts, as opposed to other investments—such as R&D, wages, workforce development, and capital investments—plays any role in the disappointing productivity that the Federal Reserve has observed in the US economy?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable Catherine Cortez Masto
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the November 28, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on December 1, 2017.

Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Senator Cortez Masto:

1. The Fed recently released a proposal seeking to minimize bank Boards of Directors' engagement with bank examiners on supervisory issues, instead relying more on bank managers to flag items for the Board that require attention. This moves in precisely the wrong direction after the Wells Fargo scandal.

a. Why should the Fed's proposal on bank boards apply to recidivist firms like Wells Fargo?

The *Proposed Guidance on Supervisory Expectation for Boards of Directors*[1] seeks to focus the directors and our supervisory staff on key attributes of effective boards and their role in overseeing institutions. The proposed guidance clarifies that expectations for boards of directors are distinct from expectations for management. Rather than minimizing examiner engagement with directors, that distinction allows our examiners to spotlight the core responsibilities of effective boards, one of which is to ensure the independence and stature of the risk management and internal audit functions. The proposed guidance would make boards accountable for supporting a risk management function that is valued for identifying risks and escalating concerns about controls. As I have said publicly, the failure to ensure the independence of these functions from the revenue generators and risk takers has been shown to be dangerous, and this is something for which the board is accountable.[2] The proposal also states that an effective board will hold senior management accountable for a variety of key actions, including the development and implementation of performance management and compensation programs that encourage prudent risk-taking behaviors and business practices, which emphasizes the importance of compliance with laws and regulation, including consumer protection.

2. Both you and Vice Chair Quarles have stated a desire to provide more "granular" information to banks about stress tests.

a. If you make more information about the tests public, how do you anticipate preventing big banks from gaming the system by rigging their portfolios to match the models you reveal?

As I have stated previously, the Federal Reserve is committed to increasing the transparency of the stress testing process, but I also believe the benefits of increased transparency must be carefully weighed against the potential downsides of providing the firms subject to the stress test with full details about the models.

For example, complete knowledge of the models could lead to a "model monoculture" in which all firms have similar internal stress testing models, which could increase the correlation of risk

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[1] *See* "Proposed Guidance on Supervisory Expectation for Boards of Directors," 82 FR 37219 (August 9, 2017).
[2] See "The Role of Boards at Large Financial Firms," remarks by Governor Jerome H. Powell at the Large Bank Directors Conference, August 30, 2017. https://www.federalreserve.gov/newsevents/speech/powell20170830a.htm.

in the system, and miss key idiosyncratic risks faced by the firms.

Federal Reserve staff has developed and will be seeking public comment on a proposal that aims to enhance the understanding of the Federal Reserve's models through disclosure of information about the range of loss rates produced by our models for given asset types. That proposal will be published in the Federal Register soon. These proposed enhanced model disclosures would provide more insight into how the Federal Reserve's supervisory models treat different types of loans than has previously been provided.

The enhanced model disclosures strive to strike an appropriate balance between transparency and the continued effectiveness of our models, and we will seek comments on the proposal from the public.

3. In your testimony, you said that stress testing is "maybe the single most successful" post-crisis innovation.

a. Can you guarantee that less frequent or rigorous stress testing would be as successful as under current law?

Capital stress tests, which played a critical role in bolstering confidence in the capital positions of U.S. firms in the wake of the 2007 to 2009 financial crisis, have become one of the most important features of our supervisory program. Stress tests play a critical role in ensuring that firms have sufficient capital to continue lending through periods of economic stress and market turbulence, and that their capital is adequate in light of their risk profiles. If we do make changes to the stress testing program, we would seek to do so in a way that does not undermine the program's aim of keeping firms well capitalized and, in turn, safe and sound.

The dynamic nature of banks and the risks they face could render the results of stress tests stale within a short timeframe. Accordingly, we believe there are safety and soundness and financial stability benefits in conducting the tests annually for large and complex U.S. banking organizations. If Congress granted us the flexibility to conduct stress tests at a different frequency than annually for smaller and less complex firms, we would consider the tradeoff between potentially less current information about banks' risks against the reduced burden of less frequent stress tests.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Senator Catherine Cortez Masto:</u>

The Fed recently released a proposal seeking to minimize bank Boards of Directors' engagement with bank examiners on supervisory issues, instead relying more on bank managers to flag items for the Board that require attention. This moves in precisely the wrong direction after the Wells Fargo scandal.

- Why should the Fed's proposal on bank boards apply to recidivist firms like Wells Fargo?

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable Christopher Van Hollen
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the November 28, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on December 1, 2017.

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Senator Van Hollen:</u>

1. While your predecessors were careful not to wade into the specifics of the fiscal decisions made by Congress, they did express concerns about rising debts.

a. Are you concerned about rising debt?

Yes, I am concerned. If current budget policies do not change, the Congressional Budget Office projects that the further aging of the population, rising health care costs, and growing interest payments on the debt will all contribute importantly to rising budget deficits and an unsustainable trend in the ratio of the federal debt to GDP. A large and growing federal government debt, relative to the size of the economy, over the coming decades would have negative effects on the economy. In particular, a rising federal debt burden would reduce national saving, all else equal, and put upward pressure on longer-term interest rates. Those effects would be likely to restrain private investment, which, in turn, would tend to reduce productivity and overall economic growth.

b. How do you believe adding $1.5 trillion to the national debt will impact the Federal Reserve's monetary policy decisions and the economy overall?

Fiscal policy in general, and the size of the national debt in particular, are only some of the many factors affecting the overall economic environment in which we will be conducting monetary policy. In my answer immediately above, I outlined some of the longer-term effects that a larger national debt might have on the national economy. While those effects may ultimately prove to be important, they will mostly play out only slowly, over long periods of time. In general, in the day-to-day and month-to-month conduct of monetary policy, we can be more tactical, in that we can respond quickly to unfolding developments. Indeed, we will respond to many changing factors over coming years.

c. Do you know of any credible analysis that indicates that this tax cut would "pay for itself?"

Because the Federal Reserve is not assigned a role in estimating the budgetary effects of changes in fiscal policy, it would not be appropriate for me to comment on any specific tax proposal. But generally speaking, changes in tax policy would have to generate sizeable and persistent increases in economic growth in order for the revenues lost from tax cuts to be offset by the revenues gained because taxable incomes and profits are higher.

2. This past March, you spoke at West Virginia University College of Business and Economics about the History and Structure of the Federal Reserve. In that speech you discussed how the Federal Reserve needs "to have diversity in gender and race both at the Board and at the Reserve Banks." Please discuss how you will prioritize diversity at the Federal Reserve should you become Chair. You have previously recommended in your annual letter to Reserve Banks that they look beyond the corporate and financial sector to labor and community organizations for Reserve Bank directors.

a. Do you think the Reserve Banks have been receptive to your recommendations?
b. How will you continue to prioritize diversity of industry and sector representation throughout the Federal Reserve System?
c. Please provide an assessment of the Federal Reserve's progress on diversity.

Diversity is a critical aspect of all successful organizations, and I am committed to fostering diversity and inclusion throughout the Federal Reserve System. In my experience, we make better decisions when we have a range of backgrounds and voices around the table.

The Federal Reserve recognizes the value of a diverse workforce at all levels of the organization. We are committed to achieving further progress, and to better understanding the challenges to improving and promoting diversity of ideas and backgrounds. This has been an ongoing objective, and, if confirmed, I assure you that diversity will remain a high priority objective for the Federal Reserve.

As Administrative Governor and Chair of the Committee on Board Affairs, I have supported and encouraged the Federal Reserve Board's (Board) efforts to enhance diversity. In my role as Chair of the Board Committee on Federal Reserve Bank Affairs, I have worked with the Reserve Banks to promote diversity throughout the System. Recognizing the value of diversity at all levels of the System, including at the highest levels, I have worked work closely with the Reserve Banks to assure that they have a diverse slate of qualified candidates for president searches. The Reserve Banks, working closely with the Board, have also been looking at ways to further develop a diverse pool of talent in a thoughtful, strategic fashion, readying them for leadership roles throughout the Federal Reserve System.

To foster diversity more broadly, a long-term holistic plan is necessary with a focus on doing the utmost to recruit and bring people in and provide them paths for success. That means having an overall culture and organization that is focused on diversity and demonstrates its ongoing commitment at all levels, starting at the top. For example, we have an internal work stream at the Board to coordinate economic inclusion and diversity efforts that is comprised of the Office of Minority and Women Inclusion Director, Division Directors, senior staff and Board Members. It focuses on initiatives not just at the Board but also more broadly throughout the System. I am part of this team, as are other Board members, and we meet regularly to discuss initiatives and progress.

The Board focuses considerable attention on increasing gender, racial, and sector diversity among directors because we believe that Reserve Bank boards function most effectively when they are constituted in a manner that encourages a variety of perspectives and viewpoints. Monetary policymaking also benefits from having directors who effectively represent the communities they serve because we rely on directors to provide meaningful grassroots economic intelligence. Because all directors serve in this role, we believe it is important to consider the characteristics of both Reserve Bank and Branch boards.

Each year, the Board carefully reviews the demographic characteristics of Reserve Bank and Branch boards. This information is shared with Reserve Bank leadership, including the current

Chair and Deputy Chair of each board, and areas for improvement are highlighted. The Board's Bank Affairs Committee regularly discusses this topic with Reserve Bank leadership during the annual Bank evaluation meetings.

Although there is surely room for further improvement, the Federal Reserve has made significant progress in recent years in recruiting highly qualified women and minorities for director positions. For example, we anticipate that in 2018:

- six of the twelve Reserve Banks boards of directors will be chaired by a woman, and three of those Banks will have a woman serving as both Chair and Deputy Chair;
- five Reserve Banks will have a racially diverse Chair or Deputy Chair, and one additional Bank will have a racially diverse director in both roles; and
- 50% of Reserve Bank Chairs and 67% of Deputy Chairs will be diverse in terms of gender and/or race (with a racially diverse woman counted only one time).

The System's directors represent a wide variety of industries and sectors, and we have seen significant improvement in increasing representation from historically underrepresented groups, including consumer/community and labor leaders. For example, in 2017 every Reserve Bank except one has a consumer/community or labor representative serving on its board. In addition, consumer/community and labor directors serve on numerous Branch boards throughout the System. In addition, other Board-appointed directors are affiliated with organizations that allow them to provide unique and invaluable insights into their communities and regional economies.

As you know, section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act charged the Board with developing standards for equal employment opportunity and the racial, ethnic, and gender diversity in our workforce and senior management, as well as for increased participation of minority-owned and women-owned businesses in programs and contracts. With regard to contracting, the Board has utilized national and local organizations advocating for minority companies as a method to connect directly with qualified companies and we participate in numerous outreach events that provide a platform for the Board's staff to discuss the procurement process with potential vendors while also providing information on future procurement opportunities.

I believe it is important to continue to build on these efforts. Continued collaboration with advocacy groups will help the Fed better understand the challenges minority businesses face as well as help the firms better navigate the Fed's acquisition process.

3. In response to the financial crisis, the Federal Reserve instituted the Comprehensive Capital Analysis and Review (CCAR). This annual exercise has helped ensure that institutions have well-defined and forward-looking capital planning processes that account for unique risks of the institution and sufficient capital to continue operations through times of economic and financial stress.

a. Please describe how you believe the CCAR has benefited our financial system.

The Comprehensive Capital Analysis and Review (CCAR) was designed to address critical weaknesses at the largest banks that threatened their viability and, in turn, the stability of the U.S. financial system during the recent financial crisis. At that time, these banks were:

- Unable to understand the adverse effects they could suffer under extreme stress or the impact of such effects upon their financial condition;
- Unable to gather basic data necessary to accurately determine their own exposures, including determining their total exposure to particular counterparties across their firm and the location and value of the collateral they held;
- Reluctant to cut their distributions – particularly dividends – even as stress was growing, lest they signal weakness to the markets; and
- Significantly undercapitalized as a result of being unable to understand the material risks to which they were exposed.

CCAR and stress testing have prompted improvement in capital adequacy and capital planning at the largest U.S. banks in the years since the crisis. U.S. firms have substantially increased their capital since the first round of stress tests led by the Federal Reserve in 2009. The common equity capital ratio--which compares high-quality capital to risk-weighted assets--of the 34 bank holding companies in the 2017 CCAR has more than doubled from 5.5 percent in the first quarter of 2009 to 12.5 percent in the first quarter of 2017. This reflects an increase of more than $750 billion in common equity capital to a total of $1.25 trillion during the same period.

CCAR has also required firms to steadily improve their risk management and capital planning practices. As a result, some of the firms are now close to meeting our supervisory expectations for capital planning. It will continue to be important to assess the capital planning practices of these firms, given the dynamic nature of banks and the risks that they face.

b. Do you believe the Economic Growth, Regulatory Relief and Consumer Protection Act, as it is written provides the Federal Reserve with any implicit or explicit signals to alter the way and frequency with which it administers the CCAR?

I am still familiarizing myself with the bill. I understand that it is scheduled to be marked up this week and is still subject to change, but in general I support the overall framework of the legislation. One provision of the bill under consideration would increase the $50 billion asset threshold for supervisory stress testing to $100 billion. If the threshold for supervisory stress testing were raised, and a supervisory stress test were no longer done for some firms, an adjustment to the CCAR quantitative assessment would be appropriate for these firms as well.

Another provision of the bill would change the required frequency of supervisory stress testing from "annual" to "periodic" for firms with between $100 billion and $250 billion of total assets. Banks with between $100 billion and $250 billion in total consolidated assets are an important source of credit to consumers and businesses. As a result, it is important that they continue to maintain sufficient capital.

We believe there are safety and soundness and financial stability benefits in conducting capital stress tests on a periodic basis based on a bank's size and complexity. If Congress granted us the flexibility to conduct stress tests at a different frequency than annually, we would consider the tradeoff between potentially less current information about banks' risks against the reduced burden of less frequent stress tests.

c. Does the Federal Reserve plan on altering the frequency by which it administers the CCAR within the next two years?

Under current law, we have no plan to reduce the frequency of CCAR within the next two years.

4. One of the hallmarks of the Federal Reserve is its independence as an agency that is ultimately accountable to the public and the Congress.

a. How would you respond to efforts by members of the Executive Branch to exert influence over the Federal Reserve's monetary and regulatory policy?

The independence that Congress granted the Federal Reserve is a hallmark of our institution and allows us to pursue policies--both monetary and regulatory--that are appropriate for the health and safety of the U.S. economy and its banking system, but which could be politically unpopular or difficult. Our highly trained staff conducts objective analysis that allows Board members and Federal Open Market Committee participants to make decisions so as to achieve maximum employment, price stability, and a stable financial system. I intend to preserve the Federal Reserve's independence, which I see as essential for us to achieve our Congressionally-mandated goals.

b. What will you do as Chair to maintain the Federal Reserve's independence?

Historical studies and economic research have shown the importance of independence in enabling the Federal Reserve to achieve its mandated goals. If confirmed, I plan to continue our tradition of independence and nonpartisanship by fostering an environment that supports objective analysis and research, and promoting a culture in which policymakers express their viewpoints and achieve consensus. I will also continue my predecessors' commitment to transparent communications with the Congress and the public, so that the Federal Reserve can be held accountable for its performance.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Senator Chris Van Hollen:

While your predecessors were careful not to wade into the specifics of the fiscal decisions made by Congress, they did express concerns about rising debts.

- Are you concerned about rising debt?
- How do you believe adding $1.5 trillion to the national debt will impact the Federal Reserve's monetary policy decisions and the economy overall?
- Do you know of any credible analysis that indicates that this tax cut would "pay for itself?"

This past March, you spoke at West Virginia University College of Business and Economics about the History and Structure of the Federal Reserve. In that speech you discussed how the Federal Reserve needs "to have diversity in gender and race both at the Board and at the Reserve Banks." Please discuss how you will prioritize diversity at the Federal Reserve should you become Chair. You have previously recommended in your annual letter to Reserve Banks that they look beyond the corporate and financial sector to labor and community organizations for Reserve Bank directors.

- Do you think the Reserve Banks have been receptive to your recommendations?
- How will you continue to prioritize diversity of industry and sector representation throughout the Federal Reserve System?
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- Please describe how you believe the CCAR has benefited our financial system.
- Do you believe the Economic Growth, Regulatory Relief and Consumer Protection Act, as it is written provides the Federal Reserve with any implicit or explicit signals to alter the way and frequency with which it administers the CCAR?
- Does the Federal Reserve plan on altering the frequency by which it administers the CCAR within the next two years?

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
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- What will you do as Chair to maintain the Federal Reserve's independence?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable David Perdue
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the November 28, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on December 1, 2017.

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Senator Perdue:</u>

1. Governor Powell: As you know, federal law allows for banking regulators to impose temporary consent orders on financial institutions to address deficiencies at these organizations. I understand that there are several inter-agency consent orders in place for companies that, despite having met the obligations of their consent orders for some time, have not had the consent orders lifted due to inaction on the part of the Federal Reserve Board. As the Treasury Department's June Report (A Financial System That Creates Economic Opportunities: Banks and Credit Unions) outlined, the regulatory agencies need to improve this. Specifically, the reports states "A greater degree of inter-agency cooperation and coordination pertaining to regulatory actions and consent orders should be encouraged, in order to improve the transparency and timely resolution of such actions.". This is an achievable task and should be adopted swiftly, particularly as it pertains to the remaining inter-agency consent orders that appear to be unnecessarily left in place.

a. Could you please provide me with an update on existing consent order statuses and what the Federal Reserve is doing to give these the appropriate level of attention so companies can avoid being left in limbo for an indeterminate timeframe?

In some limited cases the Federal Reserve Board (Board) enters into formal enforcement actions against regulated institutions where other banking regulators are parties to the same action. In these cases, we coordinate closely with the other regulators that are parties to the action. In deciding whether any enforcement action should be terminated, the Board's consistent practice is to require that the institution subject to the action show that all corrective measures required by the action have been properly implemented, and these corrections have been sustained for an appropriate period and are expected to be sustainable in the future. The Board is committed to lifting enforcement actions on a timely basis when these conditions are met, and Board staff is reviewing our policies and practices in this area and assessing ways to increase interagency coordination for actions shared by multiple banking regulators.

2. Governor Powell, the global financial crisis of 2007-2012 created the term SIFI – systematically important financial institution. Globally, the Basel Committee created a methodology to identify Globally Systemically Important Banks (G-SIB). Beyond the G-SIBs, Dodd-Frank gave the Federal Reserve the power to impose enhanced supervision on bank holding companies over $50 billion. Meanwhile in Europe, the European Banking Authority uses an activity based test to identify their Other Systemically Important Institutions (O-SIIs).

a. Is the size of a financial institution a sufficient assessment of its risk to the financial system or is there merit in the European model (O-SII) that takes into account a more comprehensive list of factors including size, substitutability, complexity, interconnectedness, and global cross-jurisdictional activity?

The Federal Reserve has been working for many years to make sure that our regulation and supervision is tailored to the size, risk profile, and systemic footprint of individual institutions. I believe that it is not only appropriate to recognize the different levels of risk and types of risk that different institutions in the system pose, but that it also makes for better and more efficient regulation. Efficient regulation allows the financial system to more efficiently support the real economy.

While the Board currently has some authority to tailor the enhanced prudential standards included in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Board generally cannot eliminate the application of these standards to covered firms. In particular, Congress required that certain enhanced prudential standards must apply to firms with \$10 billion or more in total assets, with other standards beginning to apply at \$50 billion in total assets.

I am aware that Congress is currently considering whether and how to raise existing statutory thresholds in the Dodd-Frank Act, and I have expressed support for increasing these thresholds. I also understand that Congress is considering an alternative to simply raising the thresholds that would entail the use of a more complex, multi-factor approach to decide which firms are subject to enhanced prudential standards. As I have indicated previously, I am comfortable with both of these approaches for further tailoring of section 165 of the Dodd-Frank Act. More specifically, I think that an increase in the Dodd-Frank Act statutory thresholds, combined with authority to apply enhanced prudential standards below the new threshold, along the lines provided for in the bill under consideration by the Senate Committee on Banking, Housing, and Urban Affairs, would help produce a supervisory and regulatory framework that is better tailored to the size, systemic footprint, and risk profile of banking firms. If I were to be confirmed, I would stand ready to continue working with Members on this issue.

3. Governor Powell, we've had 3 rate hikes in the past year yet we haven't seen an exact replication on yield rates. In fact, as seen below, the rates on U.S notes and bonds (2-10 years and 30 years) have not moved at all or seen a dip.

U.S Treasuries Interest Rates

Date	1 mo	3 mo	6 mo	1 yr	5 yr	10 yr	20 yr	30 yr
12/5/2016	0.34	0.49	0.63	0.82	1.84	2.39	2.76	3.05
11/24/2017	1.14	1.29	1.45	1.61	2.07	2.34	2.58	2.76

a. Do you believe this is a reflection of general global instability and the growth of risk within the pricing of bonds?

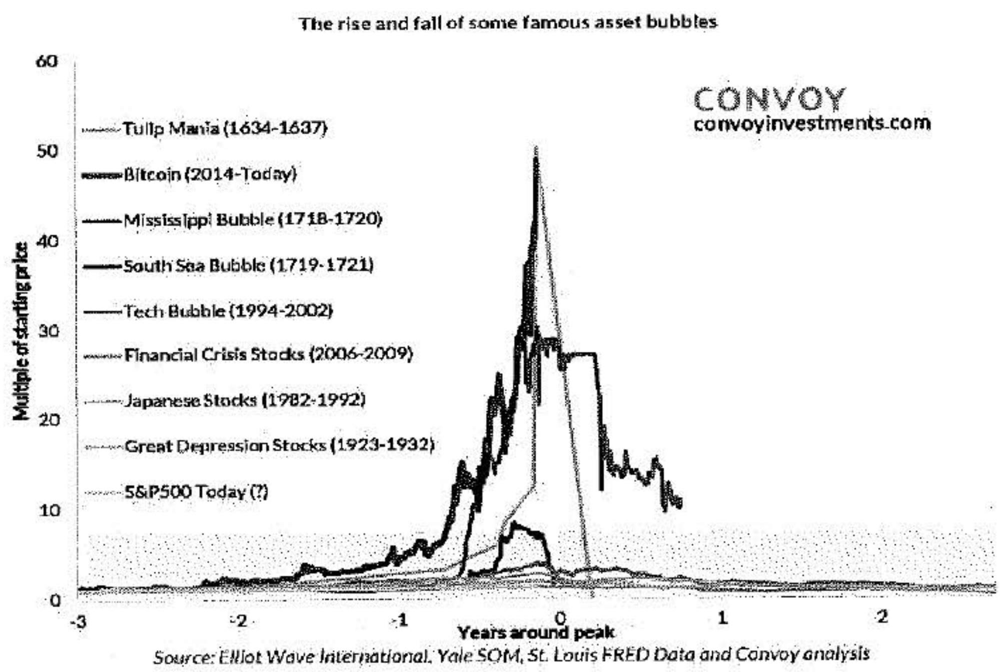
The yields on Treasury securities with maturities out to two years have responded to the policy firming of the Federal Reserve over the past year largely as one would expect. For example, 1- and 2-year Treasury yields have moved up about 75 basis points and 60 basis points, respectively, since the end of last year. Longer term Treasury yields have not increased by as much as one might expect based on historical relationships. For example, 10- and 30-year yields have declined by about 10 and 30 basis points, respectively, since the end of last year. Market participants have pointed to a number of factors as contributing to the decline in longer-term Treasury yields over the last year including some scaling back in the expectations for fiscal stimulus, reduced concerns that inflation could move sharply higher, an increase in demand for longer-term assets by institutional investors, and asset purchase programs by central banks. Longer-term yields in many advanced countries have edged lower over the last year, suggesting that global forces may be contributing to the low level of long-term yields.

b. Do you believe this is a temporary situation or a new global norm?

The level of longer-term interest rates around the world can be expected to rise gradually over time as the global economy recovers further and central banks normalize the stance of monetary policy. However, many analysts have suggested that the so-called "equilibrium" level of interest rates may be lower now than in the past. Indeed, the median long-run level of the federal funds rate in projections prepared by Federal Open Market Committee participants in September stood at 2.8 percent--almost a percentage point lower than comparable projections prepared two years ago. Analysts have pointed to a number of factors that could be contributing to a lower equilibrium level of interest rates including aging populations and slower productivity growth in many advanced economies, changes in regulation, and increased caution on the part of businesses in their investment spending.

4. Governor Powell, as a continuation of our conversation on bitcoin during the hearing.

a. Do you have concerns that bitcoin is a significant asset bubble and if asset prices were to correct, would this create a regional, super-regional, or national economic crisis?
b. What would the contagion effect be?
c. Are there any weaknesses in our global financial structure that would be susceptible to operation risks?



The use of digital currencies has expanded. But from the standpoint of analysis, the "currency" or asset at the center of some of these systems is not backed by other secure assets, has no intrinsic value, is not the liability of a regulated banking institution, and in leading cases, is not the liability of any institution at all.

Asset prices can be volatile, and it is quite difficult to make reliable assessments about the right level for any given asset class. The problem is even more difficult with digital currencies, because they are so new and there are so many questions about the factors that drive their value and their status as a new asset class. As a result, it is difficult to say whether there is currently an asset bubble in the price of bitcoin. However, the price of bitcoin has been quite volatile throughout its existence, and recently bitcoin has experienced losses of more than 20% of its value in just a few hours. Those experiences give us some confidence that even if there were a more significant correction in the price of bitcoin in the near term, there would be limited spillover to regional, super-regional, or nation economies. Recent experience also suggests that contagion has been limited to prices of other digital currencies.

While these digital currencies may not pose major concerns at their current levels of use, more serious financial stability issues may result if they achieve wide-scale usage. Risk management can act as a mitigant, but if the central asset in a payment system cannot be predictably redeemed for the U.S. dollar at a stable exchange rate in times of adversity, the resulting price risk and potential liquidity and credit risk pose a large challenge for the system. A related issue is operational risk, if there are large surges in the number of transactions as holders of an asset try to settle purchases and sales of transactions in a concentrated window of time.

During times of crisis, the demand for liquidity can increase significantly, including the demand for the central asset used in settling payments. Even private-sector banks and certainly non-banks can have a hard time meeting large-scale demands for extra liquidity at the very time when their balance sheets may be in question. Moreover, this inability to meet the demand for extra liquidity can have spillover effects to other areas of the financial system.

Nonetheless, at this time, I do not see bitcoin as having sufficient scale in volume or value to make the overall global financial structure susceptible to operational or other disruptions.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Senator David Perdue:</u>

Governor Powell: As you know, federal law allows for banking regulators to impose temporary consent orders on financial institutions to address deficiencies at these organizations. I understand that there are several inter-agency consent orders in place for companies that, despite having met the obligations of their consent orders for some time, have not had the consent orders lifted due to inaction on the part of the Federal Reserve Board. As the Treasury Department's June Report (A Financial System That Creates Economic Opportunities: Banks and Credit Unions) outlined, the regulatory agencies need to improve this. Specifically, the reports states "A greater degree of inter-agency cooperation and coordination pertaining to regulatory actions and consent orders should be encouraged, in order to improve the transparency and timely resolution of such actions.". This is an achievable task and should be adopted swiftly, particularly as it pertains to the remaining inter-agency consent orders that appear to be unnecessarily left in place.

- Could you please provide me with an update on existing consent order statuses and what the Federal Reserve is doing to give these the appropriate level of attention so companies can avoid being left in limbo for an indeterminate timeframe?

Governor Powell, the global financial crisis of 2007-2012 created the term SIFI – systematically important financial institution. Globally, the Basel Committee created a methodology to identify Globally Systemically Important Banks (G-SIB). Beyond the G-SIBs, Dodd-Frank gave the Federal Reserve the power to impose enhanced supervision on bank holding companies over $50 billion. Meanwhile in Europe, the European Banking Authority uses an activity based test to identify their Other Systemically Important Institutions (O-SIIs).

- Is the size of a financial institution a sufficient assessment of its risk to the financial system or is there merit in the European model (O-SII) that takes into account a more comprehensive list of factors including size, substitutability, complexity, interconnectedness, and global cross-jurisdictional activity?

Governor Powell, we've had 3 rate hikes in the past year yet we haven't seen an exact replication on yield rates. In fact, as seen below, the rates on U.S notes and bonds (2-10 years and 30 years) have not moved at all or seen a dip.

- Do you believe this is a reflection of general global instability and the growth of risk within the pricing of bonds?

- Do you believe this is a temporary situation or a new global norm?

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
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Date	1 mo	3 mo	6 mo	1 yr	5 yr	10 yr	20 yr	30 yr
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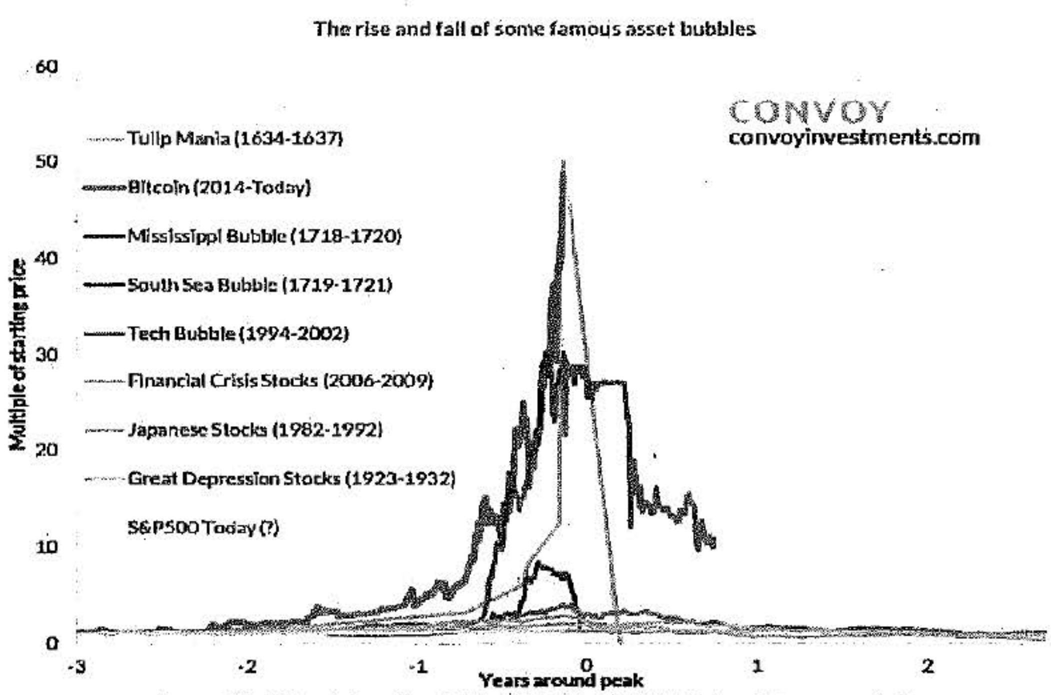
Governor Powell, as a continuation of our conversation on bitcoin during the hearing.

- Do you have concerns that bitcoin is a significant asset bubble and if asset prices were to correct, would this create a regional, super-regional, or national economic crisis?

- What would the contagion effect be?

- Are there any weaknesses in our global financial structure that would be susceptible to operation risks?



Source: Elliot Wave International, Yale SOM, St. Louis FRED Data and Convoy analysis

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable Elizabeth Warren
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the November 28, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 1, 2017.

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Senator Warren:</u>

1. In June of this year, The Treasury Department released a report entitled "A Financial System that Creates Economic Opportunities: Banks and Credit Unions."[1] The report contained dozens of recommendations for rolling back financial regulations. These recommendations closely resembled the wish lists created by big bank lobbying groups.[2] The attached summary lists all of the recommendations that fall into the Federal Reserve's jurisdiction.

a. For each listed recommendation in the Fed's jurisdiction, please state briefly whether you agree or disagree with the recommendation, and explain why.

We must not forget the severity of the financial crisis and its material adverse impact on families, businesses, and the broader economy. The core reform--capital, liquidity, stress testing, and resolvability--put in place since the crisis are necessary if we are to have a more resilient financial system. But, at the same time, we are looking at ways to better tailor some of the new financial regulations to achieve similar levels of systemic resilience with greater efficiency.

It is seldom true that complex systems are constructed perfectly on the first try. For example, there are areas where it might be appropriate to make adjustments to more narrowly focus financial stability reforms on larger, more systemically important banking firms.

The Federal Reserve Board (Board) has not taken a position on many of the recommendations in the report. There are a number of recommendations in the report that I would support and that, in fact, the Board had already begun to implement before the report was published. For example, I believe that we should continue to further tailor statutory and regulatory requirements based on the risks presented by firms. I also believe that we should continue to streamline regulation of community banks, including simplifying capital requirements.

However, I also believe that we must maintain strong capital and liquidity requirements for large, complex financial institutions. Having strong capital and liquidity requirements for the global systemically important banks that constrains their leverage and risk-taking, for example is an intended consequence of the post-crisis reforms and should be maintained. Any changes to the regulatory regime for these firms should be narrowly targeted at specific aspects of regulations that are having an unintended effect.

In all our efforts, the Federal Reserve's goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. As we consider the recommendations in the Treasury report, that is the lens through which the Board would view any future regulatory changes. If I were to be confirmed, I would look forward to continuing to work with our fellow regulatory agencies and with Congress to achieve these important goals.

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[1] https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.
[2] http://ourfinancialsecurity.org/wp-content/uploads/2017/06/The-Trump-Treasury-And-The-Big-Bank-Agenda.pdf.

2. In 2013, then-Fed Chairman Bernanke reportedly responded to concerns expressed by you and two other governors that it was time to slow the Fed's rate of asset purchases.3 Chair Bernanke wanted to continue asset purchases at their elevated level because of the continued fiscal austerity and gridlock being imposed by Congress at the time, but in order to achieve unanimity on the Board of Governors, he announced intentions to slow asset purchases. It has been speculated that this announcement caused the so-called "taper tantrum" in which investors suddenly withdrew their money from the bond market.

a. Can you explain your role in the taper tantrum?

A novel feature of the asset purchase program started in late 2012 was its open-ended nature. We said at the time that we would continue this program until we saw a substantial improvement in the outlook for the labor market. I supported this open-ended approach, but was concerned that we needed to have a plan for exiting the program even if such an improvement did not occur because our asset purchases were found to be ineffective. As reflected in the meeting minutes, the Federal Open Market Committee (FOMC) discussed the efficacy of our asset purchases in depth during that period. By the spring of 2013, we began to see signs that the outlook for the labor market was improving, as we had hoped. The taper tantrum had, in my view, less to do with changes in market expectations for our asset purchases as it had with changes in expectations for the path of the federal funds rate. The rise in yields of around 100 basis points was too large to have been plausibly explained by balance sheet effects alone and is more consistent with the perception that our policy stance had become less accommodative. These changes were not intended by Chairman Bernanke's communications. Subsequent FOMC communications were successful in clarifying that the prospective reduction in the pace of our asset purchases did not imply a change to our intentions for the path of the federal funds rate.

b. Did you think the economic recovery was sufficient at that time to reduce the Fed's support for the economy?

The tapering of our asset purchases began only in December 2013. At that time I thought it was appropriate to reduce the pace at which the FOMC was adding accommodation. It is important to note that tapering did not imply tightening monetary policy, as Chairman Bernanke emphasized throughout the summer and fall of 2013. To use a car analogy, tapering did not mean tapping the brakes, but merely easing off a little bit of the accelerator. The challenge during the taper tantrum episode was that our intention to slow the pace of asset purchases later in 2013 was initially misunderstood as an intention to raise interest rates sooner. Subsequent communications were successful at aligning the public's expectations for the federal funds rate better with the FOMC's intentions.

c. What communication practices from the Fed might prevent incidents like the taper tantrum from occurring again?

Communicating about the course of monetary policy when operating with multiple tools is inherently challenging. The communications earlier this year in the run-up to our announcement of our plan to reduce the size of our balance sheet illustrate some lessons learned from the taper

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[3] https://sites.google.com/site/kocherlakota009/home/policy/thoughts-on-policy/2-6-16.

tantrum episode. In particular, the FOMC informed the public through the minutes of its meetings well before any decisions were made. Moreover, in the addendum to our Normalization Principles and Plans that the FOMC issued in June, we emphasized that, in current circumstances, the federal funds rate would be the primary means for adjusting the stance of monetary policy. This statement was intended to clarify that our actions regarding the balance sheet at this time should not be interpreted as a decision to alter the stance of monetary policy. The very muted financial market response to our announcements and actions suggests that the public understood our intentions.

3. At your confirmation hearing, you stated that you believed that there no US banks that were too big to fail. When Lehman Brothers failed in 2008, sparking the financial crisis, it had $639 billion in assets. As of now, JPMorgan Chase has roughly four times that amount of assets.

a. Do you honestly believe that if JPMorgan Chase failed tomorrow, taxpayers would not need to bail the bank out to stop another financial crisis?

It may be useful to clarify what it means to ask whether any firm remains "too-big-to-fail." By my answer, I intended to convey my view that we have made enough progress that the failure of one of our most systemically important financial institutions, while undoubtedly posing a severe shock to the economy, could more likely than not be resolved without critically undermining the financial stability of the United States. As I also said, we expect our most systemically important firms to continue to make steady progress toward assuring the achievement of that goal. Finally, I would add that higher levels of capital and liquidity and stress testing substantially reduce the likelihood that one of our most systemically important financial institutions would fail.

During the financial crisis, large financial institutions were unprepared to be resolved. As demonstrated by Lehman Brothers, firms had not been required, nor seen the need, to take specific actions to prepare themselves for resolution. This lack of preparedness contributed to the disruption that the failure of Lehman ultimately generated.

Since the financial crisis, the statutory framework established by Congress and the efforts of the U.S. regulators have made the largest banking firms more resilient and have significantly improved their resolvability. In particular, for the largest, most systemically important firms, we have increased the quantity and quality of capital that they maintain, have established capital surcharges that are scaled to each firm's systemic footprint, and have required them to issue long-term debt that can be converted to equity as part of a resolution.

Through Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress established a process for the Federal Reserve and the Federal Deposit Insurance Corporation to identify resolution weaknesses at firms, to provide clarity about what actions need to be taken, and to follow through on penalties should weaknesses remain. This process is designed to foster resolution planning and enables the agencies to assess whether a firm could be resolved under bankruptcy without severe adverse consequences for the financial system or the U.S. economy.

Specifically, the resolution planning process requires firms to demonstrate that they have adequately assessed the challenges that their structure and business activities pose to resolution and that they have taken action to address those issues. They must also confront the resolution consequences of their day-to-day management decisions on a continual basis, particularly those related to structure, business activities, capital and liquidity allocation, and governance.

For all these reasons, the financial system today is substantially more able to absorb the shocks that would result from the material financial distress of failure of a large, complex financial firm.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Senator Elizabeth Warren:

In June of this year, The Treasury Department released a report entitled "A Financial System that Creates Economic Opportunities: Banks and Credit Unions."[4] The report contained dozens of recommendations for rolling back financial regulations. These recommendations closely resembled the wish lists created by big bank lobbying groups.[5]

The attached summary lists all of the recommendations that fall into the Federal Reserve's jurisdiction.

- For each listed recommendation in the Fed's jurisdiction, please state briefly whether you agree or disagree with the recommendation, and explain why.

In 2013, then-Fed Chairman Bernanke reportedly responded to concerns expressed by you and two other governors that it was time to slow the Fed's rate of asset purchases.[6] Chair Bernanke wanted to continue asset purchases at their elevated level because of the continued fiscal austerity and gridlock being imposed by Congress at the time, but in order to achieve unanimity on the Board of Governors, he announced intentions to slow asset purchases. It has been speculated that this announcement caused the so-called "taper tantrum" in which investors suddenly withdrew their money from the bond market.

- Can you explain your role in the taper tantrum?
- Did you think the economic recovery was sufficient at that time to reduce the Fed's support for the economy?
- What communication practices from the Fed might prevent incidents like the taper tantrum from occurring again?

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- Do you honestly believe that if JPMorgan Chase failed tomorrow, taxpayers would not need to bail the bank out to stop another financial crisis?

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[5] http://ourfinancialsecurity.org/wp-content/uploads/2017/06/The-Trump-Treasury-And-The-Big-Bank-Agenda.pdf
[6] https://sites.google.com/site/kocherlakota009/home/policy/thoughts-on-policy/2-6-16

Outline of the U.S. Treasury Department's Bank Regulatory Proposals, Ranked by Our Assessment of Likelihood				
Segment	**Recommendation**	**Responsibility**	**Likelihood***	**Timing**
Capital/Liquidity	Make the operational risk capital requirements more transparent	FRB, FDIC, OCC	5	2018
Community Banks	Simplify and improve calculation of mortgage servicing asset capital requirements and definition of HVCRE	Congress, FRB, FDIC, OCC	5	2018
De Novo Activity	Streamline de novo bank application process	FDIC	5	2018
Regulatory Reporting	Streamline reporting requirements	FRB, FDIC, OCC	5	2018 or later
Mortgage	Increase small creditor QM exemption from $2B in assets to a threshold between $5B and $10B	CFPB	5	2019
Bank rules	Increase DFAST threshold to $50B from $10B + grant authority to further calibrate	Congress, FRB, FDIC, OCC	4	2018
Bank rules	Raise $50B threshold, but new threshold not defined	Congress, FRB	4	2018
Capital/Liquidity	Implement administrative changes to CCAR including modeling standards and pushing it to a two-year cycle	FRB	4	2018
Capital/Liquidity	Delay Net Stable Funding Ratio and Trading Book review	FRB, FDIC, OCC	4	Late 2017 or 2018
Capital/Liquidity	Simplify capital regime through a shift away from the advanced approached	FRB, FDIC, OCC	4	2018 or later
Capital/Liquidity	Review and harmonize the application of CECL	FRB, FDIC, OCC	4	2018 or later
Capital/Liquidity	Change CCAR sequence and integrate risk-based capital with CCAR stress testing regimes	FRB	4	2019 or later
Capital/Liquidity	Significant changes to the Supplementary Leverage Ratio	FRB, FDIC, OCC	4	2018 or later
Capital/Liquidity	Expanded treatment of HQLA	FRB, FDIC, OCC	4	2018 or later
Capital/Liquidity	Revisit the G-SIB risk-based surcharge, the mandatory minimum debt ratio in TLAC, and the eSLR	FRB, FDIC, OCC	4	2018 or later
CDFI/MDI	Grant CDFIs and MDIs additional flexibility with subordinated debt/capital usage	FRB, FDIC, OCC	4	2018 or later
Credit Unions	Provide off-ramp from risk-based capital requirements if credit union has <$10B in assets or meets 10% simple leverage test	NCUA	4	2018
Credit Unions	Raise stress-testing threshold from $10B to $50B	NCUA	4	2019
Examinations	Congress should raise the applicability threshold for banks eligible for 18-month exam cycle	Congress	4	2018
Bank rules	Increase the small bank holding policy statement threshold from $1B to $2B	Congress, FRB	4	2018
Living Wills	Raise the threshold for compliance with the living will requirements with the new enhanced prudential standard threshold	FRB with FSOC	4	2018
Living Wills	Shift the living will process to a two-year cycle	FRB, FDIC	4	2018
Volcker Rule	Exempt banks with assets <$10B from the Volcker Rule	Congress	4	2018
Volcker Rule	Eliminate Volcker Rule's 60-day rebuttable presumption from the proprietary trading definition	FRB, FDIC, OCC, SEC, CFTC	4	2018/19
Volcker Rule	End requirement for banks to maintain ongoing calibration of a hedge over time	FRB, FDIC, OCC, SEC, CFTC	4	2018/19

Source: U.S. Treasury Department, Compass Point

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Segment	Recommendation	Responsibility	Likelihood*	Timing
Volcker Rule	Apply "enhanced" compliance program under Volcker Rule to banks with >$10B in trading assets/liabilities rather than the current $50B asset threshold	FRB, FDIC, OCC, SEC, CFTC	4	2018/19
Volcker Rule	Adopt a simple definition of covered funds	FRB, FDIC, OCC, SEC, CFTC	4	2018/19
Volcker Rule	Extend the "seeding period" exemption for covered funds from 1 year to 3 years	Congress	4	2018
CFPB	Shift the CFPB's funding to the appropriations process	Congress	4	2018
CFPB	Require the CFPB to issue guidance for comment in advance of taking an enforcement action that departs from historical norms	CFPB	4	2018/19
CFPB	Adopt regulations that more clearly contour the CFPB's UDAAP standard	CFPB	4	2018/19
CFPB	Have the CFPB make more frequent use of no-action letters	CFPB	4	2018/19
CFPB	Implement changes to streamline and soften the CFPB's CID process	CFPB	4	2018/19
CFPB	Promulgate regulation committing it to regularly review its rules	CFPB	4	2018/19
Mortgage	Modify Appendix Q of the ATR rule to streamline and simplify, especially for self-employed and non-traditional borrowers	CFPB	4	2019
Mortgage	Revise points and fees cap for QM loans	CFPB	4	2019
Mortgage	Clarify and modify TRID	CFPB	4	2019
Mortgage	Streamline and soften Loan Originator Compensation rule	CFPB	4	2019
Mortgage	Amend Reg AB II	SEC	4	2018 or later
Leveraged Lending	Re-issue the 2013 leveraged lending guidance for public comment	FRB, FDIC, OCC	4	2018
Small Business Lending	Consider alternatives to assessing concentration risk to allow banks engaged in CRE lending to maximize access to credit	FRB, FDIC, OCC	4	2018
Bank rules	Eliminate mid-year DFAST cycle and reduce number of supervisory scenarios	Congress, FRB, FDIC, OCC	3	2018
Bank rules	Limit the LCR to G-SIBs	FRB, FDIC, OCC	3	2018 or later
Bank rules	Limit single-counterparty credit limit rules to banks covered by new enhanced prudential standard limit	FRB with FSOC	3	2018 or later
Capital/Liquidity	No longer allow qualitative CCAR element to be the sole basis for Fed rejecting capital plans	FRB	3	2019 or later
Credit Unions	Allow credit unions to use supplemental credit (e.g., non-cum perpetual pref stock)	Congress, NCUA	3	2019
Long-Term Debt and TLAC	Recalibrate the international TLAC requirement	FRB	3	2019
Volcker Rule	Eliminate documentation requirements relating to specific assets/hedges	FRB, FDIC, OCC, SEC, CFTC	3	2018/19
CFPB	Make the CFPB Director removable at-will by the President or shift it to a multi-member commission	Congress	3	2018
Mortgage	Align the Qualified Mortgage definition with GSE eligibility requirements and phase-out the QM patch	CFPB	3	2019

Source: U.S. Treasury Department, Compass Point

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Segment	Recommendation	Responsibility	Likelihood*	Timing
Mortgage	Delay 2018 implementation of HMDA requirements	Congress, CFPB	3	2018
Mortgage	Clarify limited assignee liability for secondary market investors	CFPB	3	2018 or later
Mortgage	Review and improve the risk-weighting and stress-testing framework for securitized products	FRB, FDIC, OCC	3	2018 or later
Leveraged Lending	Allow banks to incorporate their own "robust" metrics rather than relying solely on the 6x leverage ratio	FRB, FDIC, OCC	3	2018
Small Business Lending	Consider altering the SLR for lines of credit to small and mid-sized businesses	FRB, FDIC, OCC	3	2018 or later
Duplicative Rules	FSOC authority to designate primary regulatory and amplify information sharing	Congress	2	2018 or later
Duplicative Rules	Bring Office of Financial Research under UST	Congress	2	2018 or later
Capital/Liquidity	Subject stress-testing and capital review to notice + comment process	FRB	2	2018 or later
Capital/Liquidity	End countercyclical capital buffer	FRB	2	2019 or later
Community Banks	Consider exempting community banks from the risk-based capital regime	Congress, FRB, FDIC, OCC	2	2017
Cost-Benefit Analysis	Recommends all agencies undertake cost-benefit analyses and include them in the final rule's administrative record	Federal financial regulatory agencies	2	2019
Living Wills	Make living will assessment frameworks and guidance subject to public notice and comment	FRB, FDIC	2	2019
Living Wills	Move living will oversight from the FDIC to the Federal Reserve	Congress, FRB	2	2018
FBOs	Base the application of enhanced prudential standards and living wills from FBOs on their domestic risk profiles	Congress, FRB	2	2019
IHCs	Raise the threshold for IHC compliance with the U.S. CCAR from $50B to the new threshold for enhanced prudential standards and recalibrate other requirements	FRB	2	2019
Volcker Rule	Exempt banks with assets >$10B from the Volcker Rule's proprietary trading prohibition if the firm is not subject to the market risk capital rule (trading assets >$1B or >10% of assets)	Congress	2	2018/19
Volcker Rule	Consider eliminating the purpose test from the Volcker Rule	Congress	2	2018/19
Volcker Rule	Allow banking entities and sponsored funds to share a name, with limitations	Congress	2	2018/19
Volcker Rule	Allow an exemption from the Volcker Rule's definition of "banking entity: for foreign funds owned/controlled by foreign affiliated of a U.S. bank or foreign banks with U.S. operations	Congress, FRB, FDIC, OCC, SEC, CFTC	2	2018/19
CFPB	Prohibit the CFPB from using its civil penalty fund for reasons other than remediation	Congress	2	2018
CFPB	Have the CFPB bring enforcement actions in federal district court rather than use administrative proceedings	CFPB	2	2018/19
Mortgage	Place a moratorium on additional mortgage servicing rules	CFPB, FRB, FDIC, OCC, CSBS	2	N/A
Mortgage	Repeal or revise the residential risk retention rule	Congress	2	2018
Mortgage	Enhance PLS investor protection	Congress	2	2018 or later
Mortgage	Evaluate the impact of liquidity rules on the PLS market	FRB, FDIC, OCC	2	2018 or later

Source: U.S. Treasury Department, Compass Point

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Segment	**Recommendation**	**Responsibility**	**Likelihood***	**Timing**
Small Business Lending	Repeal Section 1071 of the Dodd-Frank Act relating to small business lending data collection	Congress	2	2018 or later
Bank rules	Create "off-ramp" for well-capitalized banks	Congress	1	2018 or later
Volcker Rule	Consider an off-ramp from the Volcker Rule for highly-capitalized banks	Congress	1	2018/19
CFPB	Limit CFPB complaint database usage to federal and state agencies	Congress, CFPB	1	2018/19
CFPB	Repeal the CFPB's supervisory authority	Congress	1	2018/19

* 1 = Highly unlikely, 2 = Unlikely, 3 = Toss-Up, 4 = Likely, 5 = Highly Likely

Note: FRB = Federal Reserve Board; OCC = Office of the Comptroller of the Currency; FDIC = Federal Deposit Insurance Corporation; CSBS = Conference of State Banking Supervisors; CFPB = Consumer Financial Protection Bureau

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
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JEROME H. POWELL
MEMBER OF THE BOARD

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1. Before I dive into some of my larger economic policy questions, I do want to get you on the record regarding the bipartisan regulatory reform proposal which my colleagues and I introduced last week.

a. **A simple yes or no will do: Would anything in this bill hamper the Fed's ability to adequately monitor and regulate systemic risk of financial institutions?**
b. **Would anything in this bill increase the risk to the safety and soundness of the U.S. financial system?**

I am still familiarizing myself with the bill, and I understand that it is scheduled to be marked up this week and is still subject to change. Based on my review thus far, I believe that the bill preserves the Federal Reserve's ability to adequately monitor and regulate systemic risk of financial institutions as well as our ability to regulate firms for safety and soundness objectives. I certainly share the goal of tailoring regulation and supervision according to the size, complexity, and risk to the financial system posed by banks. An increase in the Dodd-Frank Wall Street Reform and Consumer Protection Act statutory thresholds combined with provisions that allow the Federal Reserve to apply enhanced prudential standards to firms below the new threshold, along the lines provided for in the bill under consideration, would help produce a supervisory and regulatory framework that is better tailored to the size, systemic footprint, and risk profile of banking firms.

2. One of the things that I think is critical for the Fed Chair to engage on is how policy choices will impact the larger economic picture. And one of the biggest policy choices confronting us today is what to do about trade. The answer to how we handle our trade relationships will have a huge impact on our economy and specifically will greatly impact North Dakota's economy, which is driven by commodity exports.

The Fed historically has been willing to engage on large macroeconomic policy issues such as trade. For example, in 2007, then Fed Chair Bernanke gave a speech entitled: "Embracing the Challenge of Free Trade: Competing and Prospering in a Global Economy"

a. **Do you agree with then former Fed Chair Bernanke's statement that "restricting trade by imposing tariffs, quotas, or other barriers is exactly the wrong thing to do"?**

The Federal Reserve is entrusted to achieve its congressionally mandated objectives of price stability and maximum sustainable employment. Matters of trade policy are the responsibility of the Congress and the Administration.

In general, trade and access to global markets provide many benefits for businesses and firms, including larger and deeper markets for their products and a wider selection of inputs for production. Consumers also benefit in terms of greater variety of goods and more competitive prices. Because of these and other benefits, more open and globalized economies generally have been faster growing, more productive, and more dynamic. However, the economic shifts brought on by trade have costs, and the loss of jobs in some industries or professions have been very painful for those affected. Policymakers and economists alike are increasingly cognizant of the need to design policies to support workers and families so that the benefits of globalization and trade can be more widely and evenly shared.

b. Do you share Mr. Bernanke's view that a response to the dislocations that may result from trade – such as a retreat into protectionism and isolationism - would be "self-defeating and, in the long run, probably not even feasible."

U.S. exporters have benefited from access to foreign markets. To the extent that we raise our barriers to foreign goods, we should expect to face increased barriers overseas. Such developments would harm U.S. firms through a number of channels. Not only would U.S. exporters face increased costs in selling their goods in foreign markets, but U.S. producers could have higher input costs and U.S. consumers would likely pay higher costs for some products as well. Overall, a decrease in the openness of trade is likely to reduce the competitiveness of U.S. producers.

c. Do you believe that the U.S. can achieve its targeted economic growth rate of 3-4% by adopting protectionist and isolationist trade policies?

I will not comment or speculate on individual policies. Overall effects would depend on the specifics of trade policies. In general, increased trade barriers should induce some U.S. firms and consumers to switch expenditures away from foreign goods and toward U.S. produced goods. However, this benefit may be offset by U.S. producers having to adapt to higher costs for intermediate inputs, and by households having to pay more for their purchases. In addition, there may be reduced demand for U.S. exports if other countries retaliate by imposing increased restrictions or tariffs on U.S. goods. Another consideration is that reduced trade and competition could lead to slower productivity growth in the U.S. economy.

3. As you're well aware, the Senate is preparing to vote on a massive tax package that the Joint Committee on Taxation and other independent experts expect to add at least $1.5 trillion to the national debt. By the time you respond to these questions, that tax bill could have already been voted on.

a. Would you recommend raising interest rates more quickly under a scenario where tax cuts marginally boost short term growth while increasing long term deficits?

The Federal Open Market Committee (FOMC) makes decisions about the stance of monetary policy so as to achieve the congressional mandate of maximum employment and price stability. Because monetary policy affects the economy only with some lag, the FOMC is focused on the outlook for the labor market and inflation. Fiscal policy affects this outlook, but is only one among many factors. Moreover, the effects of fiscal policy depend on the size and composition of a given fiscal package, and on its effects on aggregate demand versus supply.

b. How would an increase in deficits potentially impact the U.S. trade deficit? Could that foreseeably lead to off-shoring?

Generally speaking, stimulative fiscal policies tend to boost the exchange value of the dollar, which in turn would lead to higher imports into the U.S. and raise the cost of our exports to foreigners, thereby increasing the trade deficit. The net effect on manufacturing would depend on the magnitude of this effect relative to the boost to production from the stimulus to domestic demand associated with the tax cut. As of this writing, the final shape of what will be enacted is still uncertain. Even once that is known, it would likely be difficult or impossible to cleanly separate the effect of the tax package from other factors affecting the trade deficit.

c. Today we have the strongest labor market in a decade, a 4.4 percent unemployment rate, yet wages are rising barely faster than inflation - Do you believe corporate tax cuts can lead to higher wage growth? What evidence is there to support a direct relations hip between corporate rate reductions and higher wages?

While there is a consensus among economists that corporate tax reform can potentially induce greater business investment and boost economic output, productivity, and the demand for labor, there is no consensus on the magnitude of those effects nor the distribution of those benefits. In addition, a complete analysis would have to take into account other provisions in the tax package, as well as the method of financing the tax package. Assessing the net effects of all these changes is very challenging and subject to considerable uncertainty.

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- A simple yes or no will do: Would anything in this bill hamper the Fed's ability to adequately monitor and regulate systemic risk of financial institutions?

- Would anything in this bill increase the risk to the safety and soundness of the U.S. financial system?

One of the things that I think is critical for the Fed Chair to engage on is how policy choices will impact the larger economic picture. And one of the biggest policy choices confronting us today is what to do about trade. The answer to how we handle our trade relationships will have a huge impact on our economy and specifically will greatly impact North Dakota's economy, which is driven by commodity exports.

The Fed historically has been willing to engage on large macroeconomic policy issues such as trade. For example, in 2007, then Fed Chair Bernanke gave a speech entitled: "Embracing the Challenge of Free Trade: Competing and Prospering in a Global Economy"

- Do you agree with then former Fed Chair Bernanke's statement that "restricting trade by imposing tariffs, quotas, or other barriers is exactly the wrong thing to do"?

- Do you share Mr. Bernanke's view that a response to the dislocations that may result from trade – such as a retreat into protectionism and isolationism - would be "self-defeating and, in the long run, probably not even feasible."

- Do you believe that the U.S. can achieve its targeted economic growth rate of 3-4% by adopting protectionist and isolationist trade policies?

As you're well aware, the Senate is preparing to vote on a massive tax package that the Joint Committee on Taxation and other independent experts expect to add at least $1.5 trillion to the national debt. By the time you respond to these questions, that tax bill could have already been voted on.

- Would you recommend raising interest rates more quickly under a scenario where tax cuts marginally boost short term growth while increasing long term deficits?

- How would an increase in deficits potentially impact the U.S. trade deficit? Could that foreseeably lead to off-shoring?

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

- Today we have the strongest labor market in a decade, a 4.4 percent unemployment rate, yet wages are rising barely faster than inflation - Do you believe corporate tax cuts can lead to higher wage growth? What evidence is there to support a direct relations hip between corporate rate reductions and higher wages?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable Mark Warner
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the November 28, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on December 1, 2017.

<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Senator Warner:</u>

1. Growth in productivity is the ultimate driver of a higher standard of living for Americans. There has been considerable discussion in recent years about why productivity rates have been below historical trend levels. Some believe that we are not accurately measuring productivity, and that productivity is actually growing more than the rates we've seen over the last decade would suggest. Others believe that productivity has been weak because of a lack of business investment. We've seen an uptick in business investment recently, which is promising.

a. Are we accurately measuring productivity?

Productivity is notoriously difficult to measure. However, it has always been so, and research has not uncovered evidence that would support dismissing the substantial productivity slowdown as merely an artifact of mismeasurement. There have been astounding innovations in many fields in recent years, from energy to medicine, often underpinned by ongoing advances in information technology. These emerging technologies do augur well for productivity growth going forward. But as has happened in the past, such productivity gains may appear only slowly--perhaps over a very long timeframe--as new firms emerge to exploit new technologies and as incumbent firms invest in new vintages of capital and restructure their businesses.

b. Do you think that businesses until recently had little incentive to invest because of loose labor markets? In other words, because wage inflation has been weak, have businesses been able to increase output by bringing more workers into the workforce and not by increasing capital investment? Do you believe this trend has been shifting recently as the labor market tightens, attributing for the uptick in investment?

When businesses are making decisions about hiring new workers or purchasing new capital equipment, the relative cost of those two factors is an important consideration. However, even with the sluggish pace of wage gains in recent years, the ratio of wages to the marginal cost of investing in new capital has continued to rise at a fairly steady pace since the recession. In other words, firms continue to face incentives to substitute capital investment for hiring where they can. The pace of investment can vary considerably from quarter to quarter and even from year to year. One factor that probably has contributed to the relatively sluggish growth of investment during the current economic expansion is the slowdown in the growth of the labor force, which itself has importantly been driven by the aging of the population.

c. Projections show that U.S. government debt will continue to rise significantly over the coming years, even assuming a current policy baseline. Are you concerned that the resulting rise in government borrowing rates will crowd out private investment?

A large and growing federal government debt, relative to the size of the economy, over the coming decades would have negative effects on the economy. In particular, a rising federal debt burden would reduce national saving and put upward pressure on longer-term interest rates.

Those effects would restrain private investment, which, in turn, would tend to reduce productivity and overall economic growth.

d. Would incentives for companies to invest in improving their human capital, much like we incentivize businesses to improve their physical capital, could help encourage productivity gains?

As is the case for physical capital, improvements in the quality of the workforce tend to increase productivity. Thus, incentives for businesses to invest in the quality of their workforces would encourage productivity gains. Of course, it would be important for the Congress to weigh the costs and benefits of policy steps in this direction.

e. Does pressure on companies to meet short-term financial targets detracts from their ability to implement a long-term vision that may result in innovations that increase productivity?

Although the question of whether American business is overly focused on short-term financial targets has been a focus of concern for a very long time, the question still hasn't been clearly settled. One reason for this is that different measures give different answers. For instance, the share of capital spending in GDP is currently well below the level reached at similar points in the previous two business cycles. However, the share of R&D spending, perhaps a better measure of firms' willingness to focus on the future, is at an all-time high. Some research indicates that executives do feel pressure to meet key short-term metrics, such as earnings per share. On the other hand, shareholders play an important role in providing the market discipline that is necessary in a capitalist economy. Overall, the economics literature doesn't provide a clear answer, but given the importance of capital investment and good corporate stewardship to productivity, the recent wave of new research on this topic is a welcome development.

2. In Chair Yellen's testimony before the Banking Committee, she said that the "neutral rate" is low by historical standards, but that it should rise slowly over the next several years.

a. What is behind the current lower neutral federal funds rate target, and do you think these forces will abate, and if so, why?

It's important to be humble and admit that our understanding of the factors determining the neutral federal funds rate is limited. There are a few factors that we can point to. One is the aging of the population, which increases the supply of savings and reduces the demand for investment because the labor force is growing more slowly. This factor will almost certainly be with us for many years to come. Another is the slow pace of productivity growth in the aftermath of the recent recession. I am hopeful that in coming years we will see a pickup in the pace of productivity growth to historically more normal levels, but we need to watch the incoming data. Another factor that restrained the neutral rate for several years was weak economic performance in many foreign economies. This factor seems to be lifting, with solid synchronized growth across the major economies.

3. The FOMC has begun to normalize the Fed balance sheet. At the same time, the European Central Bank has signaled that its support of the European government bond market will decrease, and the Bank of Japan has also indicated it may begin to slow its asset purchases. And U.S. government deficit projections increase significantly over the coming years.

a. Will the resulting material drop in Fed demand for longer-dated Treasuries and agency debt, when combined with the increased U.S. government debt supply, significantly push up U.S. bond rates?

All else equal, reductions in demand for longer-term securities from major central banks and the potential for increases in debt supply stemming from wider fiscal deficits would be expected to put some upward pressure on longer-term yields. For example, some studies have suggested that the Federal Reserve's asset purchases may be depressing longer-term Treasury yields now by something on the order of 1 percentage point. This effect would be expected to gradually fade over time as the Federal Reserve normalizes the size of its balance sheet. Of course, longer-term yields may be affected by many other factors including the evolution of the outlook for economic activity and inflation, perceptions of economic and financial risks, and longer-term forces such as aging populations and slowing productivity growth. On balance, most forecasts have longer-term Treasury yields rising gradually over time but to a long-run level that is fairly low by historical standards. For example, in the economic projections prepared by the Congressional Budget Office earlier this year, the ten-year Treasury yield was projected to rise gradually over time to a long-run level of about 3-3/4 percent.

b. Have you been able to quantify how much you think long-end U.S. rates could move up as a result of these U.S. and global forces?

As noted above, the normalization of the stance of monetary policy and the size of the Federal Reserve's balance sheet would be expected to put some upward pressure on the level of long-term interest rates over time. Many other factors could affect longer-term yields as well. Most economic forecasts have longer-term Treasury yields rising gradually over time but to a long-run level that is relatively low by historical standards. For example, in the economic projections prepared by the Congressional Budget Office earlier this year, the ten-year Treasury yield was projected to rise gradually over time to a long-run level of about 3-3/4 percent.

c. As a result, do you think there could be a significant negative effect on U.S. mortgage rates and the housing recovery at a time when the housing sector still has room to grow compared to historic norms?

Mortgage rates are still low in historical terms, and are likely to remain low for some time, which will provide support for the housing market. In addition, higher household formation is creating a need for more housing than we are currently building, whether for rental or for ownership by occupants, and with job creation continuing at a solid pace, conditions are favorable for some further recovery in this sector.

4. Dodd-Frank Act supervisory stress testing is a forward-looking quantitative evaluation of the impact of stressful economic and financial market conditions on BHCs' capital. Under current law, banks with over $50 billion are subject to enhanced prudential standards.

a. Do you view stress tests as an essential part of the enhanced prudential standards?

Yes, stress tests are one of the core post-crisis regulatory reforms. They allow us to assess whether firms hold enough capital to withstand a severe stress while still being able to function and support lending to households and businesses. Unlike traditional capital requirements, stress tests provide a forward-looking assessment of losses banks may incur under adverse economic scenarios. In doing so, the stress tests help determine firms' capital needs when they will be needed most--in a serious economic downturn.

To maintain the efficacy of our stress testing regime, we have made regular improvements to them in response to feedback from banks and the public. These improvements--which have included tailoring our stress testing regime to be less burdensome for smaller institutions and most stringent for the largest, most systemically important firms--have helped our regulatory and supervisory program for the largest firms remain relevant and effective. Our guiding principle in modifying our stress testing regime is that any changes should enhance the resilience of the most systemically important U.S. firms in the most efficient and effective manner possible. We will continue to consider whether additional tailoring of our stress testing regime is merited in order to achieve that objective.

5. On October 21, 2016 – over one year ago – the Federal Reserve Board announced plans to enter negotiations with FINRA to potentially act as the collection agent of U.S. Treasury securities secondary market transactions data for trades done by banks. You stated at the time that, "(t)he collection of data would allow the U.S. official sector a more complete view of Treasury securities trading in the secondary market."

a. When will the Fed come out with a proposed rule to collect data on bank transactions in Treasuries?

The collection of data on secondary market transactions in Treasury securities was a major recommendation of the Interagency Working Group's Joint Staff Report on the market events of October 15, 2014, and is a key policy goal. The Financial Institution Regulatory Authority's (FINRA) collection of data from broker-dealer reporting of Treasury secondary market transactions on its Trade Reporting and Compliance Engine (TRACE), begun in July, is already providing valuable insights into the market, although the data collection is still in an early phase. As shown by the events of October 14, 2014, the overall objective of collecting Treasury market transactions data on a regular basis is a sound one; until recently, U.S. authorities have had far more information on equities and corporate bond trading than we do on trading in government bonds.

While depository institution trading activity currently appears to be a small proportion of overall activity in this market, collecting this information from depository institutions would allow a more complete analysis of the Treasury trading data and could help identify and address potential anomalies in the secondary market for Treasury securities. Allowing depository institutions to report through the FINRA TRACE system will save significant costs and resources. In addition, to properly monitor markets, the data collected under the Federal Reserve Board's (Board) authority would need to be combined with the broker-dealer data to be collected by FINRA, so direct reporting by the banks to FINRA seems to be the most efficient method.

Accordingly, over the past year, Federal Reserve Board staff have entered in negotiations with FINRA to act as the Board's collection agent for depository institution transactions data in secondary market transactions in Treasury securities. Under such an agreement, the collection of depository institution data by FINRA on the Board's behalf would mirror FINRA's data collection from broker-dealers to the closest extent possible. Certain details of a potential agreement are still being worked out, including issues such as information technology security, cost, access to the data, and agency confidentiality and use. Once the feasibility of a FINRA collection on behalf of the Board has been conclusively established, the Board would plan to request comment on a requirement for the reporting by banks. Among the issues that the Board would seek comment on is the specification of cutoff rules for a reporting requirement in order to avoid placing a burden on smaller banks that are unlikely to have significant transactions in this market. The Board is hopeful that negotiations with FINRA can be concluded soon and that a request for comment can be published in the near future.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Senator Mark Warner:

Growth in productivity is the ultimate driver of a higher standard of living for Americans. There has been considerable discussion in recent years about why productivity rates have been below historical trend levels. Some believe that we are not accurately measuring productivity, and that productivity is actually growing more than the rates we've seen over the last decade would suggest. Others believe that productivity has been weak because of a lack of business investment. We've seen an uptick in business investment recently, which is promising.

- Are we accurately measuring productivity?

- Do you think that businesses until recently had little incentive to invest because of loose labor markets? In other words, because wage inflation has been weak, have businesses been able to increase output by bringing more workers into the workforce and not by increasing capital investment? Do you believe this trend has been shifting recently as the labor market tightens, attributing for the uptick in investment?

- Projections show that U.S. government debt will continue to rise significantly over the coming years, even assuming a current policy baseline. Are you concerned that the resulting rise in government borrowing rates will crowd out private investment?

- Would incentives for companies to invest in improving their human capital, much like we incentivize businesses to improve their physical capital, could help encourage productivity gains?

- Does pressure on companies to meet short-term financial targets detracts from their ability to implement a long-term vision that may result in innovations that increase productivity?

In Chair Yellen's testimony before the Banking Committee, she said that the "neutral rate" is low by historical standards, but that it should rise slowly over the next several years.

- What is behind the current lower neutral federal funds rate target, and do you think these forces will abate, and if so, why?

The FOMC has begun to normalize the Fed balance sheet. At the same time, the European Central Bank has signaled that its support of the European government bond market will decrease, and the Bank of Japan has also indicated it may begin to slow its asset purchases. And U.S. government deficit projections increase significantly over the coming years.

- Will the resulting material drop in Fed demand for longer-dated Treasuries and agency debt, when combined with the increased U.S. government debt supply, significantly push up U.S. bond rates?

- Have you been able to quantify how much you think long-end U.S. rates could move up as a result of these U.S. and global forces?

- As a result, do you think there could be a significant negative effect on U.S. mortgage rates and the housing recovery at a time when the housing sector still has room to grow compared to historic norms?

Dodd-Frank Act supervisory stress testing is a forward-looking quantitative evaluation of the impact of stressful economic and financial market conditions on BHCs' capital. Under current law, banks with over $50 billion are subject to enhanced prudential standards.

- Do you view stress tests as an essential part of the enhanced prudential standards?

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable Patrick Toomey
United Stated Senate
Washington, D.C. 20510

Dear Senator:

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Please let me know if I may be of further assistance.

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Enclosure

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<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Senator Toomey:</u>

1. The Dodd-Frank Act instructed the Fed to develop enhanced prudential standards for bank holding companies (BHCs) with more than $50B in total consolidated assets. That number was far too low and the hard cutoff was very problematic. There is no reason to consider a bank that grows from $49B to $50B as suddenly a threat to financial stability.

I applaud Chairman Crapo and the bipartisan group of Banking Committee members who have agreed to increase the threshold. However, I remain concerned that a $250B threshold suffers from the same weakness as the $50B threshold. That is, a bank's systemic risk profile does not suddenly change when it grows from $249B to $250B in assets.

In fact the Dodd-Frank Act makes very clear that enhanced prudential standards should still be tailored in their application. It states that the Board may "differentiate among companies… taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors…"

a. **Will you use your authority under Dodd-Frank to right size regulation for all regulated institutions – from community banks to midsize, regional, and even the largest banks?**

The Federal Reserve has been working for many years to make sure that our regulation and supervision is tailored to the size, systemic footprint, and risk profile of individual institutions. I believe that it is not only appropriate to recognize the different levels of risk and types of risk that different institutions in the system pose, but that it also makes for better and more efficient regulation. Efficient regulation allows the financial system to more efficiently support the real economy. If I were to be confirmed, I would be committed to the Federal Reserve continuing to tailor its supervisory and regulatory framework to the size, systemic footprint, and risk profile of the different classes of banking firms in our economy.

The failure or distress of a large bank can harm the U.S. economy. The recent financial crisis demonstrated that excessive risk-taking at large banks makes the U.S. economy vulnerable. The crisis led to a deep recession and the loss of nearly nine million jobs. Our regulatory framework must reduce the risk that bank failures or distress will have such a harmful impact on economic growth in the future. As we do so, effective and efficient regulation should take into account the risk of the institution.

While the Federal Reserve Board (Board) currently has some authority to tailor the enhanced prudential standards included in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Board generally cannot eliminate the application of these standards to covered firms. In particular, Congress required that certain enhanced prudential standards must apply to firms with $10 billion or more in total assets, with other standards beginning to apply at $50 billion in total assets. I am aware that Congress is currently considering whether and how to raise existing statutory thresholds in the Dodd-Frank Act, and I have expressed support for increasing these thresholds. I also understand that

Congress is considering an alternative to simply raising the thresholds that would entail the use of a more complex, multi-factor approach to decide which firms are subject to enhanced prudential standards. If I were to be confirmed, I would stand ready to continue working with Members on this issue.

It is important to note that the Federal Reserve already tailors its regulation and supervision of firms above $250 billion. For example, firms with more than $250 billion in total assets that are not considered to be global systemically important banks (GSIBs) are not subject to risk-based capital surcharges, the enhanced supplementary leverage ratio, or total loss-absorbing capacity and long-term debt requirements to facilitate orderly resolution. I fully expect that we would continue to tailor the application of regulations for such firms if Congress were to raise the threshold. We are looking at ways we might better tailor liquidity regulations, for example, to maintain resilience with greater efficiency.

2. Interest on excess reserves has become a key tool of monetary policy for the Fed. In Chairwoman Yellen's words, "Paying interest on reserve balances enables the Fed to break the strong link between the quantity of reserves and the level of the federal funds rate and, in turn, allows the Federal Reserve to control short-term interest rates when reserves are plentiful."

a. Do you expect interest on excess reserves to remain a key tool in implementing monetary policy, or would you like to return the pre-crisis monetary policy toolkit?

The payment of interest on excess reserves contributes to effective implementation of monetary policy by helping to manage the level of the federal funds rate and other short-term interest rates. Most major central banks have the authority to pay interest on excess reserves and have used this authority to help manage the level of short-term interest rates. In the current circumstances, interest on excess reserves is essential to the Board's ability to manage the level of short-term interest rates even with a very elevated level of reserve balances in the system.

The Federal Reserve's authority to pay interest on reserves is an important tool to reduce the burdens on banks associated with reserve requirements and to manage the level of short-term interest rates, both in normal times and during periods of financial stress. Even if the Federal Reserve ultimately returned to an operating system very similar to that in place prior to the crisis, the ability to pay interest on reserves would enhance the effectiveness of monetary policy implementation.

b. Do you see any risks associated with breaking the strong link between the quantity of reserves and the level of the federal funds rate?

The payment of interest on reserves provides flexibility for the Federal Reserve to implement monetary policy in a variety of settings. In the current circumstances, the level of reserves in the banking system is very large as a result of the large scale asset purchase programs conducted by the Federal Reserve to support economic recovery and stem disinflationary pressures in the aftermath of the crisis. In this environment, even sizable changes in the quantity of reserves do not affect the level of interest rates, and the ability to pay interest on reserves is the essential tool that allows the Federal Reserve to implement monetary policy effectively.

The Federal Open Market Committee (FOMC) has initiated its program for normalizing the size of the Federal Reserve's balance sheet and has noted that it expects the long-run level of reserves in the banking system will be significantly smaller than at present. In the longer-run, the FOMC could choose to continue to operate in a so-called "floor system" in which policy implementation is implemented primarily through changes in the interest rate on reserves. Alternatively, the FOMC could return to a "corridor system" with a much smaller quantity of reserves in the banking system than at present. In that type of system, the Federal Reserve would again manage the level of short-term interest rates through frequent open market operations aimed at fine-tuning the quantity of reserves in the banking system. Even in this framework, interest on reserves would be a useful tool to help keep the federal funds rate close to the target established by the FOMC. Either type of operating system would allow the FOMC to conduct monetary policy effectively to promote its long run goals of maximum employment and stable prices.

3. In 2008, Chairwoman Yellen, then the President of the Federal Reserve Bank of San Francisco, stated: "As Japan found during its quantitative easing program, increasing the size of the monetary base above levels needed to provide ample liquidity to the banking system has no discernible economic effects aside from those associated with communicating the Bank of Japan's commitment to the zero interest rate policy."

a. Do you agree with Chairwoman Yellen's 2008 assessment that increasing the size of the monetary base above levels needed to provide ample liquidity has no discernible economic effects?

In my view, it is not the increase in the monetary base, or alternatively in banks' reserves at the central bank, per se that has beneficial effects for the economy. Those effects are mostly determined by what types of assets the central bank acquires with the reserves it creates. In the case of our asset purchases, these were long-maturity Treasury securities and agency mortgage-backed securities. These purchases put downward pressure on longer-term interest rates and helped to make overall financial conditions more accommodative. These changes in financial conditions, in turn, helped to foster economic recovery and stem disinflationary pressures in the aftermath of the crisis.

b. Even with multiple rounds of quantitative easing, inflation has consistently been below the Fed's target. Why do you think that is the case?

While it is true that inflation has generally fallen short of the Committee's 2 percent objective over the past several years, that shortfall has for the most part been explicable by economic conditions, with good reason to view it as temporary. During the early years of the recovery from the Great Recession, inflation was held down by slack in resource utilization. Later on, in 2015 and into 2016, inflation was held down by a sharp rise in the dollar, falling import prices, and falling energy prices. More recently, the softness in inflation seems to have been exaggerated by what look like one-off reductions in some categories of prices, including, for example, a large decline in quality-adjusted prices for wireless telephone services. These factors appear to be largely behind us.

Given the ongoing strengthening in labor markets, and with measures of longer-term inflation expectations broadly stable, I expect inflation to move higher next year. Most of my colleagues on the FOMC agree with this assessment. In the September Summary of Economic Projections, the median forecast anticipated personal consumption expenditure price inflation moving back to 2 percent by 2019. However, monetary policy will adjust in response to incoming news, and we will be closely monitoring inflation developments to see whether this outlook is validated in the time ahead.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

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I applaud Chairman Crapo and the bipartisan group of Banking Committee members who have agreed to increase the threshold. However, I remain concerned that a \$250B threshold suffers from the same weakness as the \$50B threshold. That is, a bank's systemic risk profile does not suddenly change when it grows from \$249B to \$250B in assets.

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- Will you use your authority under Dodd-Frank to right size regulation for all regulated institutions – from community banks to midsize, regional, and even the largest banks?

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- Do you expect interest on excess reserves to remain a key tool in implementing monetary policy, or would you like to return the pre-crisis monetary policy toolkit?

- Do you see any risks associated with breaking the strong link between the quantity of reserves and the level of the federal funds rate?

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- Do you agree with Chairwoman Yellen's 2008 assessment that increasing the size of the monetary base above levels needed to provide ample liquidity has no discernible economic effects?

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

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MEMBER OF THE BOARD

December 4, 2017

The Honorable Robert Menendez
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<u>Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States from Senator Menendez:</u>

1. With rising levels of household debt, widening inequality, and the neutral interest rate at historically low levels, it's critical that the Federal Reserve have the ability to respond in the event of another economic decline.

a. What signs so you see of inflation coming close to the Fed's 2 percent target, let alone exceeding it by dangerous amounts?

While inflation has generally fallen short of the Federal Open Market Committee's (FOMC) 2 percent objective over the past several years, that shortfall has for the most part been explicable by economic conditions, with good reason to view it as temporary. During the early years of the recovery from the Great Recession, inflation was held down by slack in resource utilization. Later, in 2015 and into 2016, inflation was held down by a sharp rise in the dollar, falling import prices, and falling energy prices. More recently, the softness in inflation seems to have been exaggerated by what look like one-off reductions in some categories of prices, including, for example, a large decline in quality-adjusted prices for wireless telephone services. These factors appear to be largely behind us.

Given the ongoing strengthening in labor markets, and with measures of longer-term inflation expectations broadly stable, I expect inflation to move higher next year. Most of my colleagues on the FOMC agree with this assessment. In the September Summary of Economic Projections, the median forecast anticipated personal consumption expenditures (PCE) price inflation moving back to 2 percent by 2019. However, monetary policy will adjust in response to incoming news, and we will be closely monitoring inflation developments to see whether this outlook is validated by incoming data.

b. What would be the cost to the economy of slightly overshooting inflation versus the cost to the economy of choking off growth if the Fed were to continue tightening without a clear indication that inflation is reaching or exceeding its target?

The FOMC has said that the 2 percent PCE inflation objective is symmetrical, in the sense that the Committee would be concerned about inflation running persistently above or below 2 percent. For a number of years after the end of the Global Financial Crisis, the economy was far from reaching either 2 percent inflation or full employment, which called for accommodative monetary policy. With unemployment at 4.1 percent and some other indicators suggesting that we are near full employment, the Committee has been gradually returning monetary policy settings to more normal levels. Since monetary policy works with a lag, the Committee acts based on forecasts of the path of inflation and employment. As shown in the September 2017 Summary of Economic Projections, most members of the Committee forecast that inflation will return to the 2 percent objective over the next two years. Although a temporary, slight overshooting of the inflation target might not be a serious problem, it would be possible for this process to run too far, and for the FOMC to get behind the curve in preventing a serious overheating of the economy. In particular, waiting too long to tighten monetary policy could require the FOMC to eventually raise interest rates rapidly, which could risk disrupting financial markets and pushing the economy into a recession. That is why we have been on a path of gradually adjusting the stance of policy to promote the longevity of the expansion. Of course, monetary policy is not on a preset course: We will continue to respond to incoming information about the tightness of the labor market and the pace of inflation, and will adjust our policy accordingly.

2. Compensation practices at large financial firms prior to the crisis incentivized excessive risk-taking and created a business environment with no guard rails where banks played fast and loose with the savings and investments of hard-working families. Ultimately those same families paid the cost when the crisis hit and they lost their homes to foreclosure and saw their savings wiped away in the blink of an eye. In response, we passed a law requiring the financial regulators to prohibit payment practices that encourage inappropriate risk-taking at the largest banks. In a January 2015 speech you gave at the Brookings Institution, you noted that the Federal Reserve Board strongly encouraged reforms to compensation practices at large banks and financial institutions—reforms which you said would be "codified and strengthened" by pending rulemakings.

a. **Understanding that it is a joint rulemaking requiring input from other agencies, will you commit to doing everything in your power to finalize the Section 956 incentive-based compensation rulemaking?**

Incentive compensation is an important tool to attract qualified employees and executives to financial institutions. It also is important that compensation programs at banking firms provide incentives for employees to act in the long-term interest of the firm. The supervision of incentive compensation can play a role in helping safeguard financial institutions against practices that threaten safety and soundness or could lead to material financial loss. In particular, supervision can help address incentive compensation practices that encourage inappropriate risk-taking at an institution, which may also have effects on other institutions or the broader economy.

The federal banking agencies, Federal Housing Finance Agency, the Securities and Exchange Commission, and National Credit Union Administration published a proposed incentive compensation rule in response to the requirements of section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in June 2016. The agencies received over 150 comment letters on the proposal. If confirmed, I will support Vice Chairman Quarles' work with Federal Reserve staff and the other five federal agencies to consider the comments received on the 2016 proposed rule. In addition, I support efforts to continue to evaluate incentive compensation practices at banking firms as a part of ongoing supervision.

3. Governor Powell, expanding diversity at the Federal Reserve, at other financial regulatory agencies, and in the financial services industry is essential—the quest for diversity is an issue of fairness, opportunity, and it is a realization by all that our economic strength is tied to our inclusivity. I worked to include a provision in the Wall Street Reform Act to establish Offices of Minority and Women Inclusion at the federal financial regulators, including at the Fed. Both in the financial industry and the federal government, I firmly believe institutions are stronger when they are built on a foundation

of more diverse backgrounds and viewpoints. In order to be successful, diversity efforts absolutely require commitment and attention from top leadership, and full integration into human resources, contracting, and other relevant processes.

a. **How do you plan to enhance diversity and inclusion, and can I have your commitment to make it a priority to improve diversity both at the Fed and among regulated institutions?**

Diversity is a critical aspect of all successful organizations, and I am committed to fostering diversity and inclusion throughout the Federal Reserve System. In my experience, we make better decisions when we have a wide range of backgrounds and voices around the table.

The Federal Reserve recognizes the value of a diverse workforce at all levels of the organization. We are committed to achieving further progress, and to better understanding the challenges to improving and promoting diversity of ideas and backgrounds. This has been an ongoing objective, and, if confirmed, I assure you that diversity will remain a high priority objective for the Federal Reserve.

As Administrative Governor and Chair of the Committee on Board Affairs, I have supported and encouraged the Federal Reserve Board's (Board) efforts to enhance diversity. In my role as Chair of the Board Committee on Federal Reserve Bank Affairs, I have worked with the Reserve Banks to promote diversity throughout the System. Recognizing the value of diversity at all levels of the System, including at the highest levels, I have worked work closely with the Reserve Banks to assure that they have a diverse slate of qualified candidates for president searches. The Reserve Banks, working closely with the Board, have also been looking at ways to further develop a diverse pool of talent in a thoughtful, strategic fashion, readying them for leadership roles throughout the Federal Reserve System.

To foster diversity more broadly, a long-term holistic plan is necessary with a focus on doing the utmost to recruit and bring people in and provide them paths for success. That means having an overall culture and organization that is focused on diversity and demonstrates its ongoing commitment at all levels, starting at the top. For example, we have an internal work stream at the Board to coordinate economic inclusion and diversity efforts that is comprised of the Office of Minority and Women Inclusion Director, Division Directors, senior staff and Board Members. It focuses on initiatives not just at the Board but also more broadly throughout the System. I am part of this team, as are other Board members, and we meet regularly to discuss initiatives and progress.

As you know, section 342 of the Dodd-Frank Act charged the Board with developing standards for equal employment opportunity and the racial, ethnic, and gender diversity in our workforce and senior management, as well as for increased participation of minority-owned and women-owned businesses in programs and contracts. With regard to contracting, the Federal Reserve has utilized national and local organizations advocating for minority companies as a method to connect directly with qualified companies and we participate in numerous outreach events that provide a platform for Federal Reserve staff to discuss the procurement process with potential vendors while also providing information on future procurement opportunities.

I believe it is important to continue to build on these efforts. Continued collaboration with advocacy groups will help the Federal Reserve better understand the challenges minority businesses face as well as help the firms better navigate the Federal Reserve's acquisition process.

The Federal Reserve also was required to develop standards for assessing the diversity policies and practices of the entities we regulate. The standards provide a framework for regulated institutions to assess and establish or strengthen their diversity policies and practices, and are intended to promote transparency and awareness of diversity policies and practices within the institutions. The Federal Reserve has encouraged and continues to strongly encourage the institutions we regulate to provide their policies, practices, and self-assessment information and to maximize transparency, to disclose on their websites their diversity policies and practices, and to share information related to their self-assessments.

4. As you may know, the National Oceanic and Atmospheric Administration's National Centers for Environmental Information tracks U.S. weather and climate events that have significant economic impacts, specifically those disasters or events where the overall damage costs reach or exceed $1 billion dollars. From 1980-2016, the annual average number of billion-dollar plus events was 5.5, but for the most recent 5 years (2012-2016), the annual average nearly doubled to 10.6 events exceeding $1 billion in damages, including Superstorm Sandy which caused $65 billion in damages. In 2017, we've already seen 15 weather and climate events exceeding $1 billion. Obviously, local economies impacted by these storms see both short- and longer-term impacts including destruction of capital, labor market shifts, and reconstruction efforts. As we see the number of these storms increase I think it is critical that we understand the economic impacts and potential risks.

a. **In your view, does the increasing frequency of economically significant natural disasters and climate-related events pose a potential risk to the long-term economic outlook and to the nation's financial stability?**
b. **Do you believe that it is in the economic interest of the United States to take steps to mitigate the worst impacts of climate change?**

The potential implication of climate change for the U.S economy is an important issue that warrants further study. However, this issue is well outside of the remit of the Federal Reserve System, and I will leave it to others to decide how best to address that issue. That said, the implications of climate change and its effects on the economy are likely to be more relevant for various aspects of fiscal policy and the longer-run growth trend of the economy than they are for the short-term evolution of the business cycle.

5. In January, the Minneapolis Federal Reserve published a report estimating that if the Federal Open Market Committee had been required to follow the Taylor Rule for the last five years, 2.5 million more Americans would be out of work today.

a. **Do you accept the analysis that suggests strictly following the Taylor Rule would undermine the Federal Reserve's ability to achieve its full employment mandate?**

John Taylor's well-known 1993 rule, and the many variants on that rule sparked by his research, represent an important contribution to the vast literature concerning the conduct of monetary policy. That said, the 1993 rule called for raising the federal funds rate above its effective lower bound in 2012--a year when the unemployment rate averaged more than 8 percent. The rule calls for a funds rate about 100 basis points higher than today's rate. A range of models of the economy suggest that these significantly higher rates would have led to slower progress in reducing unemployment.

6. In a recent speech, FDIC Chair Gruenberg said that improved cushions of capital and liquidity at large U.S. banking organizations are not a source of competitive weakness relative to banks in other jurisdictions, rather they are a competitive strength.

a. Do you agree with the view that because of post-crisis capital, stress testing, liquidity, and resolvability reforms, our financial institutions are better positioned to play a stabilizing role in the next downturn rather than contributing to deeper economic contraction?

Our financial system is stronger and more resilient than it was a decade ago, in large part as a result of stronger levels of high quality capital and liquidity in the system. Stronger risk-based capital and liquidity regulations, together with our stress testing program, help ensure that large U.S. banks are better positioned to continue lending through periods of economic stress and market turbulence.

Although U.S. banks are subject to high regulatory capital and liquidity standards, U.S. banks have been successful competitors in the global financial markets in recent years. Internationally active U.S. banks are meaningfully more profitable than their largest foreign bank peers and have much higher price-to-book ratios and returns on equity. U.S. banking organizations have also been able to expand lending while maintaining high capital and liquidity buffers required by the Federal Reserve.

U.S. banking organizations have also taken important steps in recent years to improve their resolvability, including meaningful adjustments to their structure, operations and internal allocation of loss absorbing capacity and liquidity resources. These changes help reduce the potential impact of a large banking organization's failure on U.S. financial stability.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Senator Robert Menendez:

With rising levels of household debt, widening inequality, and the neutral interest rate at historically low levels, it's critical that the Federal Reserve have the ability to respond in the event of another economic decline.

- What signs so you see of inflation coming close to the Fed's 2 percent target, let alone exceeding it by dangerous amounts?

- What would be the cost to the economy of slightly overshooting inflation versus the cost to the economy of choking off growth if the Fed were to continue tightening without a clear indication that inflation is reaching or exceeding its target?

Compensation practices at large financial firms prior to the crisis incentivized excessive risk-taking and created a business environment with no guard rails where banks played fast and loose with the savings and investments of hard-working families. Ultimately those same families paid the cost when the crisis hit and they lost their homes to foreclosure and saw their savings wiped away in the blink of an eye. In response, we passed a law requiring the financial regulators to prohibit payment practices that encourage inappropriate risk-taking at the largest banks. In a January 2015 speech you gave at the Brookings Institution, you noted that the Federal Reserve Board strongly encouraged reforms to compensation practices at large banks and financial institutions—reforms which you said would be "codified and strengthened" by pending rulemakings.

- Understanding that it is a joint rulemaking requiring input from other agencies, will you commit to doing everything in your power to finalize the Section 956 incentive-based compensation rulemaking?

Governor Powell, expanding diversity at the Federal Reserve, at other financial regulatory agencies, and in the financial services industry is essential—the quest for diversity is an issue of fairness, opportunity, and it is a realization by all that our economic strength is tied to our inclusivity. I worked to include a provision in the Wall Street Reform Act to establish Offices of Minority and Women Inclusion at the federal financial regulators, including at the Fed. Both in the financial industry and the federal government, I firmly believe institutions are stronger when they are built on a foundation of more diverse backgrounds and viewpoints. In order to be successful, diversity efforts absolutely require commitment and attention from top leadership, and full integration into human resources, contracting, and other relevant processes.

- How do you plan to enhance diversity and inclusion, and can I have your commitment to make it a priority to improve diversity both at the Fed and among regulated institutions?

As you may know, the National Oceanic and Atmospheric Administration's National Centers for Environmental Information tracks U.S. weather and climate events that have significant economic impacts, specifically those disasters or events where the overall damage costs reach or exceed $1 billion dollars. From 1980-2016, the annual average number of billion-dollar plus events was 5.5, but for the most recent 5 years (2012-2016), the annual average nearly doubled to 10.6 events exceeding $1 billion in damages, including Superstorm Sandy which caused $65 billion in damages. In 2017, we've already seen 15 weather and climate events exceeding $1 billion. Obviously, local economies impacted by these storms see both short- and longer-term impacts including destruction of capital, labor market shifts, and reconstruction efforts. As we see the number of these storms increase I think it is critical that we understand the economic impacts and potential risks.

- In your view, does the increasing frequency of economically significant natural disasters and climate-related events pose a potential risk to the long-term economic outlook and to the nation's financial stability?

- Do you believe that it is in the economic interest of the United States to take steps to mitigate the worst impacts of climate change?

In January, the Minneapolis Federal Reserve published a report estimating that if the Federal Open Market Committee had been required to follow the Taylor Rule for the last five years, 2.5 million more Americans would be out of work today.

- Do you accept the analysis that suggests strictly following the Taylor Rule would undermine the Federal Reserve's ability to achieve its full employment mandate?

In a recent speech, FDIC Chair Gruenberg said that improved cushions of capital and liquidity at large U.S. banking organizations are not a source of competitive weakness relative to banks in other jurisdictions, rather they are a competitive strength.

- Do you agree with the view that because of post-crisis capital, stress testing, liquidity, and resolvability reforms, our financial institutions are better positioned to play a stabilizing role in the next downturn rather than contributing to deeper economic contraction?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 4, 2017

The Honorable Sherrod Brown
United Stated Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the November 28, 2017,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on December 1, 2017.

Questions for The Honorable Jerome H. Powell, Chairman-Designate, Board of Governors of the Federal Reserve System from Ranking Member Brown:

1. Secretary Mnuchin said that the Trump Administration could accomplish 80 percent of the bank deregulation listed in Treasury's June report without any help from Congress.[1] Before this Committee in June, you called the Treasury report on bank deregulation, a "mixed bag."

a. **If you are confirmed, what will you do to oppose the recommendations you believe would be harmful to financial stability, consumers, and safety and soundness?**
b. **Randy Quarles is now in the role as Vice Chair for Supervision at the Federal Reserve. If you are confirmed as Chair, how do you see your role in relation to the Vice Chair of Supervision's when it comes to regulatory policy?**

The Treasury report acknowledged that regulatory policies since the financial crisis have improved the safety and soundness of the financial system, and it noted that the U.S. banking system is significantly better capitalized as a result of post-crisis regulatory capital requirements and stress testing. The report also made a series of recommendations for the U.S. regulatory agencies to consider in order to reduce regulatory burden on the banking system.

The Federal Reserve is committed to continuing to evaluate the effects of regulation on financial stability and on the broader economy, and to make adjustments as appropriate. As we do that, however, I would reiterate that we should preserve the core pillars of regulatory reform that I discussed in my testimony before the Senate Committee on Banking, Housing, and Urban Affairs on June 22, 2017--capital, liquidity, stress testing, and resolvability. Moreover, I believe that we should continue to tailor our rules to the different risks of different firms and, in particular, work to reduce unnecessary burden on community banks.

As for my role as Federal Reserve Board (Board) Chair vis-à-vis the Vice Chairman for Supervision, if I were to be confirmed, I expect that the Vice Chairman will be the Board's primary point person on regulatory and supervisory matters and will lead the committee that is responsible for formulating recommendations to the Board on such matters. Decisions about regulations and material supervisory policies are made by all of our Board members, however, rather than by any one person.

2. In a 2015 Bloomberg Television interview, Randy Quarles said the following about Dodd-Frank, "The macro issue is that the government should not be a player in the financial sector. It should be a referee. And the practice, and the policy, and the legislation that resulted from the financial crisis tended to make the government a player. They put it on the field as opposed to simply reffing the game."

[1] https://www.reuters.com/article/us-usa-banks-regulation/u-s-treasury-unveils-financial-reforms-critics-attack-idUSKBN1932KQ.

a. **While we can all agree that the federal government should be a referee when it comes to supervision, do you agree with Governor Quarles' view on the role of the government in the financial sector following the crisis?**

In response to questions for the record on this topic, Vice Chairman Quarles stated, "My approach to policy making, and particularly to regulation, has been that the discretion of policy makers, and particularly of regulators, should be as constrained as possible. Where discretion remains, regulators should be as clear as possible about how they will exercise it in the future so that their actions are predictable and there is less uncertainty as to what the policy will be." I share that general approach to regulatory and supervisory policy making.

b. **In your confirmation hearing, you noted that you and Vice Chair Randal Quarles are "very well aligned on [your] approach to supervision." Are there any areas on bank supervision policy where you and Vice Chair Quarles disagree?**

I am pleased that Vice Chairman Quarles is now leading our efforts in this area and will not only be building on the work underway, but will be bringing a fresh perspective to many issues. I believe that we share the foundational objectives to post-crisis regulatory reform-- preserving the core measures of capital, stress testing, liquidity, and resolvability. Vice Chairman Quarles will bring his perspective on how to best achieve those objectives. We both agree that we need a resilient, well-capitalized, well-regulated financial system that is strong enough to withstand even severe shocks and support economic growth by lending through the economic cycle.

The financial crisis was devastating--the worst economic downturn since the Great Depression. The work that has been underway at the Board to calibrate regulation and supervision aims to achieve and build on the strength and systemic resilience that we currently enjoy with greater efficiency. If confirmed for this position, I look forward to working with all my colleagues on the Board, who bring a diversity of viewpoints to these very important issues.

3. Vice Chair Quarles in his maiden speech at the Federal Reserve earlier this month said that, "changing the tenor of supervision will probably actually be the biggest part of what it is that I can do."[2] He said this to note that near-term changes in banking rules would be difficult, but that day-to-day changes in regulators' tone was more immediately achievable.[3]

a. **Do you agree that Federal Reserve supervisors need to change their "tenor?" If so, please elaborate on what this means.**

I feel strongly that, as public servants, we can best fulfill our mission by being transparent in our processes and open to a range of perspectives. An open dialogue between supervisors and supervised firms can foster safety and soundness because both parties can be more willing to

[2] https://www.wsj.com/articles/feds-quarles-changes-to-bank-stress-tests-on-front-burner-1510080513.

[3] Ibid.

discuss difficult but important issues that need to be addressed. I believe that conducting supervision in a mutually respectful way best furthers our goal of ensuring the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency.

4. At the time Countrywide was teetering and was bought by Bank of America, it had $211 billion in assets and originated around one in five mortgages in the country.

   a. In hindsight, would it have been useful for a large lender like Countrywide to have been subject to enhanced capital or liquidity standards, stress tests, or to have prepared a living will?

Banking organizations of all sizes have benefited from the stronger regulatory standards that were implemented after the financial crisis. Prior to the crisis, many large banking firms operated with excessive leverage, inadequate and low-quality capital, and insufficient liquidity, and did not have effective systems to identify and manage their risks. Banks generally viewed mortgages as a relatively low-risk asset and did not consider the possibility of a nationwide decline in house prices. A change in that view would have led to wider recognition of Countrywide's and the industry's needs for additional capital and liquidity as well as greater ability to foresee and manage their risks.

Following the financial crisis, the Federal Reserve overhauled its regulatory and supervisory regime to focus on improving the resiliency of large banking organizations, as well as to reduce the risks to the system in the event that these firms experienced distress or failure. Under the Federal Reserve's current regulatory and supervisory regime, large financial institutions are expected to maintain capital planning and liquidity risk management processes to determine the amount of capital and liquidity needed to continue operations through a range of conditions. Stress tests are an important element of this regime. Large financial institutions are also required to conduct recovery and resolution planning. And as I have said publicly, we also recognize the need to further tailor regulation to the size and risk profile of institutions.

Congress principally addressed the Countrywide problem in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) by eliminating the Office of Thrift Supervision and reassigning supervisory and regulatory authority over thrifts to the Office of the Comptroller of the Currency, and supervisory and regulatory authority over thrift holding companies to the Federal Reserve.

5. Legislation this Committee will soon consider quintuples the threshold at which enhanced financial stability rules apply to banks.

   a. If confirmed, will you commit to not raising it further using the Federal Reserve's existing authority upon a recommendation from the FSOC?

I have supported raising the $50 billion asset threshold for application of enhanced prudential standards. An increase in the Dodd-Frank Act statutory thresholds, while also providing flexibility for the Federal Reserve to apply such standards to firms between $100 billion and $250 billion in total assets, along the lines provided for in the bill under consideration by the Senate Committee on Banking, Housing, and Urban Affairs, would help produce a supervisory and regulatory framework that is better tailored to the size, systemic footprint, and risk profile of banking firms. Passage of legislation to raise the threshold would make it less likely that the Financial Stability Oversight Council (FSOC) would take up such a recommendation.

6. Legislation this Committee will soon consider would deregulate banks with up to $250 billion in assets from financial stability rules.

a. Would you believe that every bank up to $250 billion in assets – if it failed – no longer needs a living will?

Resolution planning has been helpful for gaining a greater understanding of resolution options for large banking organizations, particularly for banking firms with significant nonbank operations, critical operations, or cross-border operations. Resolution planning requirements should also be tailored to the size and complexity of the firm, with the most complex firms subject to the highest standards. Smaller and less complex firms likely do not need the same frequency of, and detail in, their living wills as larger and more complex firms, because their plans for resolution are less susceptible to becoming obsolete due to changes in their businesses and business models. In addition, as demonstrated in the financial crisis, complex and cross-border operations may complicate a firm's resolution, posing risk to the financial system more broadly.

b. Are you confident that each of these banks could be resolved through bankruptcy, without any taxpayer support?

The bankruptcy of a banking organization with less than $250 billion in assets would present significantly less potential risk to U.S. financial stability than the failure of the largest, most interconnected banking organizations. Therefore, the Board has tailored its efforts to focus on improving the resolvability of the largest, most interconnected banking organizations, which generally have more than $250 billion in consolidated assets. For example, the Board's resolution-related rules requiring minimum total loss-absorbing capacity and stays of early termination rights in qualified financial contracts apply only to global systemically important banking organizations (GSIBs). Through the resolution planning process, the Board and the Federal Deposit Insurance Corporation (FDIC) have also provided substantially more extensive direction to the U.S. GSIBs and certain non-U.S. GSIBs to improve their resolvability than to their smaller and less complex counterparts.

7. At your confirmation hearing when asked if we "still have banks that are "too-big-to-fail," you said, "I would have to say no to that." In addition, when asked if there is any rule that you believe should be made stronger, you responded, "I think they are tough enough." While I agree with you that Dodd-Frank has led to a substantially stronger banking system, the money center banks remain very large, complex institutions. As we have seen

time and time again, even their own boards and CEOs do not fully understand what is going on within them. I am concerned that your comments implied that we shouldn't be worried about the largest banks because efforts to date have been sufficient.

a. Do you care to elaborate on either of these answers?

My comments reflect my belief that the statutory framework established by Congress and the efforts of the U.S. regulators have made the largest banking firms more resilient and have significantly improved their resolvability. In particular, for the largest, most systemically important firms, we have increased the quantity and quality of capital that they maintain, have established capital surcharges that are scaled to each firm's systemic risk footprint, and have required them to carry long-term debt that can be converted to equity as part of a resolution.

Through Title I of the Dodd-Frank Act, Congress established a process for the Federal Reserve and the FDIC to identify resolution weaknesses at firms, to provide clarity about what actions need to be taken, and to follow through should weaknesses remain. The agencies are currently reviewing firms' resolution plans and I cannot speak for the Federal Reserve Board or the FDIC Board as to the outcome of that review. Notwithstanding, firms have clearly made substantial progress in improving their resolvability since the agencies' determinations in April 2016, as highlighted in our feedback letters and explained in their public filings.

It may be useful to clarify what it means to ask whether any firm remains "too-big-to-fail." By my answer, I intended to convey my view that we have made enough progress that the failure of one of our most systemically important financial institutions, while undoubtedly posing a severe shock to the economy, could more likely than not be resolved without critically undermining the financial stability of the United States. As I also said, we expect our most systemically important firms to continue to make steady progress toward assuring the achievement of that goal. Finally, I would add that higher levels of capital and liquidity and stress testing substantially reduce the likelihood that one of our most systemically important financial institutions would fail.

In addition, progress towards becoming more resolvable may not be permanent. The resolvability of firms will change as markets evolve and as firms' activities, structures, and risk profiles change. Firms must remain vigilant in confronting the resolution consequences of their day-to-day management decisions. It is therefore important to have a credible, ongoing process for the agencies to identify and address resolution weaknesses. The resolvability standard set by Congress and applied by the agencies accomplishes that, and as such I believe it is "tough enough." Of course, there may be areas identified by the agencies where more work by the firms needs to be done. In my view, that would be consistent with the statutory framework and standard currently in place.

As for the question of rules that may need improvement or toughening, I would add that there are a number of post-crisis regulations that are not yet finalized, and that we continue to advance.

These include, for example, the net stable funding ratio and single-counterparty credit limits for large banking firms.

8. Studies of capital other than those funded by industry, including some by Federal Reserve economists, suggest that modest increases in capital for the nation's largest banks are still warranted.

a. Do you agree?

My view is that risk based capital requirements for our G-SIBs are neither too low nor too high.

Since the financial crisis, bank capital requirements have been strengthened considerably to substantially improve both the quality and quantity of capital. Moreover, a robust stress testing regime is now the binding capital requirement for many of the largest and most systemically important banks.

A number of studies have examined the relative costs and benefits of bank capital requirements. These studies use data and assumptions on the cost and severity of financial crises and the costs of increasing capital requirements to estimate the level of capital requirements that results in the largest net benefit to the economy. Such studies have been conducted by economists affiliated with the Basel Committee on Banking Supervision (2010), The Bank of England (2015), the Federal Reserve Bank of Minneapolis (2016), as well as economists at the Federal Reserve Board (2017). Some of these studies produce results that are consistent with current levels of capital for the G-SIBs, while others call for more capital. This range in capital levels among the different studies reflects varying assumptions and data sources.

A different and perhaps preferable way to assess capital adequacy is through stress testing. Our G-SIBs should be able to survive a shock at least as severe as the Global Financial Crisis while still meeting their capital requirements, and thereby retain the confidence of the markets. With all of the G-SIBs now passing the quantitative test in Comprehensive Capital Analysis and Review, that requirement is arguably met.

9. At your confirmation hearing, you stated that stress testing is "a really important post-crisis innovation, maybe the single most successful, and the banks will say that to you privately." You further explained that your "strong preference" for banks between $100 billion and $250 billion in total consolidated assets would be to "have meaningful stress testing for them." For "systemically important banks," you added, "we really want the most stringent things to be happening," and "the most stringent stress tests in particular."

a. Do you believe that it is important for regulators to subject banks with over $250 billion in total consolidated assets to stress tests on at least an annual basis?

Yes, I believe it is important to continue to subject banks with total consolidated assets greater than $250 billion to stress tests on an annual basis. Large banks' risks may evolve rapidly, and conducting stress tests annually helps us to incorporate those changes in risks and ensure large banks continue to have sufficient capital to weather a severe stress and continue to lend.

Stress testing is a critical tool to help us ensure the safety and soundness of large banks and the financial stability of our overall economy. Our stress tests have significantly strengthened these firms by better ensuring that they have enough capital to survive a severe economic downturn and continue lending to households and businesses. Our stress tests also provide public visibility into the risks faced by these large banks, which was sorely lacking before the financial crisis and can help enhance market discipline.

The results of the most recent stress tests indicate that the banking system is strongly capitalized, which is good for the U.S. economy because it means banks have the ability to lend and support economic activity, even during a severe recession.

b. How often should stress tests be conducted for banks with between $100 billion and $250 billion in total consolidated assets?

Banks' capital positions have improved significantly since the crisis, in part due to stress tests that have been conducted annually. Banks with between $100 billion and $250 billion in total consolidated assets are an important source of credit to consumers and businesses. As a result, it is important that they continue to maintain sufficient capital to enable them to lend even in the event of a severe stress.

The dynamic nature of banks and the risks they face could render the results of stress tests stale within a short timeframe. Accordingly, we believe there are safety and soundness and financial stability benefits in conducting capital stress tests on a periodic basis based on a bank's size and complexity. If Congress granted us the flexibility to conduct stress tests at a different frequency than annually, we would consider the tradeoff between potentially less current information about banks' risks against the reduced burden of less frequent stress tests.

10. Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act established additional oversight of entities designated as Systemically Important Financial Market Utilities (SIFMUs), such as clearinghouses, by authorizing the Federal Reserve Bank to provide SIFMUs with deposit accounts, as well as discount and borrowing privileges during unusual and exigent circumstances.

a. Do you agree that Title VIII provides important financial stability tools for regulators in the form of enhanced oversight, deposit accounts, and discount and borrowing privileges during unusual and exigent circumstances?

Title VIII creates an enhanced framework for the supervision of financial market utilities (FMUs), including central counterparties, that have been designated as systemically important by the FSOC. This enhanced supervision framework allows the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), and the Board (together, the agencies) to prescribe enhanced risk management standards for FMUs and provides mechanisms for information-sharing and coordination among the supervisory agencies. It provides the Board with the ability to obtain a certain level of insight across all designated FMUs through examination participation and notification of material rule changes and also provides the Board with certain limited enforcement authority.

Effective risk management of FMUs enhances the stability of the financial system. It is important that FMUs be overseen consistently, and in a manner that focuses on the safety of the system as a whole and not just its individual components. The role given to the Board under Title VIII allows for such a systemic view of FMUs and assists the supervisory agencies in promoting consistency across the various designated FMUs.

The agencies have adopted regulations that have materially raised the expectations to which systemically important FMUs are held and that have improved FMUs' credit and liquidity risk management frameworks and enhanced their operational resilience. Further, the CFTC, SEC, and Board's respective requirements for FMUs designated under Title VIII require these firms to manage their risks by relying on private-sector resources only, without any assumption of reliance on public funds during times of market stress.

b. **Would eliminating the Federal Reserve's authority to provide accounts for customer margin and access to liquidity facilities during a financial crisis increase the potential for market instability during a crisis?**

Title VIII permits the Board to authorize a Federal Reserve Bank to establish an account for and provide services to a designated FMU. Conducting settlements using central bank money, where available, is consistent with strong risk management practices. It is likely that that the provision of accounts and services to certain designated FMUs has reduced risk in the system by minimizing credit and liquidity risk associated with holding margin payments and contingent liquidity resources in commercial bank accounts.

11. In June, I asked you about the status of the Board's work to incorporate the GSIB surcharge into the stress tests. At the time you said, that it was "the plan" to move forward and were currently "working on it."

a. **Six months later, what progress has been made?**
b. **When do you anticipate completion of the Board's work on incorporating the surcharge?**

We have made significant progress towards the completion of a package that would simplify the Board's capital regime by more closely integrating the regulatory capital rule and stress testing. A key element of the proposal would be the introduction of a stress capital buffer that would be sized based on the results of the stress test.

Staff is working to finalize the proposal, including an analysis of its potential impact, after which the Board would consider the full proposal. While I cannot predict the timing or outcome of the Board's consideration, if the Board were to approve the proposal, it would then be issued for notice and comment.

12. Several Federal Reserve rulemakings required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 remain uncompleted. Additionally, there remain several other rulemakings initiated by the Federal Reserve that are likewise not complete. Please indicate if you intend to complete the rulemakings cited below, and if so, on what timetable.

a. **Board of Governors of the Federal Reserve System, Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 12,414**
b. **Board of Governors of the Federal Reserve System, Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38,631**
c. **Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Federal Housing Finance Agency & Securities and Exchange Commission, Incentive-based Compensation Arrangements, 81 Fed Reg. 37,670**
d. **Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 Fed Reg. 35,124**
e. **Board of Governors of the Federal Reserve System, Single-Counterparty Credit Limits for Large Banking Organizations, 81 Fed. Reg. 14,328**

Board staff is actively engaged in reviewing the public comments received on these proposed rulemakings. With regard to the interagency rulemakings listed above, we also are working with staff from the other agencies. While I cannot provide an exact schedule, I expect that we will work diligently to address the public comments received on these rulemakings and finalize the rules as appropriate.

13. As Chair of the Fed's Committee overseeing the Federal Reserve Banks' operations including the presidential search processes, we have seen some improvement in the diversity of the regional bank presidents, the Boards of Directors, the Banks' workforces, and better interactions with advocacy groups in the Banks' communities.

a. **If confirmed, what more will you do to increase the diversity of the leadership, workforce and opinions in the Federal Reserve System?**

Diversity is a critical aspect of all successful organizations, and I am committed to fostering diversity and inclusion throughout the Federal Reserve System. In my experience, we make better decisions when we have a wide range of backgrounds and voices around the table.

The Federal Reserve recognizes the value of a diverse workforce at all levels of the organization. We are committed to achieving further progress, and to better understanding the challenges to improving and promoting diversity of ideas and backgrounds. This has been an ongoing objective, and, if I am confirmed, I assure you that diversity will remain a high priority objective for the Federal Reserve.

As Administrative Governor and Chair of the Committee on Board Affairs, I have supported and encouraged the Board's efforts to enhance diversity. In my role as Chair of the Committee on Federal Reserve Bank Affairs, I have worked with the Reserve Banks to promote diversity throughout the System. Recognizing the value of diversity at all levels of the System, including at the highest levels, I have worked closely with the Reserve Banks to assure that they have a diverse slate of qualified candidates for president searches. The Reserve Banks, working closely with the Board, have also been looking at ways to further develop a diverse pool of talent in a thoughtful, strategic fashion, readying them for leadership roles throughout the Federal Reserve System.

To foster diversity more broadly, a long-term holistic plan is necessary with a focus on doing the utmost to recruit and bring people in and provide them paths for success. That means having an overall culture and organization that is focused on diversity and demonstrates its ongoing commitment at all levels, starting at the top. For example, we have an internal work stream at the Board to coordinate economic inclusion and diversity efforts that is comprised of the Office of Minority and Women Inclusion Director, Division Directors, senior staff and Board Members. It focuses on initiatives not just at the Board, but also more broadly throughout the System. I am part of this team, as are other Board members, and we meet regularly to discuss initiatives and progress.

b. Do you believe the dual mandate is a critical part of monetary policy?

Yes. The Congress established the Federal Reserve more than a century ago to provide a safer and more flexible monetary and financial system. And, almost exactly 40 years ago, it assigned us monetary policy goals: maximum employment, meaning people who want to work either have a job or are likely to find one fairly quickly; and price stability, meaning inflation is low and stable enough that it need not figure into households' and businesses' economic decisions.

I have had the great privilege of serving under Chairman Bernanke and Chair Yellen, and, like them, I will do everything in my power to achieve those goals while preserving the Federal Reserve's independent and nonpartisan status that is so vital to their pursuit.

In 2012, the Federal Open Market Committee (FOMC) published a statement discussing its longer-term goals and the monetary policy strategy it follows to achieve them; this statement is reaffirmed each January. At our meetings, FOMC policymakers evaluate economic conditions and the outlook, and we decide on the monetary policy that we think will be most likely to deliver maximum employment and price stability over the medium term.

14. According to former Chair Bernanke's memoir "Courage to Act," in 2013, he wanted to continue asset purchases at their elevated level because of the continued fiscal austerity and gridlock in Congress. But, in order to achieve unanimity on the Board of Governors, he slowed asset purchases in order to respond to concerns raised by you and two other governors. Some suggest that this announcement caused the so-called "taper tantrum" in which investors suddenly withdrew their money from the bond market.

a. Did you think the economic recovery was sufficient at that time to reduce the Fed's support for the economy? What do you believe caused the "taper tantrum"?

When the FOMC agreed to undertake a new asset purchase program in September 2012, we indicated that the purchases would continue until there was a substantial improvement in the outlook for the labor market, but that we would also take account of the efficacy and costs of the purchases. At the FOMC's May 2013 meeting, shortly before the taper tantrum, I voted along with other policymakers to continue purchases of Treasury and mortgage-backed securities--the unemployment rate was at that time around 7-1/2 percent and other indicators of the labor market suggested that considerable slack remained.

The market reaction began in late May 2013 after Chairman Bernanke mentioned the possible tapering of our asset purchase program for the first time during congressional testimony; longer-term yields rose further following the June press conference when he mentioned tapering again. These remarks seem to have been interpreted as a message not only about the course of our asset purchases, but also about how soon we might raise our target range for the federal funds rate from its effective lower bound. The rise in yields of around 100 basis points was too large to have been plausibly explained by balance sheet effects alone, and is more consistent with the perception that our monetary policy stance had become less accommodative. One of the lessons we learned was the need to clearly distinguish in our communications between the federal funds rate and asset purchases.

b. What communication practices from the Fed might prevent incidents like the taper tantrum from occurring again?

Monetary policy is complicated, particularly when the FOMC is using both the policy rate and the balance sheet as tools. Communicating about one of the tools can have unintended consequences for the other--as we experienced during the taper tantrum. One of the lessons we learned is that it is important to clearly distinguish between the two tools. This year, we have increased the target range for the federal funds rate on two occasions and initiated a program to gradually reduce the Federal Reserve's balance sheet. We began discussing options for tapering the reinvestments of maturing Treasury and agency securities last spring and informed the public about these discussions through the FOMC meeting minutes. In June, we updated our normalization principles and plans to outline how our redemption program would work. At our September meeting, we agreed that the time had come to begin to implement this program. We used a sequence of communications about the change to our reinvestment policy because we wanted to separate our actions on the federal funds rate from the winding down of our securities holdings. In addition, we wanted to give financial market participants time to understand and plan for the effects of our redemptions. Our communications were well received in financial markets and the commencement of our redemption program has progressed very smoothly.

15. At your confirmation hearing, you mentioned several times the impact of the opioid crisis on the labor force participation rate especially for prime age men. In September, Senator Donnelly and I sent a letter to Chair Yellen asking her to devote resources to Fed research into this issue and to encourage the Federal Reserve Banks to work with their community leaders to find ways to address this crisis. She committed that the Fed would continue to explore this issue.

a. Do you think there is more the Fed can do to try to understand the impact of the opioid crisis on the economy? If so, what?

The opioid epidemic is a crisis that goes well beyond its effects on the economy. It has resulted in a sharp increase in the rate of drug deaths in the United States since 2000, and it has had devastating effects on too many individuals and their families, as well as on many communities. As Anne Case and Angus Deaton have documented, this crisis has spread extensively over the past 20 years and is now evident in virtually all parts of the United States.

In terms of its economic effects, the opioid epidemic has likely contributed to the downward trends in the labor force participation rates of prime-age men and women and reduced worker productivity, while adding to health care expenditures and the costs of the criminal justice system. With employers now finding it more difficult to fill their open positions with qualified and productive workers, the effects of the opioid crisis are likely constraining the potential growth rate of the U.S. economy, although it is difficult to quantify how large those effects might be.

We will continue to engage with researchers on this important issue, as well as look for ways in which we can contribute to a better understanding of its effects on local communities.

16. The Fed's long term growth projection from September was 1.8%. Earlier this week several prominent economists suggested that tax changes could increase growth by 0.1% or less. The Joint Committee on Taxation's recent estimate shows an annual increase of less than 0.08%. You indicated at your confirmation hearing that they Fed has not done modeling that tries to anticipate the impact on the economic growth rate of federal fiscal policy, including possible tax changes, because it is too speculative.

a. **Does this mean that the Fed's economists only look at existing law when modeling potential GDP growth?**
b. **If not, could you describe their approach?**

In preparing their individual forecasts that feed into the Summary of Economic Projections (issued quarterly in conjunction with the Chair's press conferences), FOMC participants are free to make their own judgments about the likely future evolution of fiscal policy. And indeed, views among FOMC participants have differed this year about what fiscal effects should be built into their forecasts; I am among those who have assessed the situation as too uncertain to warrant building in the effects of fiscal-policy changes; others have assessed the odds on passage of some fiscal action as sufficiently high as to warrant making some allowance in their projections. Participants are not constrained to consider only current law with regard to fiscal policy.

While it is not possible for me to speak for any other FOMC participant in this regard aside from myself, in general the issue you are raising is a judgment call. Some of the factors that affect my thinking are:

- Likelihood of enactment: How likely is the given change to be enacted, and in exactly what form?
- What are the likely effects of a given change in fiscal policy on the future evolution of the economy? I would take into account what the economics literature has to say about particular changes for aspects of the economy that are most relevant for the Federal Reserve. This assessment can be highly uncertain, and the uncertainty around these estimates may have increased the reluctance of some FOMC participants to factor a change in fiscal policy into their outlook.
- Timing: Will the contemplated change in fiscal policy affect the performance of the macroeconomy within the next 2-3 years, which is the timeframe most relevant for operational near-term decisions about monetary policy?

I should emphasize that FOMC participants strive to take a comprehensive approach in their assessment of the outlook, and fiscal policy is only one of the many factors that bear on the outlook. I should also emphasize that our congressional mandate is very clear about what we should focus on--maximum employment and price stability. We assess various factors for their implications for those variables. Other agencies, of course, are responsible for assessing other implications of various fiscal actions.

Committee on Banking, Housing, and Urban Affairs
Board of Governors of the Federal Reserve System Nomination Hearing
November 28, 2017

Questions for The Honorable Jerome H. Powell, Chairman-Designate, Federal Reserve Bank of the United States on behalf of Ranking Member Brown:

Secretary Mnuchin said that the Trump Administration could accomplish 80 percent of the bank deregulation listed in Treasury's June report without any help from Congress.1 Before this Committee in June, you called the Treasury report on bank deregulation, a "mixed bag."

- If you are confirmed, what will you do to oppose the recommendations you believe would be harmful to financial stability, consumers, and safety and soundness?

- Randy Quarles is now in the role as Vice Chair for Supervision at the Federal Reserve. If you are confirmed as Chair, how do you see your role in relation to the Vice Chair of Supervision's when it comes to regulatory policy?

In a 2015 Bloomberg Television interview, Randy Quarles said the following about Dodd-Frank, "The macro issue is that the government should not be a player in the financial sector. It should be a referee. And the practice, and the policy, and the legislation that resulted from the financial crisis tended to make the government a player. They put it on the field as opposed to simply reffing the game."

- While we can all agree that the federal government should be a referee when it comes to supervision, do you agree with Governor Quarles' view on the role of the government in the financial sector following the crisis?

- In your confirmation hearing, you noted that you and Vice Chair Randal Quarles are "very well aligned on [your] approach to supervision." Are there any areas on bank supervision policy where you and Vice Chair Quarles disagree?

Vice Chair Quarles in his maiden speech at the Federal Reserve earlier this month said that, "changing the tenor of supervision will probably actually be the biggest part of what it is that I can do."2 He said this to note that near-term changes in banking rules would be difficult, but that day-to-day changes in regulators' tone was more immediately achievable.3

- Do you agree that Federal Reserve supervisors need to change their "tenor?" If so, please elaborate on what this means.

At the time Countrywide was teetering and was bought by Bank of America, it had $211 billion in assets and originated around one in five mortgages in the country.

[1] https://www.reuters.com/article/us-usa-banks-regulation/u-s-treasury-unveils-financial-reforms-critics-attack-idUSKBN1932KQ
[2] https://www.wsj.com/articles/feds-quarles-changes-to-bank-stress-tests-on-front-burner-1510080513
[3] Ibid

- In hindsight, would it have been useful for a large lender like Countrywide to have been subject to enhanced capital or liquidity standards, stress tests, or to have prepared a living will?

Legislation this Committee will soon consider quintuples the threshold at which enhanced financial stability rules apply to banks.

- If confirmed, will you commit to not raising it further using the Federal Reserve's existing authority upon a recommendation from the FSOC?

Legislation this Committee will soon consider would deregulate banks with up to $250 billion in assets from financial stability rules.

- Would you believe that every bank up to $250 billion in assets – if it failed – no longer needs a living will?

- Are you confident that each of these banks could be resolved through bankruptcy, without any taxpayer support?

At your confirmation hearing when asked if we "still have banks that are "too-big-to-fail," you said, "I would have to say no to that." In addition, when asked if there is any rule that you believe should be made stronger, you responded, "I think they are tough enough." While I agree with you that Dodd-Frank has led to a substantially stronger banking system, the money center banks remain very large, complex institutions. As we have seen time and time again, even their own boards and CEOs do not fully understand what is going on within them. I am concerned that your comments implied that we shouldn't be worried about the largest banks because efforts to date have been sufficient.

- Do you care to elaborate on either of these answers?

Studies of capital other than those funded by industry, including some by Federal Reserve economists, suggest that modest increases in capital for the nation's largest banks are still warranted.

- Do you agree?

At your confirmation hearing, you stated that stress testing is "a really important post-crisis innovation, maybe the single most successful, and the banks will say that to you privately." You further explained that your "strong preference" for banks between $100 billion and $250 billion in total consolidated assets would be to "have meaningful stress testing for them." For "systemically important banks," you added, "we really want the most stringent things to be happening," and "the most stringent stress tests in particular."

- Do you believe that it is important for regulators to subject banks with over $250 billion in total consolidated assets to stress tests on at least an annual basis?

- How often should stress tests be conducted for banks with between $100 billion and $250 billion in total consolidated assets?

Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act established additional oversight of entities designated as Systemically Important Financial Market Utilities (SIFMUs), such as clearinghouses, by authorizing the Federal Reserve Bank to provide SIFMUs with deposit accounts, as well as discount and borrowing privileges during unusual and exigent circumstances.

- Do you agree that Title VIII provides important financial stability tools for regulators in the form of enhanced oversight, deposit accounts, and discount and borrowing privileges during unusual and exigent circumstances?

- Would eliminating the Federal Reserve's authority to provide accounts for customer margin and access to liquidity facilities during a financial crisis increase the potential for market instability during a crisis?

In June, I asked you about the status of the Board's work to incorporate the GSIB surcharge into the stress tests. At the time you said, that it was "the plan" to move forward and were currently "working on it."

- Six months later, what progress has been made?

- When do you anticipate completion of the Board's work on incorporating the surcharge?

Several Federal Reserve rulemakings required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 remain uncompleted. Additionally, there remain several other rulemakings initiated by the Federal Reserve that are likewise not complete. Please indicate if you intend to complete the rulemakings cited below, and if so, on what timetable.

- o Board of Governors of the Federal Reserve System, Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 12,414

- o Board of Governors of the Federal Reserve System, Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38,631

- o Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Federal Housing Finance Agency & Securities and Exchange Commission, Incentive-based Compensation Arrangements, 81 Fed Reg. 37,670

- o Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 Fed Reg. 35,124

- o Board of Governors of the Federal Reserve System, Single-Counterparty Credit Limits for Large Banking Organizations, 81 Fed. Reg. 14,328

As Chair of the Fed's Committee overseeing the Federal Reserve Banks' operations including the presidential search processes, we have seen some improvement in the diversity of the regional bank presidents, the Boards of Directors, the Banks' workforces, and better interactions with advocacy groups in the Banks' communities.

- If confirmed, what more will you do to increase the diversity of the leadership, workforce and opinions in the Federal Reserve System?

- Do you believe the dual mandate is a critical part of monetary policy?

According to former Chair Bernanke's memoir "Courage to Act," in 2013, he wanted to continue asset purchases at their elevated level because of the continued fiscal austerity and gridlock in Congress. But, in order to achieve unanimity on the Board of Governors, he slowed asset purchases in order to respond to concerns raised by you and two other governors. Some suggest that this announcement caused the so-called "taper tantrum" in which investors suddenly withdrew their money from the bond market.

- Did you think the economic recovery was sufficient at that time to reduce the Fed's support for the economy? What do you believe caused the "taper tantrum"?

- What communication practices from the Fed might prevent incidents like the taper tantrum from occurring again?

At your confirmation hearing, you mentioned several times the impact of the opioid crisis on the labor force participation rate especially for prime age men. In September, Senator Donnelly and I sent a letter to Chair Yellen asking her to devote resources to Fed research into this issue and to encourage the Federal Reserve Banks to work with their community leaders to find ways to address this crisis. She committed that the Fed would continue to explore this issue.

- Do you think there is more the Fed can do to try to understand the impact of the opioid crisis on the economy? If so, what?

The Fed's long term growth projection from September was 1.8%. Earlier this week several prominent economists suggested that tax changes could increase growth by 0.1% or less. The Joint Committee on Taxation's recent estimate shows an annual increase of less than

0.08%. You indicated at your confirmation hearing that they Fed has not done modeling that tries to anticipate the impact on the economic growth rate of federal fiscal policy, including possible tax changes, because it is too speculative.

- Does this mean that the Fed's economists only look at existing law when modeling potential GDP growth?

- If not, could you describe their approach?

United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510-6075

December 1, 2017

The Honorable Jerome H. Powell
Chairman-Designate
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Gov. Powell:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs on November 28, 2017 at our nomination hearing. In order to complete the hearing record, we would appreciate your answers to the enclosed questions by 10:00 am on Monday, December 4, 2017. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo

Mike Crapo
Chairman

MC/dr

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

January 25, 2018

The Honorable Darin LaHood
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the written questions that you submitted following the November 29, 2017,[1] hearing before the Joint Economic Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on December 6, 2017.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative LaHood:

1. "Chair Yellen: At the hearing, we had an exchange on CMBS and you said you'd get back to me with more information on your concerns in that area. Can you comment more on your concerns in this space?"

Hearing exchange:

Representative LaHood. I had a question as it related to the commercial mortgage market. And we are all aware in 2008, 2009 when we had the financial crisis as it related to the housing mortgage market, and as we look at the growth of Amazon and other online retailers across the country, really changing the business model as it relates to retailers. And we continue to see traditional brick-and-mortar stores and malls and others being really obliterated across the country -- JCPenney, Macy's, Sears Roebuck, and large malls. And in a lot of medium-size markets, there continues to be vacant commercial properties, and these type of brick-and-mortars become more and more unproductive.
And as we look at the commercial mortgage market, I wonder if you could comment on whether there is a possibility, as these unproductive properties continue this trend, of causing a financial crisis like we saw in 2008 and these markets going bad.

Mrs. Yellen. So I think you are raising an important question. I don't have detailed information at my fingertips on these trends. I think that delinquency rates generally remain pretty low in commercial real estate. There are legacy properties incorporated in CMBS that have much higher delinquency rates. But we are focused on underwriting standards at banks, at maintaining strong underwriting standards to protect the banking system against possible weaknesses that could result in especially commercial real estate. We are seeing overall in commercial real estate that valuations are very high and we have highlighted elevated asset prices. Commercial real estate generally is an area, also, where we do see elevated prices or low cap rates. So we are focused on soundness of underwriting standards and the safety and soundness of banks associated with it, but in detail, just how this trend is going to play out, I would like to get back to you on that.

Representative LaHood. And as you sit here today, do you have any fears or concerns?

Mrs. Yellen. Well, these are obviously significant trends that are affecting retail. You know, what they will mean for banks is something I would like to look at more closely and get back to you.

Changes in the retail sector, such as the growth of online sales, have been generating stress on existing retail properties for quite some time. That stress is evident in slower price appreciation of retail properties relative to other property types and higher default rates for legacy properties in the commercial mortgage-backed securities (CMBS) market. Default rates for CMBS loans secured by retail properties, as well as default rates for commercial real estate (CRE) loans at held in bank portfolios, are significantly higher than loans backed by non-retail properties. As of June 2017, the average default rate for CMBS loans secured by retail properties was 0.83 percent over the previous year while the default rate for CMBS loans backed by non-retail properties was 0.54 percent. The comparable rates for CRE loans held at banks with assets more than $50 billion, including construction loans but excluding owner-occupied loans, were 0.15 percent for loans backed by retail properties, and 0.09 percent for loans backed by non-retail properties.[1] That difference in performance reflects stronger underwriting standards at banks, which are in part due to Federal Reserve regulatory and supervisory programs that are intended to promote the resiliency of individual banks and the financial system as a whole. Further, the annual stress test evaluates the ability of large banks to continue to support the economy while undergoing significant stress. In the 2017 Dodd-Frank Act Stress Test exercise, the Federal Reserve projected that the 34 participating banks had sufficient capital to absorb $493 billion in losses (including more than $56 billion in losses from domestic commercial real estate) under the supervisory severely adverse scenario.

As I mentioned at the hearing, banks are reportedly tightening standards and terms on a range of CRE property types. Most responses to the July 2017 Senior Loan Officer Opinion Survey (SLOOS) indicate that lending standards on all types of CRE loans are either at or somewhat tighter than the midpoint of the range of standards and terms for these banks between 2005 and mid-2017.

Nevertheless, CRE borrowers and lenders potentially face the prospects of additional losses. We believe that the market is aware of, and is responding appropriately to these long-term trends in the retail space. Our focus in financial stability at the Federal Reserve is ensuring that the system can absorb such events rather than amplifying them, so that households and businesses with no connection to this industry suffer in the form of reduced access to credit. We will continue to closely monitor trends in the retail market and their potential impact on the stability of the banking system as a whole and at the individual bank level.

[1] The default rate is defined as the share of loans that are current in the previous quarter transitioning to a default status in the current quarter. Loans more than 90 days delinquent, in special servicing (for CMBS loans), or identified as non-accrual or in remediation (for bank loans) are considered in default.

December 6, 2017

Rep. LaHood JEC QFR for Chair Yellen

1. "Chair Yellen: At the hearing, we had an exchange on CMBS and you said you'd get back to me with more information on your concerns in that area. Can you comment more on your concerns in this space?"

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Representative LaHood. I had a question as it related to the commercial mortgage market. And we are all aware in 2008, 2009 when we had the financial crisis as it related to the housing mortgage market, and as we look at the growth of Amazon and other online retailers across the country, really changing the business model as it relates to retailers. And we continue to see traditional brick□and□mortar stores and malls and others being really obliterated across the country □□ JCPenney, Macy's, Sears Roebuck, and large malls. And in a lot of medium□size markets, there continues to be vacant commercial properties, and these type of brick□and□mortars become more and more unproductive.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

January 4, 2017

The Honorable Maggie Hassan
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the November 29, 2017,[1] hearing before the Joint Economic Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

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<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Hassan:</u>

1. We had a hearing in this committee in July on the number of open jobs in our economy right now. And at that time, there were over 6 million open jobs in the U.S. It would seem to me that if there are that many open jobs out there, we would see an increase in wages in an attempt to attract talent. But we have seen a lot of wage stagnation. Do you have an opinion on why that might be? Or what we could do to address that?

Although the step-up in wage growth has been modest thus far, we are hearing more anecdotes about emerging labor shortages among our contacts. Employers reportedly are responding to these shortages by broadening the range of workers they are willing to hire, providing more training to new employees, increasing workforce flexibility, and in some cases raising wages, all of which are favorable developments. If the labor market continues to tighten, we would expect wage growth to pick up somewhat further.

That said, one likely reason for the sluggish pace of wage growth in recent years is that productivity growth has been disappointing for quite some time, and a continuation of this pattern would tend to temper any further pickup in wage growth. Thus, a very high priority for the nation should be to boost the pace of productivity growth; this is essential for ensuring that standards of living improve at a more satisfactory pace. While there is disagreement about what policies would most effectively boost productivity, a variety of policy initiatives would likely contribute. More investment, both through improved public infrastructure and more encouragement for private investment, would likely play a meaningful role. More effective regulation likely could contribute as well. And better education, at all grade levels and including adult education, could both promote productivity growth and contribute to higher incomes not just on average, but throughout our society.

2. Generally speaking, corporations are doing better than ever. Our unemployment rate is low. But workers' wages have not gone up. Broadly speaking, in your opinion what are some of the potential implications of a corporate tax cut right now? Will it/how will it impact the decisions of the Fed on monetary policy?

Over long periods of time, productivity growth is a key determinant of wage growth, and thus one likely reason for sluggish wage gains in recent years is that the pace of productivity increases has been quite slow for some time. Corporate tax changes that reduced the cost of capital and led to higher business cash flows could boost investment and the capital stock, which, in turn, could raise labor productivity and wages. However, a persistent increase in federal government debt associated with tax cuts could put some upward pressure on longer-term interest rates, which could tend to mitigate some of the boost to investment and productivity. That said, corporate tax policy is just one of many factors potentially affecting the economic outlook that informs decisions about appropriate monetary policy.

Joint Economic Committee Hearing
"The Economic Outlook with Federal Reserve Chair Janet Yellen"
Questions for the Record submitted by Senator Maggie Hassan
November 29, 2017

1. We had a hearing in this committee in July on the number of open jobs in our economy right now. And at that time, there were over 6 million open jobs in the U.S. It would seem to me that if there are that many open jobs out there, we would see an increase in wages in an attempt to attract talent. But we have seen a lot of wage stagnation. Do you have an opinion on why that might be? Or what we could do to address that?

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

January 12, 2018

The Honorable Pat Tiberi
Chairman
Joint Economic Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are my responses to the written questions that you submitted following the November 29, 2017,[1] hearing before the Joint Economic Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

[1] Questions for the record related to this hearing were received on December 6, 2017.

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Chairman Tiberi:</u>

1. Chair Yellen, given the large amount of excess reserves that banks hold they have little need for interbank lending at the federal funds rate to avoid potential shortfalls in required reserves. This renders the federal funds rate largely moot, except for lending by government-sponsored enterprises (GSEs) that are ineligible to earn interest on reserves. Hence, there is no other practical means for the Fed to control short-term interest rates than to pay interest on bank reserves, as you recently explained.[1] Would you please answer the following and provide your reasons:

a. Should the current method of controlling short-term interest rates by setting the IOER rate at or above the federal funds rate become permanent or should the Fed use it only in transition until the level of banks reserves declines to where banks once again may want to exchange reserves among one another as they did prior to 2008?

As noted in the addendum to the Policy Normalization Principles and Plans issued in June of 2016, the Federal Open Market Committee (FOMC) currently anticipates reducing the quantity of reserve balances, over time, to a level appreciably below that seen in recent years but larger than before the financial crisis; the appropriate level of reserves will reflect the banking system's demand for reserve balances and the Committee's decisions about how to implement monetary policy most efficiently and effectively in the future.

The FOMC discussed a range of considerations related to the long-run policy implementation framework at the July and November FOMC meetings in 2016.[2] At the November 2016 meeting, FOMC participants noted that the present approach to policy implementation was working well and would likely remain appropriate for some time. Moreover, policymakers expected to benefit from accruing additional information before making judgments about a future implementation framework; policymakers emphasized that their current views regarding the long-run policy implementation framework were preliminary and they expected that further deliberations would be appropriate before decisions were made.

b. IOER has consistently exceeded other short-term interest rates such as 3-month Treasury and commercial paper rates. Does that inhibit banks from lending more and encourage them to hold large excess reserves?

The level of IOER has been slightly above the level of the federal funds rate over recent months but below many other short-term interest rates such as 1- to 3-month commercial paper rates. Treasury bill yields have been somewhat below IOER and most other short-term rates over recent months. In part, the relatively low level of yields on Treasury bills reflects the strong demand for these securities by global investors and the Treasury's debt management decisions which have tended to keep Treasury bills in relatively short supply.

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1 "Fed interest payments to banks are here to stay, Yellen says," By John Heltman, American Banker, November 21, 2017.

2 Summaries of the discussion of those topics was included in the minutes for those meetings (See https://www.federalreserve.gov/monetarypolicy/fomcminutes20160727.htm and https://www.federalreserve.gov/monetarypolicy/fomcminutes20161102.htm).

e. The Fed's professed goal to shrink its balance sheet can have a contractionary effect on the economy. Does raising the IOER rate, as is anticipated, not make it more difficult for the Fed to shrink its balance sheet?

The Federal Reserve initiated its plan to normalize the size of its balance sheet over time beginning in October of last year. Under the plan, the Federal Reserve will scale back the extent to which it reinvests principal payments on its existing securities holdings. As a result, the balance sheet will gradually decline over a period of several years.[3]

The gradual runoff of the Federal Reserve's balance sheet is projected to put some upward pressure on longer-term interest rates over time. For example, based on some estimates, the Federal Reserve's elevated holdings of longer-term securities is currently keeping longer-term interest rates about 90 basis points lower than would otherwise be the case.[4] As the Federal Reserve's balance sheet declines, this effect on longer-term interest rates will gradually decline as well. Of course, there are many factors affecting the level of longer-term interest rates and many observers have projected that longer-term interest rates will remain quite low for many years to come.

The gradual normalization of the Federal Reserve's balance sheet is a factor that the FOMC must take into account in adjusting the level of the federal funds rate. All else equal, the reduction in the Federal Reserve's balance sheet and the corresponding gradual increase in term premiums embedded in longer-term interest rates are factors that would result in a flatter trajectory for the target range for the federal funds rate than would otherwise be the case. That is one of the reasons the FOMC has noted in recent statements that it anticipates that the level of the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.

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[3] For more details on the likely path of the Federal Reserve's balance sheet, see the Annual Report of the System Open Market Account at: https://www.newyorkfed.org/medialibrary/media/markets/omo/SOMAPortfolioandIncomeProjections_July2017Update.pdf.

[4] See Bonis et. al. at https://www.federalreserve.gov/econres/notes/feds-notes/projected-evolution-of-the-soma-portfolio-and-the-10-year-treasury-term-premium-effect-20170922.htm.

Joint Economic Committee Hearing
"The Economic Outlook with Federal Reserve Chair Janet Yellen"
Questions for the Record submitted by Chairman Pat Tiberi
November 29, 2017

Interest on Excess Reserves (IOER)

Chair Yellen, given the large amount of excess reserves that banks hold they have little need for interbank lending at the federal funds rate to avoid potential shortfalls in required reserves. This renders the federal funds rate largely moot, except for lending by government-sponsored enterprises (GSEs) that are ineligible to earn interest on reserves. Hence, there is no other practical means for the Fed to control short-term interest rates than to pay interest on bank reserves, as you recently explained.[1] Would you please answer the following and provide your reasons:

- Should the current method of controlling short-term interest rates by setting the IOER rate at or above the federal funds rate become permanent or should the Fed use it only in transition until the level of bank reserves declines to where banks once again may want to exchange reserves among one another as they did prior to 2008?
- IOER has consistently exceeded other short-term interest rates, such as 3-month Treasury and commercial paper rates. Does that inhibit banks from lending more and encourage them to hold large excess reserves?
- Is it possible that the Fed setting the IOER rate above market rates is the proximate cause of inflation consistently undershooting the Fed's 2 percent inflation target? Why would it not be?
- What would happen to inflation and employment if the Fed set the IOER rate at or below the 3-month Treasury bill yield?
- The Fed's professed goal to shrink its balance sheet can have a contractionary effect on the economy. Does raising the IOER rate, as is anticipated, not make it more difficult for the Fed to shrink its balance sheet?

[1] "Fed interest payments to banks are here to stay, Yellen says," By John Heltman, American Banker, November 21, 2017.

Board of Governors of the Federal Reserve System
Washington, D. C. 20551

Jerome H. Powell
Chairman

April 18, 2018

The Honorable Ben Sasse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the March 1, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on March 20, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Sasse:</u>

1. As you know, the Administration has invoked Section 201 of the Trade Act of 1974 to impose significant tariffs on solar panels and washing machines.

- **As Federal Reserve Chairman, your job is to stay abreast on the state of our economy. These tariffs will almost certainly impact our economy, I believe for the worse. What economic indicators are you consulting to evaluate the economic impact of these tariffs?**
- **What has been the international response to these tariffs and the initial economic impact of these tariffs?**

The Federal Reserve is entrusted to achieve its congressionally mandated objectives of price stability and maximum sustainable employment. Matters of trade policy are the responsibility of Congress and the Administration.

Although the implemented trade actions do have consequences for specific industries, these trade actions are targeted enough that they are likely to have small effects on aggregate price stability and national employment. Federal Reserve staff closely monitor data on U.S. trade flows as well as domestic price developments, both of which could be affected by tariff rate increases.

The international response has been consistent with World Trade Organization (WTO) rules. Canada, China, the European Union, Japan, South Korea, and Taiwan have been holding consultations with the United States under the World Trade Organization rules to protest the measures. China has claimed the right to suspend tariff concessions immediately equal to the amount of trade affected, and did so the week of April 2. The affected countries will likely proceed with the filing of WTO cases against the United States.

2. The Administration has announced that it will impose 25% tariffs on steel and 10% tariffs on aluminum under Section 232 of the Trade Expansion Act of 1962.

- **Can you identify any historical examples where tariffs have helped the United States economy or otherwise fixed the problem it was intended to address?**
- **Based on the record of the Bush Administration's 2002 – 2003 steel tariffs and other historical examples, how would you expect this 25% tariff on steel and aluminum to impact the U.S. economy?**
- **Would this answer change if countries responded with economic retaliation against the United States, such as through tariffs? For example, I hear constantly from Nebraskan agriculture and manufacturing stakeholders of their concern that other countries will respond to the potential trade barriers by retaliating against agriculture.**
- **Historically, what industries would be most impacted by this economic retaliation? For example, would agriculture be impacted?**
- **In 12 months, what economic data would you consult to evaluate the net economic impact of these tariffs in the United States?**

International trade, facilitated by low barriers to trade, is likely beneficial to the U.S. economy on net. History has shown that countries that are open to trade often are more productive and grow faster than countries that are relatively closed to trade. The challenge is that the gains from trade are not guaranteed to be distributed as to make everyone better off. It is important to realize that openness to trade can cause dislocation and impose costs on some industries and workers. In part because of these costs, effort should be taken to ensure that trade occurs on a level playing field.

Higher tariffs on products such as steel and aluminum would tend to reduce imports of these products, and shift demand toward U.S.-produced steel and aluminum. Although U.S. producers may benefit from increased domestic demand, other U.S. firms likely would have to pay more for these products when used as an intermediate input, increasing their production costs.

Currently, most of the major exporters of steel and aluminum to the United States are subject to exemptions from the tariffs, including Canada, the European Union, and Mexico. As such, the effects may be muted.

The granted exemptions are more extensive than in past episodes. For example, during the 2002 safeguard tariffs on steel, the European Union, a significant supplier of steel to the United States, was not excluded. Even so, the effects on employment and inflation from the 2002 measures were fairly muted.

If countries retaliate by increasing their tariffs on U.S. goods, this will likely hurt exporting industries in the United States by reducing their competitiveness and demand for their products. Retaliation is typically equivalent in size to the affected sales to the United States.

China's announcement of retaliatory tariffs on products such as fruit and pork on April 1 were in direct response to the steel and aluminum tariffs, and the total amount subject to tariffs was picked to match the total amount of Chinese exports of these products (about $3 billion). China also has threatened to retaliate against a larger list of products, depending on what measures the United States government takes in response to its investigation under section 301 of the Trade Act of 1974 into China's policies related to technology transfer, intellectual property, and innovation.

In calibrating retaliation, foreign countries often target industries in which the United States has a comparative advantage, such as agriculture. In part, this reflects that the United States tends to export more from sectors in which it is relatively productive. In addition, agriculture can make an appealing target for retaliation as agricultural products tend to be relatively homogenous, allowing the retaliating country to shift purchases away from the United States towards alternative producers with less disruption to local consumers.

The Federal Reserve looks at a wide range of data to assess the state of the economy. Data which might be used to evaluate the effects of the tariffs would include import and export data, as well as the prices of imports and exports. In addition, domestic employment and overall retail prices might be informative.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
March 1, 2018

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States on behalf of Senator Ben Sasse:

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- In 12 months, what economic data would you consult to evaluate the net economic impact of these tariffs in the United States?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

April 18, 2018

The Honorable Brian Schatz
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the March 1, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on March 20, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Schatz:</u>

1. I would like to follow up on our ongoing conversation on the economic impacts of climate change. I understand that the Federal Reserve's mandate and tools are entirely focused on monetary policy. However, the Federal Reserve's implementation of monetary policy is informed by its assessment of the U.S. economy, including future economic trends and risks. According to your answer to a question I posed during your confirmation, your position is that the Federal Reserve is only concerned with "short and medium term developments that may change materially over quarters and a relative small number of years, rather than the decades associated with the pace of climate change."

- **How did you arrive at the determination that there are no short or medium term impacts of climate change?**
- **Have you or your staff considered or reviewed data from our government's scientific agencies about the rate of climate change?**
- **In 2017, NOAA reported 16 separate billion-dollar climate events. Combined, these events cost the U.S. economy over $300 billion—roughly 1.5% of U.S. GDP. Do you think that severe weather events that cost the equivalent of 1.5% of GDP qualify as short and medium term developments that the Federal Reserve should be concerned about?**
- **Will you commit to having a staff-level conversation about these data sources to consider whether they should be a resource the Federal Reserve uses when assessing the national economic outlook and future economic risks?**

Each and every severe weather event reported by the National Oceanographic and Atmospheric Administration (NOAA) is consequential for the individuals and communities that are directly affected. The most severe of these events can seriously damage the lives and livelihoods of many individuals and families, devastate local economies, and even temporarily affect national economic statistics such as GDP and employment. In that sense, severe weather events do have important short-term effects on economic conditions. And in assessing current economic conditions, such as our published statistics on industrial production, we take into account information on the severity of weather events. For example, we relied on information from the Federal Emergency Management Agency and the Department of Energy to gauge the disruptions to oil and gas extraction, petroleum refining, and petrochemical and plastic resin production caused by last fall's hurricanes. Likewise, we frequently use daily measures of temperatures and snowfall at weather stations throughout the country from the NOAA to assess the short-run economic impact associated with unusually large snowfall events.

However, severe weather events are difficult to predict very far in advance. Moreover, the historical regularity has been that these type of events have not materially affected the business-cycle trajectory of the national economy, both because the disruptions to production have tended to be relatively short-lived and because such events tend to affect specific geographic areas rather than the United States as a whole. In contrast, monetary policy has broad-based effects on the U.S. economy and tends to influence macroeconomic conditions with a lag. As a result, monetary policy is not well suited to address the economic disruptions associated with severe weather events. That said, the most severe of these events have imposed a significant drain on public resources. If such events become much more frequent or more severe, the fiscal cost would likely mount, and that would be an important issue for the Congress to consider.

My staff is available to discuss these issues further if you would find that helpful.

2. There is currently $1.4 trillion in outstanding student loan debt, the highest category of consumer debt behind mortgages. It is also the most delinquent, with 11% of borrowers seriously delinquent or in default. The Federal Reserve Board of New York estimates this number is likely twice that rate, once borrowers who are in forbearance are taken into account. At the hearing, you agreed that student loan debt could create a drag on the economy as student loan debt continues to grow.

- **What indicators should we track to determine when student loan debt is starting to have a real impact on the economy?**
- **What are the ways in which student loan debt could hold back the economy and how much of an effect do you think it could have?**

Student loan debt can potentially hold back the economy through several mechanisms. First, high levels of student loan debt (and the financial burden associated with repaying such debt) may hold back student loan borrowers' savings and therefore affect decisions such as home purchases, investment, marriage, and starting a family. Second, high levels of student loan debt may increase debt-to-income ratios or reduce credit scores, leaving some borrowers with more limited access to mortgage, auto, and credit card loans. In addition, unlike other types of household debt, student loans are not dischargeable in bankruptcy, which can make these loans more burdensome in times of financial hardship. Third, if student loan debt becomes exceedingly burdensome, students may be discouraged from taking loans to go to college, thereby dampening human capital accumulation in the economy.

One important caveat to underscore is that if student loan borrowers earn more over their lifetimes as a result of obtaining more education, student loans would likely help strengthen the economy, instead of holding it back.

Accordingly, there are several indicators one could track to gauge the possible impact of student loan debt on the economy. Such indicators include auto purchases, homeownership and household formation rates, as well as savings and investment behavior, especially among young adults with student loan debt. In addition, one could track the credit performance of student loan borrowers, not only on their student debt, but also on other types of debt.

3. So far, companies benefiting from the recent tax cuts have announced over $200 billion in stock buybacks. In contrast, companies have announced only $6 billion in worker bonuses and raises.

- **As far as possible investments go, do you think stock repurchases offer the greatest potential for boosting productivity and economic growth?**
- **How do they compare to investments in capital, innovation, or worker compensation in terms of the potential for increases in productivity and economic growth?**

- **If companies put the vast majority of their gains from the new tax law into stock repurchases, would you expect to see an increase in economic growth and wages from the tax law?**

Investments in new capital equipment or innovative technologies are important factors for improving productivity and economic growth. Similarly, increased worker compensation can be a factor in encouraging individuals to join or remain in the labor force and to develop new skills, which can further increase productivity and growth. Comparing the economic effects of these investments to the eventual effects of stock buybacks is difficult because we cannot be sure where the gains from buybacks will ultimately turn up. When a company buys back its shares or pays higher dividends, the resources do not disappear. Rather, they are redistributed to other uses in the economy. For instance, shareholders may decide to invest the windfall in another company, which may in turn make productivity-enhancing investments. Or they may decide to spend the windfall on goods and services that are produced by other companies, who may in turn hire new workers. In these ways, stock repurchases would also be likely to boost economic growth.

Companies themselves are the best judges of what to do with their after-tax profits, whether it is to invest in their business, raise worker compensation, or increase returns to shareholders through dividends or share buybacks.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
March 1, 2018

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States on behalf of Senator Brian Schatz:</u>

I would like to follow up on our ongoing conversation on the economic impacts of climate change. I understand that the Federal Reserve's mandate and tools are entirely focused on monetary policy. However, the Federal Reserve's implementation of monetary policy is informed by its assessment of the U.S. economy, including future economic trends and risks. According to your answer to a question I posed during your confirmation, your position is that the Federal Reserve is only concerned with "short and medium term developments that may change materially over quarters and a relative small number of years, rather than the decades associated with the pace of climate change."

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Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
March 1, 2018

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- If companies put the vast majority of their gains from the new tax law into stock repurchases, would you expect to see an increase in economic growth and wages from the tax law?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

June 27, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2 through 7 that you submitted following the March 1, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On May 4, 2018, I provided responses to question 13 and 15. Additionally, on April 24, 2018, I provided responses to questions 1, 8 through 12, and 14. Copies of all responses have also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on March 20, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Cortez Masto:</u>

2. I appreciated your statements opposing discrimination in mortgage lending during your testimony. However, I remain concerned that if the Economic Growth, Regulatory Relief, and Consumer Protection Act, (S. 2155), becomes law the Federal Reserve will not have adequate information on the quality of mortgage loans made by 85% of the banks and credit unions in the U.S. At the hearing, you told me the Federal Reserve relies primarily on historical Home Mortgage Disclosure Act data but that data does not include specific information on mortgage loan quality or borrower characteristics. In the run up to the Financial Crisis, the Federal Reserve and other regulators missed rampant discrimination in the mortgage market; African Americans and Latinos were more than twice as likely as a white family to receive a subprime mortgage. Even if Latinos and African Americans had higher incomes and credit scores, they still received worse loans.

The Federal Reserve has oversight authority of banks with fewer than $10 billion in assets.

- **How will you ensure that those banks are not engaged in redlining or other types of discrimination if you do not have information about the loan characteristics, the borrower's credit score or other information in the expanded HMDA requirements?**

With respect to fair lending, the Fair Housing Act (FHA) and Equal Credit Opportunity Act are critical to ensuring consumers are treated fairly when offered financial products and services. Discrimination has no place in a fair and transparent marketplace. Discriminatory practices can close off opportunities and limit consumers' ability to improve their economic circumstances, including through access to homeownership and education.

The Federal Reserve's fair lending supervisory program reflects our commitment to promoting financial inclusion and ensuring that the financial institutions under our jurisdiction fully comply with applicable federal consumer protection laws and regulations. For all state member banks, we enforce the FHA, which means we review all Federal Reserve-regulated institutions for potential discrimination in mortgages, including potential redlining, pricing, and underwriting discrimination. For state member banks of $10 billion dollars or less in assets, we also enforce the Equal Credit Opportunity Act, which means we review these state member banks for potential discrimination in any credit product. Together, these laws prohibit discrimination on the basis of race, color, national origin, sex, religion, marital status, familial status, age, handicap/disability, receipt of public assistance, and the good faith exercise of rights under the Consumer Credit Protection Act (collectively, the "prohibited basis").

We evaluate fair lending risk at every consumer compliance exam based on the risk factors set forth in the interagency fair lending examination procedures. The procedures include risk factors related to potential discrimination in redlining, pricing, and underwriting. While we find that the vast majority of our institutions comply with the fair lending laws, we are committed to identifying and remedying violations when they have occurred. Pursuant to the Equal Credit Opportunity Act, if we determine that a bank has engaged in a pattern or practice of discrimination, we refer the matter to the U.S. Department of Justice (DOJ). Federal Reserve referrals have resulted in DOJ public actions in critical areas, such as redlining and mortgage-pricing discrimination. For example, in our redlining referrals, the Federal Reserve found that the banks treated majority-minority areas less favorably than non-minority areas, such as through Community Reinvestment Act (CRA) assessment-area delineations, branching, lending patterns, and marketing. For our mortgage-pricing discrimination referrals, the Federal Reserve found that the banks charged higher prices to African American or Hispanic borrowers than they charged to similarly-situated non-Hispanic white borrowers and that the higher prices could not be explained by legitimate pricing criteria.[1]

We also work proactively to support financial institutions in their efforts to guard against fair lending risks through outreach efforts that actively promote sound compliance management practices and programs. The outreach efforts include *Consumer Compliance Outlook*, a widely-subscribed Federal Reserve System publication focused on consumer compliance issues, and its companion webinar series, *Outlook Live*.[2] For example, in 2017, we sponsored an interagency webinar on fair lending supervision with almost 6,000 registrants. Several of the webinars and articles described the key risk factors related to redlining and pricing discrimination, as well as information about what banks should do to mitigate those risks.

With respect to potential discrimination in the pricing or underwriting mortgages, if warranted by risk factors, the Federal Reserve will request data beyond the public Home Mortgage Disclosure Act (HMDA) data, including any data related to relevant pricing or underwriting criteria, such as applicant interest rates and credit scores. The analysis then incorporates the additional data to determine whether applicants with similar characteristics received different pricing or underwriting outcomes on a prohibited basis (for example, on the basis of race), or whether legitimate pricing or underwriting criteria can explain the differences.[3]

With respect to potential redlining discrimination, the current data analysis does not rely on an evaluation of the additional data fields, but rather the number of HMDA mortgage applications and originations generated in majority-minority tracts by the bank and similar lenders. More specifically, the analysis reviews whether the bank's record of HMDA mortgage applications

[1] See, e.g., DOJ public fair lending settlements with Midwest BankCentre; SunTrust Mortgage Inc.; and Countrywide Financial Corporation. The public actions were based on referrals from the Federal Reserve, and can be found at: https://www.justice.gov/crt/housing-and-civil-enforcement-section-cases-1#lending. More information about recent referrals to the DOJ can be found in the Federal Reserve's annual report at www.federalreserve.gov/publications/2016-ar-consumer-and-community-affairs.htm#14890.

[2] See https://www.consumercomplianceoutlook.org/ and https://www.consumercomplianceoutlook.org/outlook-live/.

[3] A recent study of publicly-available HMDA data conducted by The Center for Investigative Reporting and published by Reveal News concluded that African Americans, Latinos, and other individuals of color were more likely to be denied loans for home purchases and home remodeling than white borrowers. See Aaron Glantz and Emmanuel Martinez, "Kept Out," Reveal News, Feb. 15, 2018, available at: https://www.revealnews.org/article/for-people-of-color-banks-are-shutting-the-door-to-homeownership/. Studies such as these put much-needed focus on racial disparities and Federal Reserve staff carefully review them. However, as noted, HMDA data have limitations. These data do not include important underwriting criteria, such as credit scores and loan-to-value ratios. If concerns arise regarding a Federal Reserve-regulated institution, we will request additional data beyond the publicly-available HMDA data to fully evaluate whether applicants with similar characteristics received different underwriting outcomes on a prohibited basis (for example, on the basis of race), or whether legitimate underwriting criteria can explain the differences.

and originations in majority-minority tracts[4] shows statistically significant disparities when compared with the lending record of similar lenders. Thus, although additional fields from the exempted institutions could enhance the data analysis, provisions in the recently enacted bill, S.2155, related to HMDA data collection requirements would not impact the Federal Reserve's ability to fully evaluate the risk of redlining discrimination. Moreover, as explained further below, the data analysis is only one aspect of the redlining analysis.

3. Historical HMDA data does not collect information on certain racial and ethnic populations at a finer level of granularity. For instance, expanded HMDA requirements that would be rolled back by S. 2155 require reporting within the Asian community (Asian Indian, Chinese, Filipino, Japanese, Korean, and Vietnamese, among others) and within the Hispanic or Latino communities (Mexican, Puerto Rican, among Cuban, among others).

- **How will you monitor and ensure that banks are not engaged in redlining specifically against some of these subgroups without collecting this data?**
- **With historic HMDA data only, do you have the capacity to discern whether lenders are charging single female borrowers higher interest rates or more expensive points and fees on mortgages compared to single men?**

Consistent with the interagency fair lending examination procedures, the Federal Reserve's redlining review evaluates whether the bank treated majority-minority census tracts less favorably with respect to the following risk factors:

- CRA assessment area,
- branching strategy,
- lending record for HMDA-reportable mortgage applications and originations,
- marketing and outreach, and
- complaints.

With respect to the lending record, the data analysis reviews the HMDA-reportable mortgage applications and originations generated in majority-minority census tracts. The definition of majority-minority tract is based on the census data classifications for the race and/or ethnicity of the residents of the census tract, rather than on HMDA data classifications. Thus, although the additional data fields from the exempted institutions could enhance the data analysis, provisions in the recently enacted bill, S.2155, related to HMDA data collection requirements would not impact the Federal Reserve's ability to fully evaluate the risk of redlining discrimination.

Also consistent with the interagency fair lending examination procedures, the Federal Reserve's pricing review evaluates the following key risk factors:

- financial incentives to charge higher prices,
- loan originator discretion to determine pricing criteria and set the price,
- disparities in pricing on a prohibited basis, and

[4] Majority-minority tracts are defined as census tracts that are more than 50 percent African American and Hispanic.

- complaints.

The analysis of potential pricing disparities includes the review of potential disparities in the annual percentage rate, interest rate, and fees. Although not included in the public HMDA data, if warranted by risk factors, the Federal Reserve will request these data as well as any other data related to relevant pricing criteria, such as the interest rate and credit score.
Also, the Federal Reserve analyzes the disparity on a prohibited basis, including potential discrimination for single females. The current HMDA data classifications allow for an analysis of potential discrimination against single females. Thus, provisions in the recently enacted bill, S.2155, related to HMDA data collection requirements would not impact the Federal Reserve's ability to fully evaluate the risk of mortgage pricing discrimination, including for single females.

Please also see the response to question 2.

4. In your testimony, you stated that data collected under HMDA's original requirements was adequate for the Federal Reserve when examining financial institutions for compliance with the Community Reinvestment Act. Wall Street Reform's expansion of HMDA requirements included a number of critical requirements that were motivated by the financial crisis, including quality of loan, interest rate and providing the legal entity identifier (LEI) of the lender.

- **Without the expanded requirements under Wall Street Reform, how is the Federal Reserve examining the quality of the loans being given to borrowers, particularly female borrowers and borrowers of color?**

To determine the risk of potential pricing or underwriting discrimination in mortgages on a prohibited basis (such as, sex, race, color, or national origin), the Federal Reserve evaluates state member banks for compliance with the FHA (and the Equal Credit Opportunity Act for state member banks with $10 billion or less in assets). Although not included in the public HMDA data, if warranted by risk factors, the Federal Reserve will request any data related to relevant pricing and underwriting criteria, such as the interest rate and credit score. Thus, provisions in the recently enacted bill, S.2155, related to HMDA data collection requirements for certain institutions would not impact the Federal Reserve's ability to fully evaluate the risk of mortgage pricing or underwriting discrimination, including for female borrowers or borrowers of color.

While we find that the vast majority of institutions regulated by the Federal Reserve comply with the fair lending laws, we sometimes find violations of the laws and regulations. If we determine that a bank has engaged in a pattern or practice of discrimination, we refer the matter to the DOJ, pursuant to the Equal Credit Opportunity Act. We also take evidence of discrimination into account when assigning consumer compliance ratings and CRA ratings, consistent with regulations and supervisory guidance.

Please also see the response to questions 2 and 3.

5. Wall Street Reform also expanded on requirements when reporting ethnicity. For example, for Asian American Pacific Islander, lenders should also provide an ethnic breakdown.

- **Without this specific data on race and ethnicity, will the Federal Reserve be able to identify discrimination against specific ethnic groups, such as Filipino or Hmong?**

Reviews of potential pricing or underwriting discrimination based on the race or ethnicity of the borrower may be impacted by HMDA data classifications, but other risk factors can be used to evaluate potential discrimination, such as loan policies and procedures, marketing, and complaints.

Please also see the response to question 2.

6. A 2014 analysis of OneWest Bank-- which was then owned by Treasury Secretary Steve Mnuchin-- found that the Bank had a "low satisfactory" on its last CRA evaluation; that only 15% of the banks' branches were located in low- and moderate-income census tracts; and that the majority of "small business" loans made by OneWest were to businesses with more than $1 million in revenue.

- **What recourse does the Community Reinvestment Act give to the Federal Reserve and other regulators when banks have this kind of record?**
- **How can banks that consistently receive low ratings for their lending to small businesses and communities of color be better incentivized to improve their record?**

The CRA regulations define the ratings and recognize that a "low satisfactory" rating under the CRA lending test and/or service test is indicative of "adequate" performance in responding to the credit needs in its assessment areas(s), taking into account the number and amount of home mortgage, small business, small farm, and consumer loans, as well as an adequate geographic distribution of loans in its assessment area(s).

The CRA ratings are publicly available, which motivates some institutions to seek to improve their rating. Regulators encourage and support banks in this aim by pointing out ways they can improve their CRA performance, which would meet supervisory expectations and enhance how their record is viewed by the public. Further, an overall CRA rating of less than satisfactory can be an impediment to favorable action on an application or notice submitted to the Federal Reserve.

7. I agree with you that sound data is critically important in informing the policy and enforcement decisions you'll be making. However, I am very concerned that such analysis fails to capture the human and economic cost of massive financial system failure. For example, in 2009, when I was Attorney General, Nevada had 165,983 people unemployed. Also that year, in a state of 3 million people, we had 28,223 personal bankruptcies, 366,606 mortgage delinquencies and 421,445 credit card delinquencies.[5] In addition, 121,000 Nevada children's lives and educations were disrupted by the foreclosure crisis. And, we had more than 219,000 foreclosures between 2007-2016.

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[5] See Center for American Progress. "10 Years Later: The Financial Crisis State by State." February 22, 2018. Available at: https://www.americanprogress.org/issues/economy/news/2018/02/22/447031/10-years-later-financial-crisis-state-state/.

- **Do you agree the Fed underestimated the human costs of the financial crisis prior to 2008?**

The recent financial crisis took a devastating toll on consumers, families, and businesses, as well as revealing weaknesses in our financial system. The fragilities that arose in the U.S. financial system by the mid-2000s resulted in the worst U.S. recession since the Great Depression and a painfully slow economic recovery.

We have worked hard in the aftermath of the crisis to make sure we have a financial system that is safer, sounder, has more capital, higher quality capital, and is less prone to crises. Financial crises are immensely costly to the well-being of households, families, individuals, and businesses. It is important to make sure we do everything we can to reduce the odds of another devastating crisis.

- **How will your analysts accurately ensure you'll get it right this time?**

The Federal Reserve has substantially increased its efforts to assess risks to financial stability on an ongoing basis, in conjunction with other U.S. agencies (through, for example, discussions at the Financial Stability Oversight Council). These efforts may provide insight into the buildup of risks and allow the appropriate regulatory agencies to take steps to mitigate risks to financial stability.

At the same time, we are aware of the challenges facing anyone trying to predict rare events such as financial crises. In part because of these challenges, the Federal Reserve has focused on increasing the resilience of the financial system, so that when detrimental, unforeseen events occur, the system absorbs, rather than amplifies, them. An important part of increased resilience is a set of higher standards for key institutions. These standards are higher for the largest, most systemic firms and include capital regulation, liquidity regulation, steps to enhance the resolvability of large bank-holding companies, and stress testing of large bank-holding companies.

We have implemented these standards as a response to the increased awareness among economists of the risks and costs of financial crises. Research, including research by staff within the Federal Reserve System, has documented the large adverse effects of financial crises and the benefits associated with regulatory standards that raise the resilience of the financial system.[6]

- **What concerns do you have that cost-benefit analysis requirements allow financial institutions the ability to sue regulators to avoid regulation?**

The Federal Reserve Board (Board) takes seriously the importance of evaluating the costs and benefits of its rulemaking efforts.

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[6] For example, the following research paper discusses these issues and related research: Firestone, Simon, Amy Lorenc, and Ben Ranish (2017). "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US," Finance and Economics Discussion Series 2017-034. Board of Governors of the Federal Reserve System (U.S.).

Under the Board's current practice, consideration of costs and benefits occurs at each stage of the rule or policymaking process. Before the Board develops a regulatory proposal, the Board often collects information directly from parties that it expects will be affected by the rulemaking through surveys of affected parties and meetings with interested parties and their representatives. In the rulemaking process, the Board also specifically seeks comment from the public on the costs and benefits of the proposed approach as well as on a variety of alternative approaches to the proposal. In adopting the final rule, the Board seeks to adopt a regulatory alternative that faithfully reflects the statutory provisions and the intent of Congress while minimizing regulatory burden. The Board also provides an analysis of the costs to small depository organizations of our rulemaking consistent with the Regulatory Flexibility Act and computes the anticipated cost of paperwork consistent with the Paperwork Reduction Act. Increasingly, the Board has published quantitative analyses in connection with its rulemakings. Recent examples include the global systemically important banks surcharge rule, the single-counterparty credit limit rule, and the long-term debt rule. To further these efforts, the Board recently established an office and hired additional staff to focus on analyzing the costs and benefits associated with its rulemakings.

The Administrative Procedure Act (APA), which the Board follows, provides for judicial review of final regulations. Affected firms have the right to challenge the actions of an administrative agency under the APA, including whether the agency has engaged in reasoned decision making. Litigation, of course, imposes certain costs on the litigants including an agency and delays the rulemaking process.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

May 4, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 13 and 15 that you submitted following the March 1, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On April 24, 2018, I provided responses to questions 1, 8 through 12, and 14. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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[1] Questions for the record related to this hearing were received on March 20, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Cortez Masto:</u>

13. For years, many of my colleagues have suggested that the Fed is unfairly hurting savers through low interest rates. On the subject of seniors, savers, and depositors, I want to ask about a proposal by a nominee to the Board of Governors, Marvin Goodfriend. For decades, Mr. Goodfriend promoted the Fed to incentivize spending by placing a tax on currency. He does admit that "the regressivity of the tax" is a concern.

- **If Mr. Goodfriend's proposal were to be implemented, can you estimate what the impact would be on savers and low-income depositors?**

Nominations to serve on the Board of Governors are made by the President and require consent of the Senate. It is up to the President and Senate to evaluate the views and qualifications of potential members of the Board. I do not want to comment on a specific nominee.

The Federal Reserve has not considered and is not planning to consider a tax on U.S. currency. Our nation's currency plays an important role as a means of payment and store of value worldwide and taking any action that could diminish its role in the domestic or global economy would need to be very carefully thought through after a thorough review and analysis of relevant data.

15. In recent years, Federal Reserve policymakers have warned that we should raise interest rates to counter asset bubbles destabilizing the financial system. Board of Governor nominee Marvin Goodfriend has suggested replacing liquidity coverage ratios and a host of other regulations with tighter monetary policy.

- **Do you believe that the blunt tool of monetary policy can be a substitute for sound financial protections? What is your reading of the historical evidence surrounding the relationship between monetary policy and asset bubbles?**

As stated above, it is up to the President and Senate to evaluate the views and qualifications of potential members of the Board. I do not want to comment on a specific nominee.

Strong regulatory and supervisory standards are critical for financial stability. In the years leading up to 2007-2008, excessive leverage and maturity transformation left the U.S. and global economy vulnerable to a deterioration in the U.S. housing market and an increase in investor concerns regarding the solvency and liquidity of large, interconnected financial institutions. Reforms since that time, enacted by Congress and implemented by the appropriate agencies, have raised loss-absorbing capacity within the financial sector and reduced the susceptibility of the financial system to destabilizing runs. Monetary policy, already tasked with the goals of price stability and full employment, should not be considered a substitute for strong financial and supervisory standards. Moreover, asset-price swings owe to many factors, and monetary policy has not generally been a prime factor in historical episodes involving large movements in asset prices.

- **Besides monetary policy, what other tools are available to temper asset bubbles?**

It is difficult to identify whether an asset price has reached an unsustainably high (or low) level. For this reason, it is important to monitor asset price developments and to consider whether, for example, unusually rapid increases in asset prices are leading to vulnerabilities in the U.S. economy that could jeopardize financial stability, price stability, or full employment. If a rapid increase in nonfinancial borrowing, leverage in the financial sector, or maturity transformation accompanied a rapid rise in asset prices, tools aimed directly at mitigating such vulnerabilities could be appropriate. For example, the Countercyclical Capital Buffer is a regulatory tool that requires the largest, most systemic bank-holding companies to build additional loss absorbing capacity when the Board identifies a need for such additional resilience.

However, the difficulties associated with the detection of vulnerabilities as they emerge highlight the need for strong regulatory and supervisory standards at all times. The capital and liquidity regulations and supervisory policies adopted by the Federal Reserve, including stress testing, represent such an approach to maintaining resilience at a level that limit excessive risk.

- **Isn't it true that countries with tighter monetary policy than the United States also experienced housing bubbles in the early 2000s?**

The housing boom during the early 2000s was global in nature, with house prices rising across most advanced economies. Although the availability of mortgage financing at favorable rates coincided with strong housing markets in some countries, there were particularly rapid house price gains in several economies whose key monetary policy rates never declined below 3½ percent, including Australia, New Zealand, Norway, and the United Kingdom. Each of those economies experienced house price declines, to varying degrees of severity, during the global financial crisis that followed. Subsequent studies, including at the International Monetary Fund, have found that the stance of monetary policy is not generally a good leading indicator of future house price bubbles and busts.

- **Can you speak to the scale of interest rate increases that would be needed to rein in an asset bubble?**

As noted in the second answer to question 15, it is difficult to detect whether an asset price has reached an unsustainable level. A corollary of this challenge is that it is hard to determine what factors are driving unsustainable asset-price movements. The condition of markets is one of many factors that could influence the underlying economy, but efforts to influence asset prices in a manner that is not consistent with the Federal Reserve's employment and price-stability objectives could compromise the achievement of those objectives.

Board of Governors of the Federal Reserve System
Washington, D. C. 20551

Jerome H. Powell
Chairman

April 24, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1, 8 through 12, and 14 that you submitted following the March 1, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on March 20, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Cortez Masto:

1. The Federal Reserve has the responsibility for monetary policy. The Congress has the responsibility for fiscal policy. In the past few months, Congress spent more than a trillion dollars. The majority did not spend it on investments to build our outdated bridges, roads or electrical grids. The majority did not spend it on transit to reduce gridlock and reduce pollution and improve our air quality. The trillions of dollars did not provide housing for families struggling to pay rent. Or subsidies to help parents afford the cost of child care. Nor did we invest in pre-K education. Or research and development.

Instead, multi-national corporations will see their incomes go up substantially: Warren Buffet's Berkshire Hathaway will make $29 billion more in profit. The seven largest banks will increase their income by twelve percent or more. Meanwhile, some families will see big tax increases because they can't deduct their alimony payments or all of their property and state income taxes.

Our national debt is already twice the historic average and higher than it has been at any time in history since World War II. Today, it consumes more than 77 percent of the economy. The President's proposed budget would increase that level to as much as 93 percent of our entire economy by 2028 according to the Committee for a Responsible Federal Budget.

- **If we had chosen to invest $1.5 - $2.3 trillion in rebuilding our infrastructure, investing in research and development and in our children and families, what is the Federal Reserve's estimates of the effect on wages, productivity and economic growth?**

The Federal Reserve has not prepared an estimate of the economic effects of a large investment of the kind that you describe. Any such estimate would depend critically on the particular assumptions one made about the allocation of the investment among the purposes that you describe, as well as the efficiency with which investments could be targeted to high-rate-of-return projects. The Congressional Budget Office is well situated to provide economic analysis of this kind.

8. I am very concerned about forcing more than 800,000 men and women – Dreamers -- out of the country. It is a cruel betrayal of the promises we've made to them. In Nevada, we have more than 13,000 Dreamers. If our neighbors, friends and colleagues are deported, some estimate that Nevada would lose more than $600 million in annual economic growth.

- **Organizations, on both sides of the spectrum, estimate that detaining and deporting DACA recipients could cost the U.S. economy between $280 and $460 billion a year. The United States Chamber of Commerce called ending DACA "a nightmare for America's economy."**
- **Has the Federal Reserve published any information on how the deportation of the Dreamers will affect our nation's economy?**

- **What do you think the economic impact of deporting 800,000 Dreamers – 90% or about 720,000 of whom are employed -- would be on labor force participation, economic growth and productivity?**

Over long periods of time, economic growth generally reflects the trend rate of growth of the population, the trend in labor force participation, and the trend in productivity growth. A large deportation of individuals currently living in the United States would probably reduce the level of economic output, for the simple reason that the population--and hence the workforce--would be smaller. That being said, the Federal Reserve has not published information pertaining to your questions. The manner in which economic output *per capita* would be affected is a more difficult question; the answer would depend on such factors as how the labor-force participation of the deported individuals compared with that of the remaining population; how the productivity of the deported individuals compared with that of the remaining population; and the question of whether problems of job matching would arise (if, for example, deported individuals were concentrated in particular industries, occupations, or geographic areas, and whether non-deported individuals were available and willing to fill the resulting vacancies).

9. Neel Kashkari, the President of the Federal Reserve Bank of Minneapolis recently wrote an op-ed in the Wall Street Journal on why immigration is the key to economic growth. The Minneapolis Fed estimates that boosting legal immigration by one million people a year would grow the economy by at least 0.5% a year, even under the most conservative assumptions.

- **Do you agree with the President of the Federal Reserve of Minneapolis that increasing legal immigration will grow our economy?**

Growth in the labor force is an important determinant of the longer-run growth rate of the U.S. economy. Because many legal immigrants actively participate in the workforce, changes in the pace of immigration can affect economic growth. Having said that, however, the issue of immigration is well outside of the remit of the Federal Reserve System, and it would be more prudent for others to decide how best to address that issue.

10. I represent Nevada, which is within the San Francisco Federal Reserve District. We are one of the most diverse districts in the nation – with many Latino and Asian Pacific American families.

We value that diversity because it leads to innovation, economic growth and stronger connections with other nations in our globally-connected world.
A recent report by Fed Up, Working People Still Need a Voice at the Fed: 2018 Diversity Analysis of Federal Reserve Bank Directors, found that there is inadequate diversity at the Federal Reserve. It specifically cited the San Francisco Federal Reserve as one of system's least diverse regional banks. The report states, "Despite covering some of the most demographically diverse counties in the United States, 100% of the San Francisco Fed's Board of Directors come from the banking and financial sector. The directors are 78% white and 78% male."

- **How will you work with Director Clark to improve the gender and racial diversity of the Board of Directors at the twelve regional Reserve Banks? And specifically the San Francisco Fed?**
- **How will you work to end the outsized representation and influence of the banking and business sectors among the Regional Bank Boards of Directors?**
- **Have you identified directors with non-profit, academic, and labor backgrounds that could also serve?**

Diversity is a critical aspect of all successful organizations, and I am committed to fostering diversity and inclusion throughout the Federal Reserve System. In my experience, we make better decisions when we have a wide range of backgrounds and voices around the table. I assure you that diversity is high priority objective for the Federal Reserve.

The Federal Reserve Board (Board) focuses particular attention on increasing gender, racial, and sector diversity among directors because we believe that the System's boards function most effectively when they are constituted in a manner that encourages a variety of perspectives and viewpoints. Monetary policymaking also benefits from having directors who effectively represent the communities they serve because we rely on directors to provide meaningful grassroots economic intelligence. Because all directors serve in this role, we believe it is important to consider the characteristics of both Reserve Bank and Branch boards.

Each year, the Board carefully reviews the demographic characteristics of Reserve Bank and Branch boards. This information is shared with Reserve Bank leadership, including the current Chair and Deputy Chair of each board, and areas for improvement are highlighted.

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

Although there is room for improvement, the System has made significant progress in recent years in recruiting highly qualified women and minorities for director positions. For example, in 2018, approximately 56 percent of all System directors are diverse in terms of gender and/or race (with a racially diverse woman counted only one time), which represents a 16 percentage point increase in the share of directors since 2014. With respect to the San Francisco District, 21 of 37 directors, or approximately 57 percent of all Reserve Bank and Branch directors, are diverse. On the Reserve Bank's head-office board, 4 of 9 directors, or approximately 44 percent of Reserve Bank directors, are diverse. We also have numerous directors who represent consumer/community and labor organizations serving on boards throughout the System. In addition, we gain invaluable insight and perspective from directors who are affiliated with other types of organizations, including major health care providers, universities and colleges, and regional chambers of commerce, among others.

11. Chair Yellen was the first chair in Federal Reserve history to share data with this committee about racial economic disparities during her semi-annual testimony. When she presented that data, she touted significant progress, and indeed, black unemployment fell from 11.8% at the beginning of her term to the current historically low figure of 6.8%.

- **What do you attribute this trend to?**
- **Do you think the attention that Chair Yellen paid to this issue and the policies of the Federal Reserve deserve some credit for the progress that has been made?**

The improvement in the black unemployment rate in recent years reflects the general strengthening in labor-market conditions during that time period; and the credit for the general strengthening, in turn, goes to the millions of individuals who go to work day in and day out and work hard, and to those who run businesses, take risks, and generate creative new ideas and new products.

Chair Yellen deserves great credit for shining light on the important differences in economic well-being across different segments of the population; I intend to continue that practice. As a nation, we have a long way to go before we will have achieved the objective of full economic inclusion of all segments of the population.

12. At that same testimony where Janet Yellen presented information about racial economic disparities, she said, quote "it is troubling that unemployment rates for these minority groups remain higher than for the nation overall, and that the annual income of the median African-American household is still well below the median income of other U.S. households."

Though African American unemployment is lower today, Chair Yellen's point remains true.

- **Do you think the recent progress is sufficient?**
- **What more can be done to ensure that unemployment among African Americans is equal to white unemployment?**
- **And, how do you plan to respond to reports that African Americans with a college degree have lower employment and wealth than whites with the less education? African American women and Latinos are graduating from college in record numbers but are still having a harder time finding a job.**

I do not think that recent progress has been sufficient. As I noted earlier, we have a long way to go before we will have achieved the objective of full economic inclusion of all segments of the population. The steps that will be necessary to attain full economic inclusion span virtually the entire spectrum of economic policy areas. These are important issues for Congress' consideration.

14. Chair Powell, at your nomination hearing, you told me that you supported strong consumer protections. Since that time, the Consumer Financial Protection Bureau has endured new leadership that is hostile to its mission.

- **If the Bureau continues to drop lawsuits against predatory online loan companies, like Golden Valley Lending or drop investigations against companies like World Acceptance Corporation, one of the biggest payday lenders, will the Federal Reserve's consumer protection staff pick up the slack and protect people from fraud and abuse?**
- **If the Consumer Financial Protection Bureau's leadership refuses to ask for adequate funding, will you let us know if predatory and deceptive practices start going unaddressed by a weaker Consumer Financial Protection Bureau?**
- **Has the Federal Reserve weighed in on the impact from the Consumer Bureau's decision to weaken fair lending enforcement, suspend the civil penalties fund and stop investigating the hack of 145 million people's information held by Equifax?**
- **What have you shared with the leadership of the Bureau?**

While the Board plays a consultative role in CFPB rulemakings and coordinates in the examinations as appropriate, we do not have any oversight of the CFPB organizational or structural design, which is defined in statute, nor of CFPB enforcement priorities. By statute, the organizational structure and prioritization of the CFPB's fair lending work is up to the CFPB's director to decide.

For our part, the Federal Reserve continues to carry out our supervisory and enforcement responsibilities for the financial institutions and for the laws and regulations under our authority. We remain committed to ensuring that the financial institutions under our jurisdiction fully comply with all applicable federal consumer protection laws and regulations. For example, in the last few years, the Federal Reserve has addressed unfair and deceptive practices through public enforcement actions that have collectively benefited hundreds of thousands of consumers and provided millions of dollars in restitution. In addition, our examiners evaluate fair lending risk at every consumer compliance exam. Pursuant to the Equal Credit Opportunity Act, if we determine that a bank has engaged in a pattern or practice of discrimination, we refer the matter to the DOJ. Federal Reserve referrals have resulted in DOJ public actions in critical areas, such as redlining and mortgage-pricing discrimination.

With respect to the Equifax data breach, the Federal Reserve's authority is limited. The Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (agencies) have authority to examine and regulate bank service companies under the Bank Service Company Act (BSCA).[1] Additionally, the BSCA provides the agencies with limited authority to regulate and examine the activities of other firms that provide certain services to the institutions we supervise.[2] The three largest credit reporting agencies in the United States (Equifax, Experian, and TransUnion) are not owned by insured depository institutions and are

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[1] See 12 U.S.C. § 1867(a). A "bank service company" is defined as a company that is organized to provide services authorized under the BSCA and that is owned exclusively by one or more insured depository institutions. 12 U.S.C. § 1861(b)(2).

[2] Whenever an insured depository institution, or any subsidiary or affiliate of such insured depository institution, causes to be performed for itself services authorized under the BSCA, such performance is subject to regulation and examination to the same extent as if such services were being performed by the insured depository institution itself on its own premises.12 U.S.C. § 1867(c).

thus not bank service companies. Accordingly, any authority the agencies have under the BSCA with respect to the activities of these companies would arise under the BSCA in so far as insured depository institutions (or their subsidiaries or affiliates) are outsourcing services authorized under the BSCA. To date, none of the agencies has concluded that the credit reports that credit reporting agencies sell to the institutions we supervise are services within the scope of the BHCA.

However, the Federal Reserve expects financial institutions to follow vendor management guidance issued by the Board and the Federal Financial Institutions Examination Council, which includes conducting an assessment of the relationships with third parties and their handling and protection of sensitive personal information of individuals. As such, the Federal Reserve holds the institutions we supervise accountable for conducting appropriate due diligence and risk management with respect to their relationships with third-parties, including credit reporting agencies. Our examiners regularly assess banking organizations' programs for due diligence, contract management, ongoing monitoring, and overall risk management of third party and vendor relationships as part of Federal Reserve examinations. In addition, the Board, along with the other banking agencies and the Federal Trade Commission have jointly issued rules under the Fair Credit Reporting Act that require financial institutions to maintain identity theft prevention programs. These programs must include policies and procedures for detecting, preventing, and mitigating identity theft, and we examine the banks we supervise for compliance with these rules. Finally, under the Gramm-Leach-Bliley Act, the Board and other banking agencies have issued guidelines to institutions containing standards for safeguarding their customers' data.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
March 1, 2018

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States on behalf of Senator Catherine Cortez Masto:</u>

The Federal Reserve has the responsibility for monetary policy. The Congress has the responsibility for fiscal policy. In the past few months, Congress spent more than a trillion dollars. The majority did not spend it on investments to build our outdated bridges, roads or electrical grids. The majority did not spend it on transit to reduce gridlock and reduce pollution and improve our air quality. The trillions of dollars did not provide housing for families struggling to pay rent. Or subsidies to help parents afford the cost of child care. Nor did we invest in pre-K education. Or research and development.

Instead, multi-national corporations will see their incomes go up substantially: Warren Buffet's Berkshire Hathaway will make $29 billion more in profit. The seven largest banks will increase their income by twelve percent or more. Meanwhile, some families will see big tax increases because they can't deduct their alimony payments or all of their property and state income taxes.

Our national debt is already twice the historic average and higher than it has been at any time in history since World War II. Today, it consumes more than 77 percent of the economy. The President's proposed budget would increase that level to as much as 93 percent of our entire economy by 2028 according to the Committee for a Responsible Federal Budget.

- If we had chosen to invest $1.5 - $2.3 trillion in rebuilding our infrastructure, investing in research and development and in our children and families, what is the Federal Reserve's estimates of the effect on wages, productivity and economic growth?

I appreciated your statements opposing discrimination in mortgage lending during your testimony. However, I remain concerned that if the Economic Growth, Regulatory Relief, and Consumer Protection Act, (S. 2155), becomes law the Federal Reserve will not have adequate information on the quality of mortgage loans made by 85% of the banks and credit unions in the U.S. At the hearing, you told me the Federal Reserve relies primarily on historical Home Mortgage Disclosure Act data but that data does not include specific information on mortgage loan quality or borrower characteristics. In the run up to the Financial Crisis, the Federal Reserve and other regulators missed rampant discrimination in the mortgage market; African Americans and Latinos were more than twice as likely as a white family to receive a subprime mortgage. Even if Latinos and African Americans had higher incomes and credit scores, they still received worse loans.

The Federal Reserve has oversight authority of banks with fewer than $10 billion in assets.

- How will you ensure that those banks are not engaged in redlining or other types of discrimination if you do not have information about the loan characteristics, the borrower's credit score or other information in the expanded HMDA requirements?

Historical HMDA data does not collect information on certain racial and ethnic populations at a finer level of granularity. For instance, expanded HMDA requirements that would be rolled back by S. 2155 require reporting within the Asian community (Asian Indian, Chinese, Filipino, Japanese, Korean, and Vietnamese, among others) and within the Hispanic or Latino communities (Mexican, Puerto Rican, among Cuban, among others).

- How will you monitor and ensure that banks are not engaged in redlining specifically against some of these subgroups without collecting this data?

- With historic HMDA data only, do you have the capacity to discern whether lenders are charging single female borrowers higher interest rates or more expensive points and fees on mortgages compared to single men?

In your testimony, you stated that data collected under HMDA's original requirements was adequate for the Federal Reserve when examining financial institutions for compliance with the Community Reinvestment Act. Wall Street Reform's expansion of HMDA requirements included a number of critical requirements that were motivated by the financial crisis, including quality of loan, interest rate and providing the legal entity identifier (LEI) of the lender.

- Without the expanded requirements under Wall Street Reform, how is the Federal Reserve examining the quality of the loans being given to borrowers, particularly female borrowers and borrowers of color?

Wall Street Reform also expanded on requirements when reporting ethnicity. For example, for Asian American Pacific Islander, lenders should also provide an ethnic breakdown.

- Without this specific data on race and ethnicity, will the Federal Reserve be able to identify discrimination against specific ethnic groups, such as Filipino or Hmong?

A 2014 analysis of OneWest Bank-- which was then owned by Treasury Secretary Steve Mnuchin-- found that the Bank had a "low satisfactory" on its last CRA evaluation; that only 15% of the banks' branches were located in low- and moderate-income census tracts; and that the majority of "small business" loans made by OneWest were to businesses with more than $1 million in revenue.

- What recourse does the Community Reinvestment Act give to the Federal Reserve and other regulators when banks have this kind of record?

- How can banks that consistently receive low ratings for their lending to small businesses and communities of color be better incentivized to improve their record?

I agree with you that sound data is critically important in informing the policy and enforcement decisions you'll be making. However, I am very concerned that such analysis fails to capture the human and economic cost of massive financial system failure. For example, in 2009, when I was Attorney General, Nevada had 165,983 people unemployed. Also that year, in a state of 3 million people, we had 28,223 personal bankruptcies, 366,606 mortgage delinquencies and 421,445 credit card delinquencies.1 In addition, 121,000 Nevada children's lives and educations were disrupted by the foreclosure crisis. And, we had more than 219,000 foreclosures between 2007-2016.

- Do you agree the Fed underestimated the human costs of the financial crisis prior to 2008?

- How will your analysts accurately ensure you'll get it right this time?

- What concerns do you have that cost-benefit analysis requirements allow financial institutions the ability to sue regulators to avoid regulation?

I am very concerned about forcing more than 800,000 men and women – Dreamers -- out of the country. It is a cruel betrayal of the promises we've made to them. In Nevada, we have more than 13,000 Dreamers. If our neighbors, friends and colleagues are deported, some estimate that Nevada would lose more than $600 million in annual economic growth.

Organizations, on both sides of the spectrum, estimate that detaining and deporting DACA recipients could cost the U.S. economy between $280 and $460 billion a year. The United States Chamber of Commerce called ending DACA "a nightmare for America's economy."

- Has the Federal Reserve published any information on how the deportation of the Dreamers will affect our nation's economy?

- What do you think the economic impact of deporting 800,000 Dreamers – 90% or about 720,000 of whom are employed -- would be on labor force participation, economic growth and productivity?

Neel Kashkari, the President of the Federal Reserve Bank of Minneapolis recently wrote an op-ed in the Wall Street Journal on why immigration is the key to economic growth. The Minneapolis Fed estimates that boosting legal immigration by one million people a year would grow the economy by at least 0.5% a year, even under the most conservative assumptions.

- Do you agree with the President of the Federal Reserve of Minneapolis that increasing legal immigration will grow our economy?

I represent Nevada, which is within the San Francisco Federal Reserve District. We are one of the most diverse districts in the nation – with many Latino and Asian Pacific American families.

[1] Center for American Progress. *"10 Years Later: The Financial Crisis State by State."* February 22, 2018. Available at: https://www.americanprogress.org/issues/economy/news/2018/02/22/447031/10-years-later-financial-crisis-state-state/

We value that diversity because it leads to innovation, economic growth and stronger connections with other nations in our globally-connected world.

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

- How will you work with Director Clark to improve the gender and racial diversity of the Board of Directors at the twelve regional Reserve Banks? And specifically the San Francisco Fed?

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

- Have you identified directors with non-profit, academic, and labor backgrounds that could also serve?

Chair Yellen was the first chair in Federal Reserve history to share data with this committee about racial economic disparities during her semi-annual testimony. When she presented that data, she touted significant progress, and indeed, black unemployment fell from 11.8% at the beginning of her term to the current historically low figure of 6.8%.

- What do you attribute this trend to?

- Do you think the attention that Chair Yellen paid to this issue and the policies of the Federal Reserve deserve some credit for the progress that has been made?

At that same testimony where Janet Yellen presented information about racial economic disparities, she said, quote "it is troubling that unemployment rates for these minority groups remain higher than for the nation overall, and that the annual income of the median African-American household is still well below the median income of other U.S. households."

Though African American unemployment is lower today, Chair Yellen's point remains true.

- Do you think the recent progress is sufficient?

- What more can be done to ensure that unemployment among African Americans is equal to white unemployment?

- And, how do you plan to respond to reports that African Americans with a college degree have lower employment and wealth than whites with the less education? African

American women and Latinos are graduating from college in record numbers but are still having a harder time finding a job.

For years, many of my colleagues have suggested that the Fed is unfairly hurting savers through low interest rates. On the subject of seniors, savers, and depositors, I want to ask about a proposal by a nominee to the Board of Governors, Marvin Goodfriend. For decades, Mr. Goodfriend promoted the Fed to incentivize spending by placing a tax on currency. He does admit that "the regressivity of the tax" is a concern.

- If Mr. Goodfriend's proposal were to be implemented, can you estimate what the impact would be on savers and low-income depositors?

Chair Powell, at your nomination hearing, you told me that you supported strong consumer protections. Since that time, the Consumer Financial Protection Bureau has endured new leadership that is hostile to its mission.

- If the Bureau continues to drop lawsuits against predatory online loan companies, like Golden Valley Lending or drop investigations against companies like World Acceptance Corporation, one of the biggest payday lenders, will the Federal Reserve's consumer protection staff pick up the slack and protect people from fraud and abuse?

- If the Consumer Financial Protection Bureau's leadership refuses to ask for adequate funding, will you let us know if predatory and deceptive practices start going unaddressed by a weaker Consumer Financial Protection Bureau?

- Has the Federal Reserve weighed in on the impact from the Consumer Bureau's decision to weaken fair lending enforcement, suspend the civil penalties fund and stop investigating the hack of 145 million people's information held by Equifax?

- What have you shared with the leadership of the Bureau?

In recent years, Federal Reserve policymakers have warned that we should raise interest rates to counter asset bubbles destabilizing the financial system. Board of Governor nominee Marvin Goodfriend has suggested replacing liquidity coverage ratios and a host of other regulations with tighter monetary policy.

- Do you believe that the blunt tool of monetary policy can be a substitute for sound financial protections? What is your reading of the historical evidence surrounding the relationship between monetary policy and asset bubbles?

- Besides monetary policy, what other tools are available to temper asset bubbles?

- Isn't it true that countries with tighter monetary policy than the United States also experienced housing bubbles in the early 2000s?

- Can you speak to the scale of interest rate increases that would be needed to rein in an asset bubble?

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510-6075

March 20, 2018

The Honorable Jerome H. Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Gov. Powell:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs on March 1, 2018 at our hearing entitled, *"The Semiannual Monetary Policy Report to the Congress."* In order to complete the hearing record, we would appreciate your answers to the enclosed questions as soon as possible. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo

Mike Crapo
Chairman

MC/dr

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

April 13, 2018

The Honorable Tim Scott
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the March 1, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on March 20, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Scott:</u>

1. Unemployment is at 4.1%. Wages are up 2.9% compared to a year ago – that's the biggest hike since June 2009. The economy's growing at a healthy rate – 3.2% during Q3 and 2.6% in Q4. Tax reform is going to boost that number back above 3%. Despite all the positive indicators, the market had several down days last month. Most of them were around your swearing in. If I look back at the recent past, the Federal Reserve and your predecessors have cited stock market volatility as a reason to not raise interest rates. The Fed backed down so many times that this became learned behavior: stock market volatility means no hike in interest rates. Congress says to seek maximum employment and stable prices... no more and no less. Please answer the following with specificity:

- **Is a rising stock market a pillar of monetary policy?**

My colleagues on the Federal Open Market Committee (FOMC) and I set monetary policy with the sole purpose of achieving and sustaining our statutory objectives of maximum employment and price stability. Because monetary policy affects the economy and inflation with a lag, we need to be forward looking in setting policy. That is why, each time the FOMC meets, we assess the implications of incoming information, including information about financial conditions broadly defined, for the economic outlook. Our current assessment, based on all available information, is that further gradual increases in our target for the federal funds rate will prove most appropriate for achieving and sustaining the objectives the Congress has assigned to the FOMC. We do not have a target for asset prices and we recognize that asset price fluctuations do not necessarily alter the economic outlook. Moreover, financial conditions are only one of many factors that can affect the outlook for the economy.

- **Has recent stock market volatility deterred you from your plan to raise rates later this year?**

After carefully considering all available information necessary to assess where the economy stood relative to the goals of maximum employment and price stability, and how it was likely to evolve, the FOMC concluded, on March 21, that it would be appropriate to raise the target range for the federal funds rate by a further 25 basis points. Moreover, FOMC participants generally saw the economic outlook as somewhat stronger than was the case in December, and continued to judge that further gradual increases in the federal funds rate are likely to be warranted if the economy continues to evolve as expected. Indeed most participants anticipated that, in light of the stronger outlook, the federal funds rate might rise slightly more, in coming years, than they had anticipated in December. Please bear in mind that we do not have a fixed plan for the path of the federal funds rate. We will be watching how the economy evolves in the months and years ahead relative to our maximum employment and price stability objectives. If the outlook changes, we will adjust monetary policy appropriately.

2. I sold insurance for over twenty years, and I've said it many times: our state-based system of insurance regulation is the best in the world. The President's Executive Order on financial regulation and other Administration reports favor a deferential approach by the Fed to working with primary financial regulators. When it comes to the business of

insurance that means state-based insurance regulators. Please answer the following with specificity:

- **How will you and the Federal Reserve integrate state-based insurance regulators into your work?**

The state-based system of insurance regulation provides an invaluable service in protecting policyholders. The Federal Reserve's principal supervisory objectives for all of the insurance holding companies that we oversee include protecting the safety and soundness of the consolidated firms and protecting any subsidiary depository institution, which encompasses protecting the depositors and taxpayer-backed deposit insurance fund. The Federal Reserve also undertakes supervision, through reporting, examination, and other engagement, of entities in an insurance enterprise that are not subject to financial regulation in order to protect against extant or emerging threats to the consolidated enterprise's safety and soundness.

The Federal Reserve's consolidated supervision thus is complementary to, and supplements, existing entity-level supervision by the primary functional regulators, with a perspective that considers the risks across the entire firm. We conduct our consolidated supervision of all insurance firms in coordination with state departments of insurance (DOIs), who continue their established oversight of the insurance subsidiaries. In order to maximize efficiencies and eliminate supervisory duplication or "layering," we rely upon the work and supervisory findings of the state DOIs to the greatest extent possible. We intend to continue to do so. Federal Reserve supervisors regularly meet, share supervisory information, and collaborate with state DOIs. We remain open to input from supervised firms, state DOIs, and other interested parties on how we can further tailor and better coordinate our supervision while achieving our supervisory objectives.

Moreover, in the ongoing development of a Federal Reserve capital standard for savings and loan holding companies significantly engaged in insurance activities (described as the Building Block Approach (BBA) in the Federal Reserve's advance notice of proposed rulemaking of June 2016), Federal Reserve staff have engaged, and continues to engage, with state regulators and the National Association of Insurance Commissioners in their development of the group capital calculation, a capital assessment that is structurally similar to the BBA. This ongoing dialogue aims to achieve harmonious frameworks to the greatest extent possible and minimize burden upon insurance firms supervised by both the states and Federal Reserve.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
March 1, 2018

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States on behalf of Senator Tim Scott:</u>

Unemployment is at 4.1%. Wages are up 2.9% compared to a year ago – that's the biggest hike since June 2009. The economy's growing at a healthy rate – 3.2% during Q3 and 2.6% in Q4. Tax reform is going to boost that number back above 3%. Despite all the positive indicators, the market had several down days last month. Most of them were around your swearing in. If I look back at the recent past, the Federal Reserve and your predecessors have cited stock market volatility as a reason to not raise interest rates. The Fed backed down so many times that this became learned behavior: stock market volatility means no hike in interest rates. Congress says to seek maximum employment and stable prices… no more and no less. Please answer the following with specificity:

- Is a rising stock market a pillar of monetary policy?

- Has recent stock market volatility deterred you from your plan to raise rates later this year?

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- How will you and the Federal Reserve integrate state-based insurance regulators into your work?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

April 24, 2018

The Honorable Ann Wagner
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions that you submitted following the February 27, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on March 27, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Representative Wagner:

1. Thank you, Chairman Powell.

In comments you made shortly after being sworn in as Chairman of the Federal Reserve, you noted that you were committed to "explaining what we're doing and why we are doing it (...) and will continue to pursue ways to improve transparency both in monetary policy and in regulation."

How much value to you place on being as transparent as possible, so that not only Congress, but the American people understand the decisions the Fed is making?

In 2012, the Fed dealt with a leak of confidential information relating to the deliberation of the Federal Open Markets Committee (FOMC). Information relating to the confidential documents and deliberations of the FOMC were obtained by a political intelligence firm, who shared the information in a newsletter to their clients. As you know, access to that information is valuable to markets and investors because the Fed does not make clear what it is likely to do in the future.

The leak has plagued two Fed Chairmen, and triggered an internal investigation and two Inspector General investigations, one of which that was conducted jointly with the FBI. The leaker of the information has not been found.

The Committee believes that a monetary policy rule would provide the public transparency into future monetary policy decisions, and eliminate the value of leaks.
Again, you have talked a lot about being transparent, but you are the new boss - what is going to change on the issues of securing confidential information and transparency to prevent this going forward?

Were you satisfied with how the leaker was dealt with?

Chairman Powell, the Fed is helping neither itself nor the economy here. When will the Board improve its internal governance so episodes like these don't repeat themselves?

The Congress established the Federal Reserve more than a century ago to provide a safer and more flexible monetary and financial system. The Federal Reserve is committed to transparency, which is important for any government institution. We are and should be accountable to the American people.

The need to be clear and transparent is a core principle of our approach to monetary policy, as well as our approach to regulatory and supervisory responsibilities. However, we would not be serving the goal of transparency about our conduct of monetary policy by setting the federal funds rate in a mechanistic way that would frequently be inconsistent with the achievement of our mandate. And of course transparency in supervision must balance the need to maintain confidentiality in the supervisory process.

I plan to continue our tradition of independence and nonpartisanship by fostering an environment that supports objective analysis and research, and promoting a culture in which policymakers express their viewpoints and achieve consensus. I will also continue my predecessors' commitment to transparent communications with the Congress and the public, so that the Federal Reserve can be held accountable for its work. I welcome opportunities to discuss with members of Congress ways to further improve transparency and accountability.

The Federal Open Market Committee (FOMC) and I take seriously our commitment to maintain the confidentiality of our deliberations and planning. We recognize, in particular, the importance of safeguarding confidential information that could advantage individuals who obtain access to it. For this reason, the FOMC adopted a Program for Security of FOMC Information (Program) and Policies on External Communications of FOMC Participants and Staff (together with the Program, referred to as the Policies) that require confidential treatment of all FOMC information. FOMC participants (all members of the Federal Reserve Board and all Reserve Bank presidents, whether voting or non-voting) and all FOMC staff must annually agree to the Program, and must abide in their contacts with the public by the principles laid out in the Policies. (The Program for Security of FOMC Information and FOMC Policies on External Communications are available on the Board's public website.)

The Policies aim to protect the confidentiality of the FOMC's monetary policy deliberations, and to prevent the disclosure of information in a manner such that any individual, firm, or organization could profit from acquiring that information. To this end, the Policies contain a variety of self-imposed limitations on communications by FOMC participants and Federal Reserve staff with access to FOMC information. For example, the Policies state that:

- An FOMC participant may publicly discuss his/her own views about monetary policy. However, participants have agreed not to describe the views or statements of other participants if the other participant has not already made his/her views public.
- Participants have agreed not to describe discussions at FOMC meetings beyond what is disclosed in the public minutes.
- Participants have agreed to refrain from describing their personal views about monetary policy in any meeting or conversation with any individual, firm, or organization who could profit financially from acquiring that information unless those views have already been expressed in their public communications.
- Participants have agreed to avoid giving a "prestige advantage" to outsiders through meetings or discussions.
- Similar policies apply to staff with access to FOMC information.

Over recent years, the Federal Reserve has taken numerous steps to further enhance its overall program for FOMC information security.

- All staff members with access to FOMC information must complete annual training on FOMC information security policies and procedures.
- Documents prepared for the FOMC are stored in a very secure way. Access to paper and electronic versions of such documents is limited and carefully controlled.
- Various controls in automated systems have been implemented to guard against accidental breaches of information security protocols.

With respect to the 2012 disclosure of confidential FOMC information, the Federal Reserve fully cooperated with the law enforcement community that investigated this matter. I am confident that they had access to all information and individuals and records to make the judgment they made in concluding their work.

Questions for the Record
Congressman Ann Wagner (MO-2)
Hearing: Federal Reserve Chairman Powell
Date: February 27, 2018

Thank you, Chairman Powell.

In comments you made shortly after being sworn in as Chairman of the Federal Reserve, you noted that you were committed to "explaining what we're doing and why we are doing it (...) and will continue to pursue ways to improve transparency both in monetary policy and in regulation."

How much value to you place on being as transparent as possible, so that not only Congress, but the American people understand the decisions the Fed is making?

In 2012, the Fed dealt with a leak of confidential information relating to the deliberation of the Federal Open Markets Committee (FOMC). Information relating to the confidential documents and deliberations of the FOMC were obtained by a political intelligence firm, who shared the information in a newsletter to their clients. As you know, access to that information is valuable to markets and investors because the Fed does not make clear what it is likely to do in the future.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

April 18, 2018

The Honorable Brad Sherman
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the February 27 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on March 27, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Representative Sherman:

1. Recently, you discussed the need for comprehensive, legislative GSE reform. What are the elements of a reformed system that you believe are "must-haves"? Do you believe competition in the secondary market is one of these must-haves?

The Federal Reserve is responsible for regulating and supervising banking institutions to ensure their safety and soundness, and more broadly for the stability of the financial system. A robust, well-capitalized, well-regulated housing system is vital to achieving those goals, and the long-term health of our economy.

There are a number of principles that should be considered as a part of housing finance reform. First, we ought to do whatever we can to make the possibility of future housing crises as remote as possible. Reform should be designed to attract large amounts of private capital into the housing finance system. As with banks, the goal should be to ensure that our housing finance system and its underlying institutions can continue to function even in the face of significant house price declines and severe economic conditions.

Second, any government guarantee resulting from housing finance reform should be explicit and transparent, and should apply to securities, not to institutions. Reform should not leave us with any institutions that are so important as to be candidates for too-big-to-fail.

Third, we should promote greater competition in the secondary mortgage market. The economics of securitization do not require a duopoly. Yet there is no way for private firms to acquire a government-sponsored enterprise (GSE) charter and enter the industry. Greater competition would help to reduce the systemic importance of the GSEs, and spur more innovation. Greater competition also requires a level playing field, allowing secondary market access to a wide-range of lenders and thereby giving homebuyers a choice among many potential mortgage lenders and products.

Fourth, we should consider simple approaches that restructure and repurpose parts of the existing architecture of our housing finance system. We know that housing reform is difficult; completely redrawing the system may not be necessary and could complicate the search for a solution. Using the existing architecture would allow for a continued smooth, gradual transition.

Fifth, we need to identify and build upon areas of bipartisan agreement. We should be looking for the best feasible plan to escape the unacceptable status quo of indefinite conservatorship.

2. Large data breaches are wreaking havoc on small and midsized financial institutions. Is the Federal Reserve reviewing any policies to ensure that financial institutions do not remain solely liable for the cost of breaches?

The Federal Reserve requires financial institutions, and the service providers supporting their activities, to have robust information security programs. The Federal Reserve tailors its supervisory approach based on the risks, size, and complexity of the organizations it supervises. This tailored approach is reflected in our rulemaking, supervisory guidance, reporting requirements, as well as in the execution of supervision. Under the authority of the Bank Service Company Act, the Federal Reserve provides the report of examination to serviced financial institutions, which they can use to better manage Information Technology (IT) risk.

In lieu of issuing new guidance, the Federal Reserve has been working with other financial regulatory agencies on harmonizing cybersecurity regulatory expectations across the financial services sector. Specifically, we are focused on aligning our cybersecurity expectations with existing best practices and identifying opportunities to further coordinate cyber risk supervisory activities.

Our analysis of many cyber breaches indicates most breaches could have been prevented through basic information security practices and routine security training. It is essential that financial institutions implement controls to effectively maintain basic security hygiene practices and adopt security training programs for all employees.

It also is essential that banks have appropriate cyber risk management programs in place to mitigate the risk of a data breach. Management should understand the institution's insurance needs and the limitations of insurance coverage.[1] These policies generally exclude, or may not include, liability for all areas of IT operations and cybersecurity. Financial institutions of all sizes may use cyber insurance to manage their exposure to breaches.

Financial institutions supervised by the Federal Reserve are required to follow the Gramm-Leach-Bliley Act[2] (GLBA) and maintain an information security program to protect customer data. The Federal Financial Institutions Examination Council (FFIEC) member agencies design and supervise examinations and publish the Information Technology (IT) Handbook,[3] which provides guidance for the IT security controls that can be used by financial institutions to safeguard their customers' data.

The Federal Reserve and FFIEC members recommend that financial institutions of all sizes participate in information sharing forums as a part of their process to identify, respond to, and mitigate rapidly evolving cybersecurity threats and vulnerabilities.[4] Financial institution management is expected to monitor and maintain sufficient awareness of cybersecurity threat and vulnerability information so that they may evaluate risk and adjust their information security programs accordingly.

3. Is the Federal Reserve coordinating in any way with the Treasury Department to provide access to banking for state-legal marijuana businesses?

In general, the decision to open, close, or decline a customer account or relationship is made by a bank, without involvement by the Federal Reserve. The Federal Reserve's supervisory

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[1] Per the FFIEC IT Examination InfoBase: https://ithandbook.ffiec.gov/it-booklets/management/iii-it-risk-management/iiic-risk-mitigation/iiic7-insurance.aspx.

[2] GLBA, also known as The Financial Services Modernization, requires companies acting as "financial institutions," to explain their information-sharing practices and to safeguard sensitive customer data; CFR part 208, Appendix D.

[3] https://ithandbook.ffiec.gov/it-booklets.aspx.

[4] The FFIEC recommended that regulated financial institutions participate in information sharing forums in a press release, November 3, 2014.

expectation is that a banking organization should develop and maintain adequate controls to address appropriately the risks associated with a particular customer relationship, and comply with applicable laws and regulations, including the requirements of the Bank Secrecy Act (BSA).

In 2014, the Financial Crimes Enforcement Network (FinCEN), a bureau of the Treasury Department and the administrator of BSA, issued guidance addressing the obligation of a bank to file suspicious activity reports (SARs) with respect to marijuana-related business customers.[5] This guidance was issued in connection with a Department of Justice (DOJ) statement of enforcement priorities related to marijuana-related businesses, which stated that the DOJ did not intend to prosecute those in compliance with state law, but in violation of the federal law, unless the conduct implicated one of DOJ's stated priority matters.[6] As you may know, the DOJ rescinded the 2014 statement of enforcement priorities earlier this year, however, the FinCEN guidance remains in place.[7]

Consistent with the Federal Reserve's longstanding practice, we have incorporated FinCEN's expectations related to SAR filings into our supervisory program. Specifically, in 2014, the Federal Reserve and other federal banking regulators modified the Federal Financial Institutions Examination Council's BSA/Anti Money Laundering Examination Manual and added expectations for examiners to assess whether a bank is complying with the requirement to file SARs for marijuana-related transactions.[8] We are not aware of any additional coordination efforts by the Treasury Department with the Federal Reserve to provide banking access for marijuana-related businesses.

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[5] FinCEN, "BSA Expectations Regarding Marijuana-Related Businesses", FIN-2014-001, (Feb. 14, 2014), at https://www.fincen.gov/sites/default/files/shared/FIN-2014-G001.pdf.

[6] Memorandum to United States Attorneys from James M. Cole, Deputy Attorney General, "Guidance Regarding Marijuana Enforcement" (Aug. 29, 2013), at https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.

[7] Memorandum to United States Attorneys from Jefferson B. Sessions, III, Attorney General, "Marijuana Enforcement" (Jan. 4, 2018), at https://www.justice.gov/opa/press-release/file/1022196/download.

[8] See Federal Financial Institutions Examination Council, "Bank Secrecy Act/Anti-Money Laundering Examination Manual" (2014).

Congressman Brad Sherman

Questions for the Record

Financial Services Committee Hearing "Monetary Policy and the State of the Economy"

February 27, 2018

Questions for the Honorable Jerome Powell, Chair of the Board of Governors of the Federal Reserve System:

1. Recently, you discussed the need for comprehensive, legislative GSE reform. What are the elements of a reformed system that you believe are "must-haves"? Do you believe competition in the secondary market is one of these must-haves?

2. Large data breaches are wreaking havoc on small and midsized financial institutions. Is the Federal Reserve reviewing any policies to ensure that financial institutions do not remain solely liable for the cost of breaches?

3. Is the Federal Reserve coordinating in any way with the Treasury Department to provide access to banking for state-legal marijuana businesses?

Thank you for your attention to these matters. I look forward to your prompt response.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

April 18, 2018

The Honorable Ed Royce
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the February 27 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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[1] Questions for the record related to this hearing were received on March 27, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Representative Royce:</u>

1. You have previously called for housing finance reform stating that "we need to move to a system that attracts ample amounts of private capital to stand between housing sector credit risk and taxpayers."

I could not agree more. Even in their current state, I think there is much more Fannie & Freddie could do to offload credit risk.

To be fair, you said, last summer, that this is not a normal issue on which the Fed would comment, but that we are in a "now or never moment" for reform as there is "not a current risk" with a healthy economy and housing system.

How long will this "now or never moment" last and what are the consequences of inaction?

The Federal Reserve is responsible for regulating and supervising banking institutions to ensure their safety and soundness, and more broadly for the stability of the financial system. A robust, well-capitalized, well-regulated housing system is vital to achieving those goals, and the long-term health of our economy.

Considering housing finance reform in the current environment is important for two key reasons. First, the economy and housing sector are healthy. It would be far more disruptive to implement fundamental structural changes during difficult economic times. Second, as we move further out from the crisis, we are at risk of settling for the status quo -- a government-dominated mortgage market with insufficient private capital to protect taxpayers.

Housing is the single largest asset class in our financial system, with total outstanding residential real estate owned by households of over $24 trillion and roughly $10 trillion in single-family mortgage debt. While post-crisis regulation has addressed mortgage lending from a consumer protection standpoint, the important risks to taxpayers and the broader economy and financial system have not been robustly addressed.

There has been some meaningful progress in reforming the system. In 2008, Congress enacted the Housing and Economic Recovery Act, which, among other things, created the Federal Housing Finance Agency (FHFA), modeled on and with similar powers to the Federal Deposit Insurance Corporation. Under the FHFA's oversight, the two government-sponsored enterprises' (GSE) retained investment portfolios have declined to about half of their pre-crisis size, and are expected to continue to shrink. Further, the GSEs have raised about $50 billion in private capital through their credit risk transfers programs, in essence laying off some credit risk to private investors.

The primary consequence of inaction is a government dominated mortgage market with insufficient capital. The federal government's domination of the housing sector has grown significantly since the financial crisis. Fannie Mae, Freddie Mac, FHA, and U.S. Department of Veterans Affairs have a combined market share of about 80 percent of new purchase mortgages.

While Fannie Mae and Freddie Mac have more than $5 trillion of mortgage backed securities and corporate debt outstanding, they hold only about $3 billion of capital each.

Enacting housing finance reform will protect taxpayers, be good for households and the economy, and go some distance toward mitigating the systemic risk that the GSEs still pose.

2. Before the Senate Banking Committee you mentioned that the Federal Reserve had "started a unit of economists and policy makers" focused on the cost/benefit analysis of financial regulations.

Can you give us an update on these efforts?

The Policy Effectiveness and Assessment section has begun the work on the type of cost/benefit analysis of financial regulations mentioned in my testimony. The section has a manager in place (an economist by training). Presently, the team consists of a small number of Ph.D. economists and support staff. Additional Ph.D. economists were recently hired and will be joining in the coming months. These additions will enable the section to engage more fully.

Section staff are currently working on an internal evaluation of the effectiveness of the post-crisis regulatory reforms. In addition, building upon our existing effort, the section staff are working with the leadership of the Supervision and Regulation division on crafting a policy document that lays out how the division will approach cost-benefit analysis. Similar documents are used to guide cost-benefit analyses that are conducted at other agencies. Once this work has been completed, staff will participate more actively in the rulemaking process.

3. Also, specifically, does the Fed weigh the impact of regulation on U.S. economic growth when we create standards that are higher than global norms – as with the so-called "gold plating" of the largest U.S. institutions?

Strong regulatory standards enhance the stability of the U.S. financial system. The recent financial crisis showed that the standards in place before the crisis were not strong enough to constrain banks' risk-taking. Since the crisis, the Federal Reserve, working with the other U.S. bank regulatory agencies, has put stronger standards in place, notably for capital and liquidity. The United States now has a strong banking system that has earned back the market's confidence, allowing U.S. banks to expand their lending at a healthy pace in recent years.

The Federal Reserve considers the impact of a regulation prior to putting it in place. This includes consideration of the potential benefits of a regulation from the increased safety and soundness of the banking and broader financial system, as well as any costs associated with adverse effects on economic activity. Such considerations also apply when we are implementing global standards.

Importantly, standards discussed or recommended by international bodies are not binding in the United States. None of the policy actions recommended by international forums have any effect in the United States unless they are adopted by U.S. authorities, acting under U.S. laws and through a public notice and comment period. The Federal Reserve and the other banking agencies can, of course, adopt different standards in the United States than those discussed internationally, and we have often done so to better reflect the nuances of U.S. financial institutions and markets. In addition, the international forums on financial regulation in which the Federal Reserve participates typically put their policy proposals through a public notice and comment process, similar to that of the rulemaking process in the United States, which provides additional valuable transparency.

4. Do you share the concern voiced by some that an unlevel playing field could impact the capacity of U.S. banks to lend to consumers and businesses as these activities become increasingly expensive vis-à-vis foreign banks?

Our financial system is stronger and more resilient than it was a decade ago, in large part as a result of higher levels of high quality capital and liquidity in the system. Stronger risk-based capital and liquidity regulations, together with our stress testing program, help ensure that large U.S. banks are better positioned to continue lending through periods of economic stress and market turbulence. Although U.S. banking organizations are subject to high regulatory capital and liquidity standards, these firms have been successful competitors in the global financial markets in recent years. U.S. banking organizations have been able to expand lending while maintaining high capital and liquidity buffers required by the Federal Reserve.

Since the crisis, the U.S. banking system has provided substantial support for the economy, with total loans and leases increasing by over 34 percent since December 2010. As of September 2017, domestic banks held 84.7 percent of total loans and leases in the United States, which has grown slightly since a post-crisis low of 83.8 percent at year-end 2014. We have seen no evidence that U.S. bank lending has been constrained relative to foreign banks, and we believe that strong prudential requirements, particularly for large banking firms, will produce more sustainable credit availability and economic growth through the economic cycle.

5. Your colleague Randall Quarles noted in a recent speech that there are 24 different loss absorbing requirements coming out of Dodd-Frank and that he was "reasonable certain" that this was too many. Are there specific work streams underway at the Federal Reserve that will better 'tailor' such requirements in an efficient, effective manner, and which utilize a more measured/streamlined approach to supervision and enforcement?

Yes, the Federal Reserve Board (Board) is actively working to streamline such requirements. One good example of this is our recently issued proposal for banking organizations subject to Comprehensive Capital Analysis and Review that would integrate the forward-looking stress test results into the Board's non-stress capital requirements. A result of this proposal would be to reduce the current capital-related ratio requirements these firms are subject to from 24 down to 14.

6. On a related supervisory issue, please elaborate on your earlier public comments about it being "important to acknowledge that a [bank] board's role is one of oversight, not management." Have you completed the reassessment you noted of whether the Federal Reserve's supervisory expectations for boards needs to change to ensure that this is the guiding principal and not an "ever increasing checklist?"

On August 3, 2017, the Federal Reserve announced that it was seeking public comment on a proposal regarding supervisory expectations for boards of directors. The Federal Reserve is in the process of finalizing the proposal based on consideration of the comments received.

The proposal includes proposed supervisory guidance on board effectiveness that is intended to shift our supervisory focus to boards' core responsibilities and better distinguish supervisory expectations for boards from those for senior management. The guidance focuses on five key attributes of an effective board rather than on process-oriented supervisory expectations that do not directly relate to the board's core responsibilities.

The proposal also discusses the Federal Reserve's comprehensive review of all existing supervisory expectations and regulatory requirements relating to boards of directors of bank and savings and loan holding companies of all sizes. The purpose of the review is to identify supervisory expectations for boards of directors that do not relate to their core responsibilities or do not clearly delineate the roles and responsibilities of boards from those of senior management. The Federal Reserve believes that revising or eliminating unnecessary, redundant, or outdated expectations, as appropriate, will allow boards to focus more of their time and resources on fulfilling their core responsibilities.

The Federal Reserve is conducting this review in two phases. The first phase is focused on reviewing supervisory expectations for boards set forth in existing Supervision and Regulation (SR) letters that communicate Board guidance. The preliminary results of the review, as discussed in the proposal, identified 27 SR letters for potential elimination or revision, which collectively include more than 170 supervisory expectations for holding company boards.

The Federal Reserve is in the process of considering comments received on the first phase of the review and will publish the final results of the review when the proposal is finalized.

The second phase of the review will focus on requirements and supervisory expectations for boards set forth in Board regulations or in various forms of interagency guidance. Revising Board regulations will take more time to complete, and revisions to interagency guidance involve consultation and collaboration with other federal banking agencies.

Full Committee hearing entitled: "Monetary Policy and the State of the Economy."
Tuesday, February 27, 2018 10:00 AM in 2128 Rayburn HOB

Witness: The Honorable Jay Powell, Chairman, Board of Governors of the Federal Reserve System

Questions for the Record from Rep. Ed Royce (CA-39)

GSE Reform

You have previously called for housing finance reform stating that "we need to move to a system that attracts ample amounts of private capital to stand between housing sector credit risk and taxpayers."

I could not agree more. Even in their current state, I think there is much more Fannie & Freddie could do to offload credit risk.

To be fair, you said, last summer, that this is not a normal issue on which the Fed would comment, but that we are in a "now or never moment" for reform as there is "not a current risk" with a healthy economy and housing system.

How long will this "now or never moment" last and what are the consequences of inaction?

Cost/Benefit Analysis

Before the Senate Banking Committee you mentioned that the Federal Reserve had "started a unit of economists and policy makers" focused on the cost/benefit analysis of financial regulations.

Can you give us an update on these efforts?

Also, specifically, does the Fed weigh the impact of regulation on U.S. economic growth when we create standards that are higher than global norms – as with the so-called "gold plating" of the largest U.S. institutions?

Do you share the concern voiced by some that an unlevel playing field could impact the capacity of U.S. banks to lend to consumers and businesses as these activities become increasingly expensive vis-à-vis foreign banks?

Your colleague Randall Quarles noted in a recent speech that there are 24 different loss absorbing requirements coming out of Dodd-Frank and that he was "reasonable certain" that this was too many. Are there specific work streams underway at the Federal Reserve that will better 'tailor' such requirements in an efficient, effective manner, and which utilize a more measured/streamlined approach to supervision and enforcement?

On a related supervisory issue, please elaborate on your earlier public comments about it being "important to acknowledge that a [bank] board's role is one of oversight, not management." Have you completed the reassessment you noted of whether the Federal Reserve's supervisory expectations for boards needs to change to ensure that this is the guiding principal and not an "ever increasing checklist?"

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

June 21, 2018

The Honorable Ben Sasse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the April 19, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on April 27, 2018.

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

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

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

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

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

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

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

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

From a domestic bank supervision perspective, the System has also convened an Interagency Fintech Discussion Forum to facilitate information sharing between federal banking regulators on fintech consumer protection issues and supervisory outcomes. System staff have used the Federal Reserve's publications, such as our "Consumer Compliance Outlook" bulletin, to offer financial institutions and fintech firms general guideposts for evaluating risks when considering the adoption of new technologies.

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

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

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System on behalf of Senator Ben Sasse:

- I'd like to discuss how the Federal Reserve can encourage innovation in the financial system. On October 18, 2017, now-Federal Reserve Chairman Powell gave a speech entitled "Financial Innovation: A World in Transition," where he articulated the promise and the peril of new financial technologies:
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- [T]he challenge is to embrace technology as a means of improving convenience and speed in the delivery of financial services, while also assuring the security and privacy necessary to sustain the public's trust... Rapidly changing technology is providing a historic opportunity to transform our daily lives, including the way we pay. Fintech firms and banks are embracing this change, as they strive to address consumer demands for more timely and convenient payments. A range of innovative products that seamlessly integrate with other services is now available at our fingertips. It is essential, however, that this innovation not come at the cost of a safe and secure payment system that retains the confidence of its end users.
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- To this end, what is the Federal Reserve exploring or doing to encourage innovation in the financial system in a responsible but effective manner? This is particularly important given new innovations in from fintech companies in digital currency, the payments systems, artificial intelligence, and more. For example, could the Federal Reserve increase the use of no action letters or – as the SEC has done – authorize limited pilot tests, to gather data on new technologies or regulatory innovations? Do any of these changes need statutory authorization?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

June 21, 2018

The Honorable Brian Schatz
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the April 19, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on April 27, 2018.

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

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

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

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

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

2. Bank holding companies under the Fed's supervision have been fined more than $174 billion since the financial crisis for deceptive practices, anti-money laundering violations, and glaring consumer abuses. The egregious practices at Wells Fargo led the Fed to cap the bank's growth and resulted in hundreds of millions in fines, with more to come.

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

- **Which do you think it is?**

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

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

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

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

- **Does the fact that banks have paid record fines at a time when they have made record profits mean that banks have just baked the cost of fines into their business plan?**
- **Are these fines accomplishing anything?**

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

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System on behalf of Senator Brian Schatz:

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

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- Do you agree?

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

Bank holding companies under the Fed's supervision have been fined more than $174 billion since the financial crisis for deceptive practices, anti-money laundering violations, and glaring consumer abuses. The egregious practices at Wells Fargo led the Fed to cap the bank's growth and resulted in hundreds of millions in fines, with more to come.

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- Are these fines accomplishing anything?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 9, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the April 19, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on April 27, 2018.

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

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

- **Do you believe that cost-benefit analysis disproportionately benefits industry, since the costs of compliance are easier to calculate, while the benefits of a sound financial system are more difficult to measure?**
- **You noted that the Federal Reserve underestimated the human costs of a potential financial crisis prior to 2008? Please describe some of the ways that Fed underestimated the costs of the Crisis and how you would have assessed them knowing what you know now?**
- **How will the Federal Reserve's new "policy effectiveness and assessment" unit consider the benefits of avoiding a future financial crises? How many people work in the unit? Who are they and what is their background and expertise?**
- **If they were employed at the Federal Reserve prior to the Financial Crisis, what was their role?**
- **If they published anything on the stability or risks in the financial sector between 2004-2008, please provide those documents.**

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

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

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

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

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

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

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

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

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

- **What do you think of her comments?**

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

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

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

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

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

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

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

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

The Board's action to approve the Diversity and Inclusion Strategic Plan 2016-2019 reflects the Board's strategic initiative on diversity, inclusion, and equality. The implementation of the plan involves the active involvement of leaders throughout the Board. In support of the Board's strategic objectives and commitment to attract, hire, develop, promote and retain a highly diverse workforce, each division is required to establish a diversity and inclusion scorecard. The purpose of the scorecard provides a process that helps us organize and develop a systematic effort in support of the diversity and inclusion strategic plan. I am firmly committed to addressing the division of Supervision and Regulation's and related divisions' challenges and achievement of their goals.

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

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

As directed by section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Board continues to request from the entities we regulate a submission of information that supports the diversity policies and practices of their institutions. The assessment of submissions provides an opportunity to strengthen and promote transparency of organizational diversity and inclusion within the entities' U.S. operations and provides opportunities to discuss leading practices and challenges in addressing diversity in the financial services industry. In an effort to increase the submission of diversity information, the Board is collaborating with the other financial regulatory agencies to develop symposiums, webinars and other support initiatives to provide a variety of forums to address what is needed to advance diversity in the financial and banking industry.

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

In my role as Governor and Vice Chairman of Supervision, I am available to the Director of the Office of Minority and Women Inclusion (OMWI) to meet and discuss cultivating diversity and inclusion in all aspects of employment. The OMWI Director is involved in the appointment process of official staff to ensure that the Board's leadership nomination criteria and process are inclusive. Additionally, a meeting schedule has been established for the OMWI Director and Deputy Director of Supervision Policy to discuss a range of issues within the OMWI purview.

- **How will you work to end the outsized representation and influence of the banking and business sectors among the Regional Bank Boards of Directors?**
- **Have you identified directors with non-profit, academic, and labor backgrounds that could also serve?**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

However, the Federal Reserve has addressed unfair and deceptive practices through public enforcement actions that have collectively benefited hundreds of thousands of consumers and provided millions of dollars in restitution. In 2014 and 2015, we brought two enforcement action requiring restitution for students who were not given full information about the potential fees and limitations associated with opening deposit accounts for their financial aid refunds.

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

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

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

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

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

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

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

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

The Board's staff is continuing to analyze the recommendations made by the Department of Treasury. I share Treasury's goal of improving the current supervisory and regulatory framework for CRA based on feedback from industry and community stakeholders. I agree that many of the issues and potential solutions they raised are worthy of consideration. The Board is open to considering ways to make the CRA more effective and believes there are ways to expand the area where we evaluate a bank's CRA performance without losing the regulation's focus on the unique role banks play in meeting local credit needs.

For example, I agree that it is time to review changes to the definition of "assessment area," which is the area in which a bank's CRA performance is evaluated. The banking environment has changed since CRA was enacted and the current CRA regulation was adopted. Banks may now serve consumers in areas far from their physical branches. Therefore, it is sensible for the agencies to consider expanding the assessment area definition to reflect the communities that banks serve, while retaining the core focus on place.

7. Fed Chair Powell recently said that the Fed's requirements for the largest banks are "very high and they're going to remain very high."[3] He continued, "As you look around the world, U.S. banks are competing very, very successfully. They're very profitable. They're earning good returns on capital. Their stock prices are doing well. So I'm looking for the case, for some kind of evidence that — and I'm open to this — some kind of evidence that regulation is holding them back, and I'm not really seeing that case as made at this point."[4]

- **Why did the Fed issue a proposal last week that would revise the enhanced Supplementary Leverage Ratio (eSLR), which according to the FDIC, would reduce bank capital by more than $120 billion at the nation's largest banks?**
- **With banks making big profits, why would the Fed propose to reduce capital in a significant way that diminishes protections for taxpayers and the economy?**
- **If we are seeing regulations being weakened while the banking sector is very strong economically, what do you expect to see regarding banking regulations during an actual downturn or recession?**

The proposed recalibration of the enhanced supplementary leverage ratio (eSLR) standards is an example of the Board's efforts to ensure that the post-crisis financial regulations are working as intended. Core aspects of post-crisis financial regulation have resulted in critical gains to the financial system, including higher and better quality capital, a robust stress testing regime, new liquidity regulation, and improvements in the resolvability of large firms. The financial system is stronger and more resilient as a result, helping banks to lend through the business cycle. With the revised regulatory framework in place, the Board is assessing the effect of those efforts. In undertaking this review and assessment, the Board is mindful of the need for the regulations not only to be effective for maintaining safety and soundness and financial stability, but also to be efficient, transparent, and simple.

The purpose of the eSLR proposal is to recalibrate our capital standards for banking organizations such that the ratio generally serves as a backstop to risk-based capital requirements and not as a binding constraint. Over the past few years, concerns have arisen that, in certain cases, the SLR has become a generally binding constraint rather than a backstop to the risk-based requirements. If a leverage ratio is calibrated at a level that makes it generally binding, it can create incentives for banking organizations to reduce their participation in business activities with lower risks and returns, such as repo financing, central clearing services for market participants, and taking custody deposits, even when there is client demand for those generally low-risk services and to actually increase the risk in its portfolio since it bears the same capital cost for a risky asset as for a safe and sound one.

I do not believe that the proposal would materially change the amount of capital held by U.S. global systemically important bank holding companies (GSIBs). The $121 billion figure noted in the proposal represents the potential reduction in tier 1 capital required across the lead insured

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[3] https://www.federalreserve.gov/newsevents/speech/powell20180406a.htm.

[4] Politico Pro, "Powell doesn't see need to loosen rules on biggest banks," April 6, 2018.

depository institution subsidiaries of the GSIBs; however, these firms all are wholly owned by their parent holding companies. On a consolidated basis, GSIBs would continue to be subject to risk-based capital requirements, supervisory stress testing constraints, and other limitations applicable at the holding company level that would restrict the amount of capital that such firms may distribute to investors. Due to these limitations at the holding company level, the GSIBs would be required to retain the vast majority of the $121 billion amount and would not be able to distribute it to third parties. The Board estimates that the proposal would reduce the amount of tier 1 capital required across the GSIBs by approximately $400 million. That figure is approximately 0.04 percent of the amount of tier 1 capital held by the GSIBs as of the third quarter of 2017.

8. Mr. Quarles, you have repeatedly said that since it has been a decade since the 2008 financial crisis, it is time to review and revisit all of the post-crisis financial rules to seek improvements.

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

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

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

9. Chair Powell has said not a single big bank rule requires strengthening.

- **Do you agree?**

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

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

- **Do you believe the Fed failed, as many of us do, at implementing and enforcing our consumer financial protections laws prior to the creation of the Consumer Financial Protection Bureau?**

The financial crisis revealed the need to address fundamental problems across the financial system in both the private and public sectors, including failures of risk management in many financial firms, deficiencies in government regulation of financial institutions and markets. In response, Congress enacted the Dodd-Frank Act to address the weaknesses that had emerged in various areas of the mortgage market, including underwriting standards, capitalization, and securitization, as well as consumer protection. As you know, prior to the passage of the Dodd-Frank Act in 2010, the Board had responsibility for writing regulations to implement many consumer protection laws. The Dodd-Frank Act transferred most of these responsibilities to the CFPB, and considerably expanded its consumer protection statutory authorities for supervision and enforcement, and granted the CFPB broad authorities to promulgate consumer protections regulations covering banks and non-banking entities.

Although the Board no longer has rulewriting authority for most consumer protection regulation, we remain committed to strong consumer protection to promote a fair and transparent financial marketplace, as we have for more than 40 years, through the Board's Division of Consumer and Community Affairs (DCCA), which is solely dedicated to consumer compliance supervision, community development, and consumer-focused research, analysis and outreach. Through this division, we oversee the Federal Reserve System's supervision and examination policies and programs for the banks under our supervisory authority to ensure consumer financial protection and promote community reinvestment.

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

Despite responsibilities for supervision that were transferred to the CFPB, the Federal Reserve continues to be dedicated to consumer protection and community reinvestment in carrying out our supervisory and enforcement responsibilities for the financial institutions and for the laws and regulations under our authority. We supervise all state member banks for compliance with the Fair Housing Act and Equal Credit Opportunity Act, as well as for other consumer protection rules for state member banks of $10 billion or less. Federal Reserve staff coordinate with the prudential regulators and the CFPB as part of the supervisory coordination requirements under the Dodd-Frank Act to ensure that consumer compliance risk is appropriately incorporated into the consolidated risk-management program of the approximately 135 bank and financial holding companies with assets over $10 billion.

The Federal Reserve is committed to ensuring that the financial institutions under our jurisdiction fully comply with all applicable federal consumer protection laws and regulations. For example, in the last few years, the Federal Reserve has addressed unfair and deceptive practices through public enforcement actions that have collectively benefited hundreds of thousands of consumers and provided millions of dollars in restitution. In addition, our examiners evaluate fair lending risk at every consumer compliance exam. Pursuant to the Equal Credit Opportunity Act, if we determine that a bank has engaged in a pattern or practice of discrimination, we refer the matter to the Department of Justice (DOJ). Federal Reserve referrals have resulted in DOJ public actions in critical areas, such as redlining and mortgage-pricing discrimination.

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

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

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

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

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

Prior to the creation of the FSOC, the U.S. financial regulatory framework focused narrowly on individual institutions and markets and no single regulator had the responsibility for monitoring and assessing overall risks to financial stability, which could involve different types of financial firms operating across multiple markets. The FSOC established a venue to facilitate the sharing of regulatory information and coordination to help minimize potential gaps and weaknesses.

Notably, the FSOC must publish a financial stability report each year, signed by the voting members. Past reports have highlighted vulnerabilities such as prime money market mutual funds that benefit investors who withdraw their funds first – with the potential for destabilizing runs of the kind that stressed the financial system in September 2008. Subsequent reports have noted that the Securities and Exchange Commission's (SEC) regulatory reforms, which took effect in late 2016, were instituted to mitigate the risk of runs on money funds, and led to significant structural changes in the industry, with assets flowing to funds that held only assets guaranteed by the government.

11. S&P Global warned earlier this month that leveraged lending standards were deteriorating, and that underwriting standards in this $1 trillion market continue to get weaker and weaker. One PIMCO analyst said, "I'm not sure the market can tolerate much worse."[5] There used to be guidance in place to protect against these risks, but while at the OCC, Acting Comptroller Noreika withdrew its guidance on leveraged lending. And you have said that this guidance, because it was declared a rule by the GAO, is "not something that should be cited in supervisory action or taken into account by examiner."[6]

- **So judging by your comment, the Republicans' assault on banking guidance has already had a chilling effect on the Fed's ability to constrain emerging risks, is that right?**
- **How do you plan to protect the market from systemic risk if you're telling supervisors to ignore this guidance? What does the Fed plan to replace this guidance with?**

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

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

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

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

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

- **How does the Fed have time to revisit so many rules that aren't even fully phased in yet – the Volcker Rule, the leverage ratio, risk-based capital rules – when you haven't even completed work from the recent past that was based on years and years of study?**
- **Since the election we have heard nothing about this rule being finalized or about any progress on the rule. Has this rule been abandoned, and if so, why?**

The Board began its review of the physical commodities activities of financial holding companies after a substantial increase in these activities among financial holding companies during the financial crisis. In January 2014, the Board invited public comment on a range of issues related to these activities through an advance notice of proposed rulemaking. In response, the Board received a large number of comments from a variety of perspectives. The Board considered those comments in developing the proposed rulemaking that was issued in September 2016. After providing an extended comment period (150 days) to allow commenters time to understand and address the important and complex issues raised by the proposal, the Board again received a large number of comments from a variety of perspectives, including Members of Congress, academics, users and producers of physical commodities, and banking organizations. The Board continues to consider the proposal in light of the many comments received and to monitor the physical commodities activities of financial holding companies.

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

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

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

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

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

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

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

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

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System on behalf of Senator Catherine Cortez Masto:

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

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

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

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

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

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

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

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

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

- What do you think of her comments?

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

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

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

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

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

- What steps can the Fed take to promote diversity within the financial system, especially with respect to the firms the Fed regulates?

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

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

- Have you identified directors with non-profit, academic, and labor backgrounds that could also serve?

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

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

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

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

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

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

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

- Which, if any, recommendations from the Treasury Department related to CRA do you disagree with?

Fed Chair Powell recently said that the Fed's requirements for the largest banks are "very high and they're going to remain very high."14 He continued, "As you look around the world, U.S. banks are competing very, very successfully. They're very profitable. They're earning good

[14] https://www.federalreserve.gov/newsevents/speech/powell20180406a.htm

returns on capital. Their stock prices are doing well. So I'm looking for the case, for some kind of evidence that — and I'm open to this — some kind of evidence that regulation is holding them back, and I'm not really seeing that case as made at this point."15

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

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

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

Mr. Quarles, you have repeatedly said that since it has been a decade since the 2008 financial crisis, it is time to review and revisit all of the post-crisis financial rules to seek improvements.

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

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

- Do you agree?

- Do you believe the Fed failed, as many of us do, at implementing and enforcing our consumer financial protections laws prior to the creation of the Consumer Financial Protection Bureau?

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

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

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

S&P Global warned earlier this month that leveraged lending standards were deteriorating, and that underwriting standards in this $1 trillion market continue to get weaker and weaker. One

[15] Politico Pro, "Powell doesn't see need to loosen rules on biggest banks," April 6, 2018

PIMCO analyst said, "I'm not sure the market can tolerate much worse."[16] There used to be guidance in place to protect against these risks, but while at the OCC, Acting Comptroller Noreika withdrew its guidance on leveraged lending. And you have said that this guidance, because it was declared a rule by the GAO, is "not something that should be cited in supervisory action or taken into account by examiner."[17]

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

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

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

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

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

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

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

Section 956 of the Dodd-Frank Act instructed bank regulators to reform bonuses at financial institutions, by eliminating "take the money and run" bonus practices that encouraged irresponsible risk-taking. Prior to your confirmation, regulators were close to completing rules that would have placed new limits on big bank bonuses. Yet to all appearances the Federal

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

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

Reserve and other regulators appear to have abandoned that effort completely, even as bonuses skyrocket back to pre-crisis levels.

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

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

June 19, 2018

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the April 19, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on April 27, 2018.

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

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

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

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

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

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

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

- **Will the Fed alter the Enhanced Supplementary Leverage Ratio proposal if S. 2155 passes?**
- **In what way?**

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

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

The proposal would not represent a material reduction in the amount of capital held by firms subject to the eSLR. Taking into account the capital constraints imposed by the Board's supervisory stress testing requirements, as well as the Board's regulatory capital rules, we estimate that the proposal would reduce the amount of tier 1 capital required across the GSIBs by approximately $400 million. That figure is approximately 0.04 percent of the amount of tier 1 capital held by the GSIBs as of the third quarter of 2017.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System on behalf of Senator Elizabeth Warren:

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

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

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- Will the Fed alter the Enhanced Supplementary Leverage Ratio proposal if S. 2155 passes?

- In what way?

- Why is a reduction in capital requirements necessary at this point in the business cycle?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

June 19, 2018

The Honorable Heidi Heitkamp
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the April 19, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on April 27, 2018.

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

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

- **Can you elaborate on your views regarding the connection between a government guarantee and the availability of the thirty-year fixed rate mortgage in all credit cycles?**
- **Do you believe that government guarantees promote or detract from housing market stability?**
- **During the 2000s, as private-label securitization grew to dominate the U.S. housing finance system, we saw very clearly the tendency of nonguaranteed mortgage financing to shun the thirty-year fixed rate mortgage. Indeed, during the period from 2001–2008, private-label securitization displayed a remarkable bias toward adjustable-rate products. Do you believe that nonguaranteed financing and its tendency towards adjustable rates would provide affordable access to credit for American families? In a housing downturn, do you believe that non-guaranteed mortgage financing could provide consumers with similar access to affordable, long-term housing credit?**

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

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

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

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

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

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System on behalf of Senator Heidi Heitkamp:

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

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

June 21, 2018

The Honorable Mark Warner
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the April 19, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

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

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

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

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

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

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

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

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

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

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

- **Before proposing the two rules, did the Board analyzed the effect on tier 1 capital if both proposals were adopted as proposed?**
- **What would the cumulative effect on required tier 1 capital at the holding company level be for G-SIBs if both proposals were adopted as proposed?**

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

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

could weaken one of the stronger tools we have to ensure access to credit for the underserved and investment in communities that have been left behind while others prosper.

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

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

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

I agree that it is time to review changes to the definition of "assessment area," which is the area in which a bank's CRA performance is evaluated. The banking environment has changed since CRA was enacted and the current CRA regulations were adopted. Banks may now serve consumers in areas far from their physical branches. Therefore, it is sensible for the agencies to consider expanding the assessment area definition to reflect the local communities that banks serve through delivery systems other than branches. Additional thought and analysis on this matter will be needed to determine how best to define such assessment areas and how to evaluate performance in those areas.

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

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

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

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

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

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

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

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

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

What do you think about that approach?

The Federal Reserve and the other federal banking agencies are required by statute to review the BSA/AML compliance program of the banks we supervise at each examination.[1] Thus, unless

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

this requirement is changed by Congress, banking agencies must continue to examine for BSA compliance at banking institutions.

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

Currently, the Federal Reserve and the other federal banking agencies routinely coordinate with FinCEN on a range of BSA matters. The FFIEC BSA/AML Working Group, which includes representatives of the banking agencies and FinCEN, meets regularly to share information among its members about various BSA/AML initiatives. This forum can encourage the sharing of information developed by FinCEN related to specific types of money laundering typologies and other relevant data that would help prioritize the ongoing examination efforts by the banking agencies.

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

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

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

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

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

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System on behalf of Senator Mark Warner:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- What do you think about that approach?

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

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

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 12, 2018

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the April 19, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on April 27, 2018.

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

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

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

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

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

We understand that this offset is proposed for European banks.

- **Won't a lack of offset potentially put US banks at a disadvantage for the client clearing businesses?**

Clearing improves safety for end-users and has been recognized by policy makers as such.

- **Wouldn't recognizing client margin under the leverage ratio incentive clearing?**

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

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

The exact way in which to adjust the leverage ratio to reflect this status is complex, however, and is one of a number of issues that our current capital regime raises for business involving centrally cleared products. To address potential unintended consequences of the leverage ratio on client clearing, in December 2017, the Basel Committee on Banking Supervision, of which the Board is a member, announced that it would monitor the impact of the leverage ratio's treatment of client cleared derivative transactions and review the impact of the leverage ratio on banks' provision of clearing services and its effect on central counterparty clearing. The review involves surveying client clearing market participants to understand the impact of the leverage ratio on incentives to centrally clear over-the-counter derivatives.

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

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

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

The Board is working expeditiously to implement the standardized approach for measuring counterparty credit risk (SA-CCR) in the United States. Our aim is to issue a SA-CCR proposal for public comment, jointly with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency as soon as feasible. SA-CCR has many benefits. SA-CCR, as compared to the current exposure method, would allow for increased recognition of netting and margin and results in a more risk-sensitive exposure amount for listed option contracts. We continue to believe that the best way to address these issues is through a proposal to incorporate SA-CCR into the Board's regulatory capital rule. The rule making process would allow a wide variety of market participants to consider the potential impact of SA-CCR and would open the way for its potential benefits to apply to a wide range of derivative products.

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

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

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

First: The proposed capital framework introduces a new "stress leverage buffer" for the Tier 1 leverage ratio. Like the SLR, the Tier 1 leverage ratio is not tied to the relative risk of a firm's assets. If the stress leverage buffer becomes a binding constraint, then it could

create incentives for banks to take on riskier assets and penalize banks with safe balance sheets.

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

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

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

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

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

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

4. Custodial banks, which provide safekeeping and related services to pension funds, mutual funds, endowments, and other institutional investors, have engaged in substantial dialogue with the Federal Reserve in recent years to develop a new standardized capital methodology for agency securities lending services provided to clients. These discussions have led to the inclusion of technical changes to these capital rules in the finalization of the Basel Committee's post-crisis capital reforms agreed to by the Federal Reserve in December 2017.

- **When does the Federal Reserve plan to adopt these technical changes to the capital rules for securities financing transactions?**
- **Is there an opportunity for the Federal Reserve to propose rules to implement these technical changes, and perhaps others, separately and ahead of its longer range plan to solicit public input on the broader and more substantive capital changes later this year through the Advanced Notice of Proposed Rulemaking process?**

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

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

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

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

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

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

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

6. I appreciate you putting increased attention at the Federal Reserve on the heightened risk we are facing from potential cyberattacks. I am encouraged to hear that you are working with the private-sector to help provide solutions that will protect our financial

sector as a whole. We must be diligent in protecting our financial institutions and the customers they serve, and I believe that the best solutions we can arrive at can be achieved through collaboration.

- **Can you discuss any steps the Fed has taken to strengthen the cyber infrastructure of the financial sector?**

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

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

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

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

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

- **Are there any areas where Congress can be helpful on this front?**

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

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

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

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

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

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

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

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- Are there any areas where Congress can be helpful on this front?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 12, 2018

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of your written questions that you submitted following the April 19, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on April 27, 2018.

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

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

If so, which ones?

As a general matter, leverage capital requirements should serve as a backstop to risk-based capital requirements in order to reduce incentives for firms to increase their exposure to riskier assets. The Federal Reserve Board's (Board) stress capital buffer (SCB) proposal would currently extend the proposed stress buffer concept to the tier 1 leverage ratio, but not to the supplementary leverage ratio (SLR). The Board is seeking public comment on the advantages and disadvantages of both of these specific aspects of the proposal (i.e., the elimination of the post stress SLR but retention of the tier 1 leverage ratio; see questions 1 and 3 in the preamble of the proposed rulemaking).[2]

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

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

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

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

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

[1] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180410a2.pdf.

[2] See 83 FR 18160, 18166-7 (April 25, 2018).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Board and the Office of the Comptroller of the Currency's (OCC) eSLR proposal is based on the current definitions of tier 1 capital and total leverage exposure, which include central bank deposits in the denominator of the SLR. However, the Board and the OCC thought it appropriate generally to seek commenters' views on alternatives to the proposal, including the exclusion of

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

central bank deposits from the denominator. The Board will consider all comments received in connection with the proposal.

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

As noted in the response to question 1 above, due to the confidential nature of the supervisory data included in the projected impact of the proposals on individual firms, the Board has made only aggregate impact data publicly available. The estimated impacts of the SCB proposal and of the eSLR proposal across GSIBs are described above in the response to question 2 and question 6, respectively.

While the discussion in each of the SCB proposal and the eSLR proposal reflects the estimated impact of those individual proposals relative to current requirements, in developing the proposals, the combined impact was also considered. Factoring the relatively immaterial estimated reduction in required tier 1 capital across GSIBs under the eSLR proposal ($400 million, as noted above in response to question 6) into the estimated impact of the SCB proposal across GSIBs does not meaningfully affect the estimates.

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

- **Can you elaborate on this idea?[4]**

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

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

The Board's capital rules have been designed to significantly reduce the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure were it to occur. Capital rules and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle, credit availability and economic growth. At the same time, the Board recognizes that prudential requirements should be tailored

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

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

to the size, risk, and complexity of the firms subject to those requirements. In this regard, the Board is considering additional potential modifications to its rules, including both the capital rule and the living will rule, to simplify the rules and reduce unnecessary regulatory burden without compromising safety and soundness.

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

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

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

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

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

- **Do you agree that pro-cyclical regulation has contributed to past downturns in the economy?**

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

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

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

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

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

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

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

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

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

[7] https://www.wsj.com/articles/financial-deregulation-throws-fuel-on-already-hot-economy-1524654001#comments_sector.

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

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

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

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

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

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

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

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

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

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

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

- **What problem would putting CCAR scenarios out for comment solve?**

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

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

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

- **How could enactment of S. 2155 affect the Fed's decision to revise the advanced approaches threshold?**
- **Is the Fed considering raising the advanced approaches asset threshold to a level that is higher than $250 billion?**
- **What changes to the foreign exposure threshold is the Fed considering?**

The advanced approaches threshold was established on an interagency basis with the Federal Deposit Insurance Corporation (FDIC) and OCC, and is relevant for multiple elements of the Board's regulatory framework, including capital requirements, the liquidity coverage ratio rule, and related reporting requirements. The Board believes that capital and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle credit availability and economic growth. At the same time, the Board recognizes that prudential requirements should be tailored to the size, risk, and complexity of the firms subject to those requirements and is considering ways to adjust its regulations that will simplify rules and reduce unnecessary regulatory burden without compromising safety and soundness. We currently are considering ways to better align the advanced approaches threshold with these objectives, which could include changing both the

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

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

total asset and foreign exposure thresholds, and would take S.2155 into account. Any proposed changes to the threshold would be issued for public notice and comment after consultation with the FDIC and OCC.

- **Is it your opinion that the domestic asset threshold above which foreign banking organizations (FBOs) must establish an Intermediate Holding Company (IHC) should increase from $50 billion?**
  - **If so, what is the appropriate threshold?**

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

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

- **Does the Fed plan to finalize the 2016 commodities proposal?**
  - **If not, why not?**
  - **If so, when?**

The Board began its review of the physical commodities activities of financial holding companies after a substantial increase in these activities among financial holding companies during the financial crisis. In January 2014, the Board invited public comment on a range of issues related to these activities through an advance notice of proposed rulemaking. In response, the Board received a large number of comments from a variety of perspectives. The Board considered those comments in developing the proposed rulemaking that was issued in September 2016. After providing an extended comment period (150 days) to allow commenters time to understand and address the important and complex issues raised by the proposal, the Board again received a large number of comments from a variety of perspectives, including Members of Congress, academics, users and producers of physical commodities, and banking organizations. The Board continues to consider the proposal in light of the many comments received (and to monitor the physical commodities activities of financial holding companies).

12. S&P Global warned earlier this month that leveraged lending standards were deteriorating, and that underwriting standards in this $1 trillion market continue to get weaker and weaker.[12] Previously, guidance was in place to protect banking organizations from leveraged lending risks, but while at the OCC, Acting Comptroller Noreika rescinded

[11] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160923a.htm.
[12] https://www.ft.com/content/680953c0-3e2a-11e8-b9f9-de94fa33a81e.

it. You have also said that this guidance, because it was declared a rule by the GAO, is "not something that should be cited in supervisory action or taken into account by examiner."[13]

- **How do you plan to protect banks from systemic risk stemming from leveraged lending if you're telling supervisors to ignore this guidance?**
- **Does the Fed have plans to replace the leveraged lending guidance with a proposed rule?**

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

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

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

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

- **What evidence can you point to that indicates the Volcker Rule has had a causal impact on liquidity?**
- **Is there a range of optimal liquidity?**

Federal Reserve staff and a variety of other researchers have performed substantial analyses of the recent state of financial markets and liquidity in particular. While overall results of these studies are mixed, there are findings suggesting that the Volcker Rule has had an impact on liquidity. For example, one recent study finds evidence that cost of trading distressed corporate bonds (i.e., bonds recently downgraded to below investment-grade ratings) is higher since

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

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

implementation of the Volcker Rule.[15] Furthermore, the paper finds that broker dealers subject to the Volcker Rule appear less willing to hold inventories of corporate bonds relative to other broker dealers. Taken together, these results indicate that the Volcker Rule has had an adverse impact on the liquidity of distressed corporate bonds. Other studies indicating a causal relationship between the Volcker Rule and reduced liquidity in some markets or for some instruments include Dick-Nielsen and Rossi (2016); Choi and Huh (2016); Bessembinder, Jacobsen, Maxwell, and Venkataraman (2016); and Adrian, Boyarchenko, and Shachar (2016).[16]

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

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

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

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

The quantitative trading metrics are an important component of the agencies' supervisory work to monitor compliance with the Volcker Rule. The metrics are intended to aid the staffs of the

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

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

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

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

Goldman Sachs | Equity Research

11 April 2018 | 5:32AM EDT

Americas Banks

CCAR stress capital buffer proposal expected to be constructive for the large banks

On April 10th, the Federal Reserve released a proposed rulemaking (NPR) that amends the Comprehensive Capital Analysis and Review (CCAR) in next year's test, changing risk-based capital (CET1) and Tier 1 leverage capital by adding the stress capital buffer (SCB), while removing SLR from the CCAR test - we view these proposed changes as constructive. Key takeaways include:

1. **Absolute minimum CET1 capital requirements for the banks going higher, but distributable capital could increase as binding constraints shift.** Incorporating G-SIB buffer into CCAR increases CET1 min. by 100bps on avg. and CET1 capital becomes binding for all large banks (aside from **MS**, which looks to be spot SLR bound) - **JPM**, **STT**, **NTRS** and **WFC** were formerly bound by T1 leverage. The fact that leverage looks to be binding for only one bank, and the removal of stressed SLR/spot T1 leverage look to conform with Fed intent to make leverage a backstop. That said, with shifting binding constraints, we estimate that almost every bank in our coverage sees excess capital increases (6% of market cap on avg for the largest US banks, or $54bn in total excess created), with **BAC**, **MS** and **JPM** expected to have the most incremental excess capital.
2. **Bank boards look to have greater control over the form of and ability to return capital, which we think will lead the market to assign more value to excess capital.** The proposal removes the 30% dividend soft cap and banks now need to prefund only four quarters of dividends vs. nine quarters of each of dividends and buybacks in CCAR. We think this will change the balance of capital payouts towards dividends over time, which we think could enhance valuations.
3. **These proposed changes look to be consistent with the Fed's goal of increasing transparency into CCAR.** Banks would have a three month period to respond to and question the Fed's calculation of their SCB between June 30 and October 1.

We do not run this analysis for regional banks given that, based on the proposal, they all remain bound by the same CET1 minimum requirements.

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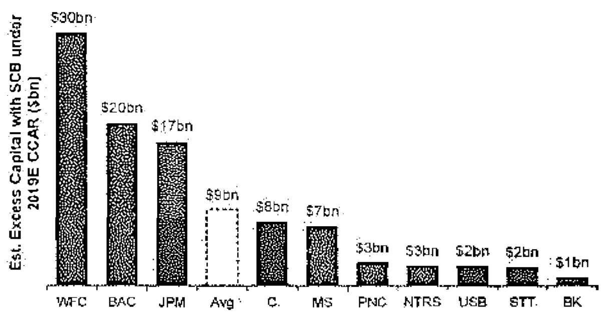
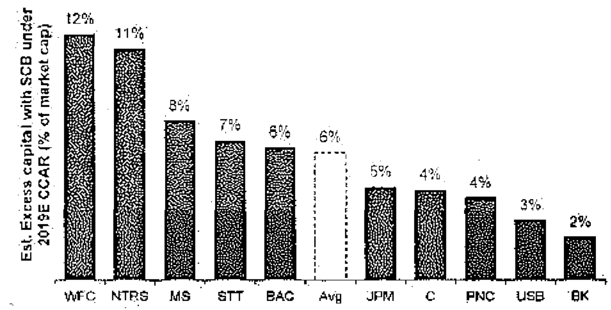
Our numbers are preliminary, for illustrative purposes and we acknowledge a range of outcomes may exist outside what we present, given we use last year's CCAR test losses, as well as the prospect the rule could change from the proposal.

Exhibit 1: With the SCB proposal, large and trust banks have $9bn of excess capital on average...
Note: Based on 2019E CCAR test, and GS estimated 4Q18 capital levels



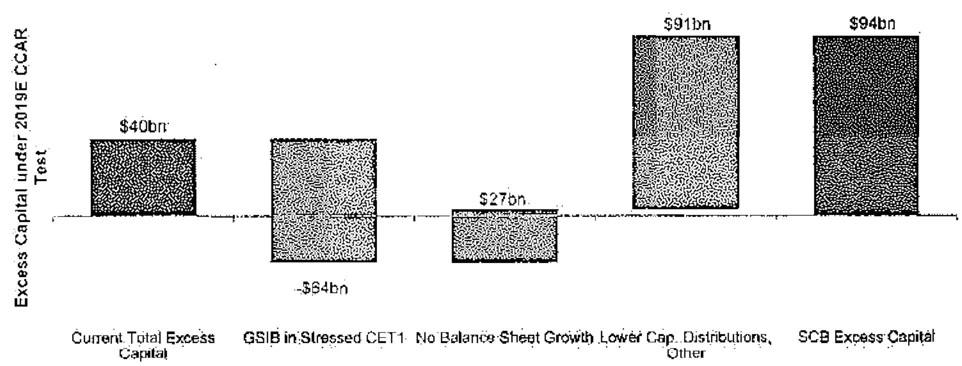
Source: Federal Reserve Board, SNL Financial, Company data, Goldman Sachs Global Investment Research

Exhibit 2: ...which equates to 6% of market cap, with WFC and NTRS best positioned
Note: Based on 2019E CCAR test, and GS estimated 4Q18 capital levels



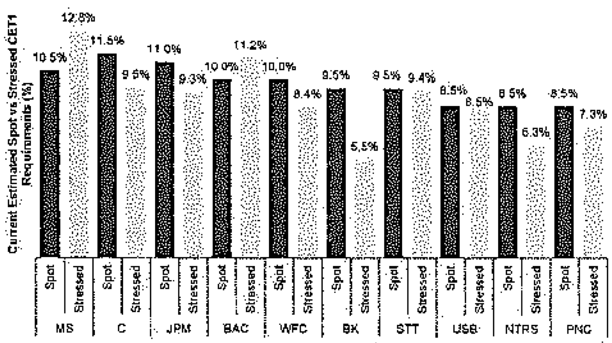
Source: Federal Reserve Board, SNL, FactSet, Company data, Goldman Sachs Global Investment Research

Exhibit 3: Large and trust banks generate $54bn of excess capital from the collective changes to the stress test
Note: Based on estimated 2019E CCAR test, and 4Q18E excess capital levels



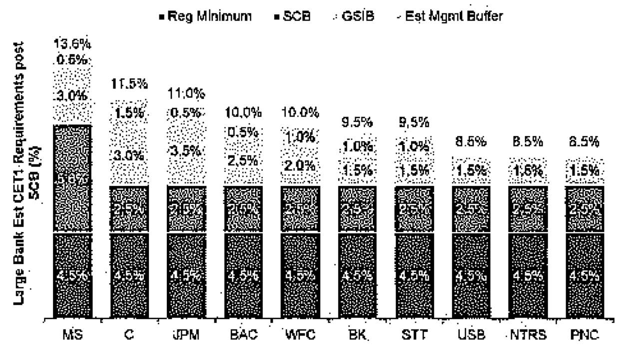
Source: Federal Reserve Board, SNL, Company data, Goldman Sachs Global Investment Research

Exhibit 4: Current bank CET1 ratios
Note: Binding ratio is the greater of spot vs stressed



Source: Federal Reserve Board, Company data, Goldman Sachs Global Investment Research

Exhibit 5: Estimated CET1 capital stacks under the SCB framework are not radically different than current standards



Source: Federal Reserve Board, Company data, Goldman Sachs Global Investment Research

- **What changes under SCB[1]:** We lay out the proposed changes for which capital ratios have been removed and how capital ratio minimum requirements have changed below and in Exhibits 6, 7 (for further detail on how banks' minimums look to change from the current CCAR test to SCB proposal, see the Appendix):
  - **CET1:** Banks remain subject to spot CET1 Advanced requirements, while CCAR minimum (SCB) capital requirements (which are compared vs. CET1 Standardized) stay roughly flat under SCB as banks need to capitalize for only four quarters of dividends (vs. nine quarters of dividends and buybacks under current test) and there is no balance sheet/RWA inflation, although this is largely offset by the inclusion of the G-SIB buffer (Exhibits 4, 5).
    - Current CCAR: Today, banks have to calculate three CET1 ratios: 1) spot Standardized; 2) spot Advanced; and 3) Stressed Standardized. For Stressed Standardized, banks compare end of year capital ratios vs. the annually determined stressed capital minimum requirement, comprised of: 4.5% Basel III minimum CET1 + capital required to capitalize for losses over the course of the CCAR test + capital required to capitalize for balance sheet/RWA inflation over the course of the test + capital required to capitalize for nine quarters of dividends and buybacks (Exhibit 6, 7).
    - NPR: In the NPR, banks have to calculate spot Advanced capital and Stressed Standardized capital (ie SCB). Stressed Standardized is calibrated as follows: 4.5% Basel III minimum CET1 + G-SIB buffer + the greater of: 1) capital required to capitalize for losses over the CCAR test + capital required to capitalize for four quarters of dividends; and 2) 2.5% CET1.
  - **Tier 1 leverage:** The NPR removes the spot Tier 1 leverage ratio, while proposing to implement a stressed buffer for Tier 1 leverage similar to the one

[1] The stress capital buffer was first proposed in a speech by former Federal Reserve Board Governor Tarullo on September 26, 2016, as discussed in our report, *Follow Up - Capital requirements increasing, but mostly positive for our coverage*, published on September 26, 2016.

for CET1. This reduces the Tier 1 leverage minimum stressed requirement due to the removal of prefunding nine quarters of divs/buybacks + removal of balance sheet inflation.

- Current CCAR: Banks' minimum consists of: 4% T1 leverage + capital required to capitalize for losses over the CCAR test + capital required to capitalize for balance sheet inflation over the course of the test + capital required to capitalize for nine quarters of dividends and buybacks (Exhibits 6, 7).
- NPR: Bank minimums falls with calibration as follows: 4% Tier 1 leverage minimum + capital required to capitalize for losses over the CCAR test + capital required to capitalize for four quarters of dividends.

☐ **SLR:** The NPR proposes to remove the SLR from the CCAR test, leaving banks only subject to spot SLR. Spot SLR consists of a 3% minimum + 2% add-on for G-SIBs.

- **All of our coverage now bound by risk-based capital (ex. MS, which is bound by spot SLR):** The proposed implementation of SCB looks to change the binding constraint for JPM, WFC, STT, NTRS from stressed Tier 1 leverage to CET1 capital, which would mean that all of our banks aside from MS are risk-based capital-bound (MS looks to be bound by spot SLR). The shift from T1 leverage to CET1 is driven by the fact that the balance sheet inflation and capital distributions comprised a bigger percentage of the required capital minimum under Tier 1 leverage vs. CET1.
- **Excess capital freed up by shifting binding constraints and implementing SCB:** We believe that changing binding constraints and the requirement that banks fund nine quarters of dividends & buybacks to only four quarters of dividends outweighs adding G-SIB to the minimum in CCAR, and each one of the money centers (ex C) sees excess capital increase, with total excess capital increasing by $54bn, or 6% on average (Exhibits 2, 3, 8). We note that our estimates are based on the 2017 CCAR test losses, and that loss severity could change over time, given potential changes to PPNR models and stress test scenarios.
- **Timeline and mulligan process changed, and the Fed can still cause firms to reduce payouts, but greater transparency into process as banks can interface with the Fed on their SCB:** While the submission date and announcement dates remain roughly the same (April 5 and June 30, respectively), the Fed has changed the timing of the CCAR test and the way in which they can require a firm to change its capital plan. Under the old test, in the case of a Fed objection a bank would have a one-time opportunity to resubmit its capital plan (i.e., mulligan). On the other hand, under the proposal, by June 30, the Fed: 1) calculates and discloses a banks' SCB; and 2) discloses whether it agrees or disagrees with a bank's capital plan. A bank then has two business days to determine whether it needs to change its capital plan in response. In addition, the effective starting point of planned capital actions changes from July 1 to October 1 (i.e., one quarter delay going forward). The first stress capital buffer would be effective starting next year, Oct 1, 2019. Notably, in an important change from current CCAR, consistent with Fed Governor Quarles' stated goal of increasing transparency into stress testing, the Fed allows banks an

opportunity to discuss their SCB with the Fed between the SCB announcement date and the effective date (i.e., between June 30 and September 30). We view this as a bank's chance to gain further clarity into the Fed's process and to receive a potential recalibration of the SCB.

Exhibit 6: The Fed has removed spot Standardized capital, spot T1 leverage capital and stress SLR capital requirements...

Current CCAR

Risk- based capital		
#	Spot / Stress ratio	Vs. which cap. regime
1)	Spot	Standardized
2)	Spot	Advanced
3)	Stress	Standardized

Leverage capital		
#	Spot / Stress ratio	Vs. which cap. regime
4)	Spot	Tier 1 leverage
5)	Spot	SLR
6)	Stress	Tier 1 leverage
7)	Stress	SLR

Fed NPR

Risk- based capital		
#	Spot / SCB ratio	Vs. which cap. regime
1)	Spot	Advanced
2)	SCB	Standardized

Leverage capital		
#	Spot / SCB ratio	Vs. which cap. regime
3)	Spot	SLR
4)	SCB	Tier 1 leverage

Source: Federal Reserve Board, Goldman Sachs Global Investment Research

Exhibit 7: ...while also reducing CCAR risk-based capital (CET1) and T1 leverage minimum requirements through reducing capital prefunding requirements and B/S inflation over the test

Note: Changes highlighted in red; Assumes a 0% countercyclical capital buffer

Current CCAR

Risk- based capital	
Spot	4.5% + 2.5% CCB + G-SIB buffer
Stress	4.5% + cap. for stress losses + cap. for balance sheet growth + cap. for 9q of buybacks & 9q of divs.

T1 Leverage capital	
Spot	4%
Stress	4% + cap. for stress losses + cap. for balance sheet growth + cap. for 9q of buybacks & 9q of divs.

SLR	
Spot	3% + 2% G-SIB buffer
Stress	3% + cap. for stress losses + cap. for balance sheet growth + cap. for 9q of buybacks & 9q of divs.

Fed NPR

Risk- based capital	
Spot	4.5% + 2.5% CCB + G-SIB buffer
SCB	**Greater of: 4.5% + G-SIB buffer + 2.5%; OR 4.5% + G-SIB buffer + capital for stress losses + capital for 4q of dividends**

T1 Leverage capital	
Spot	~~N/A~~
SCB	**4% + capital for stress losses + capital for 4q of dividends**

SLR	
Spot	3% + 2% G-SIB buffer
Stress	N/A

Source: Goldman Sachs Global Investment Research, Federal Reserve Board

Exhibit 8: We estimate implementing the SCB framework will generate over $5bn on average for the large banks, leaving them with 6% of excess capital on a market cap basis

Excess Capital for 2019E CCAR Test											
$bn	BAC	C	JPM	MS	WFC	PNC	USB	BK	STT	NTRS	Avg
Current Capital Requirements											
Excess Capital ($bn)	**2.9**	**7.9**	**4.4**	**(3.3)**	**20.5**	**2.9**	**2.5**	**1.1**	**(0.3)**	**1.2**	**4.0**
% of Market Cap (%)	1%	4%	1%	-3%	8%	4%	3%	2%	-1%	5%	2%
Binding Ratio	CET1, Standardized	CET1, Standardized	T1 Leverage	T1 Leverage	T1 Leverage	CET1, Standardized	CET1, Standardized	CET1, Advanced	T1 Leverage	T1 Leverage	-
Spot vs Stressed	Stressed	Spot	Stressed	Stressed	Stressed	Spot	Spot	Spot	Stressed	Stressed	-
CET1 Requirement (%)	11.2%	11.5%	11.0%	12.8%	10.0%	8.5%	8.5%	9.5%	9.5%	8.5%	10.1%
Stress Capital Buffer + CCAR Changes											
Excess Capital ($bn)	**19.5**	**7.9**	**17.4**	**7.3**	**30.4**	**2.9**	**2.5**	**1.1**	**2.4**	**2.5**	**9.4**
% of Market Cap (%)	6%	4%	5%	8%	12%	4%	3%	2%	7%	11%	6%
vs Baseline ($bn)	*16.7*	*0.0*	*12.9*	*10.6*	*9.9*	*0.0*	*0.0*	*0.0*	*2.7*	*1.3*	5.4
Binding Ratio	CET1, Advanced	CET1, Standardized	CET1, Standardized	SLR	CET1, Standardized	CET1, Standardized	CET1, Standardized	CET1, Advanced	CET1, Standardized	CET1, Standardized	-
CET1 Requirement (%)	10.0%	11.5%	11.0%	13.6%	10.0%	8.5%	8.5%	9.5%	9.5%	8.5%	10.1%
SCB (%)	2.5%	2.5%	2.5%	5.6%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.8%

Source: SNL, FactSet, Federal Reserve Board, Company data, Goldman Sachs Global Investment Research

New vs. old

We update estimates for BAC and MS to account for our updated view of capital payouts post the Fed's NPR on CCAR changes.

Exhibit 9: New vs. old

Ticker	Price 4/10/18	Analyst	Old Estimates							New Estimates							New vs Old Estimates				Return		
			Rating	PT	2018 P/E	1Q18E	2018E	2019E	2020E	Rating	PT	2018 P/E	1Q18E	2018E	2019E	2020E	2018E	2019E	2020E	PTs	Upside	Div	Total
BAC	$30.48	Ramsden	Buy*	$36.00	14.0x	0.61	2.54	2.92	3.22	Buy*	$36.00	14.0x	0.61	2.54	2.90	3.18	0%	-1%	-1%	0%	18%	2%	20%
MS	$54.14	Ramsden	Neutral	$59.00	13.0x	1.30	4.54	4.97	5.47	Neutral	$59.00	13.0x	1.30	4.53	4.91	5.34	0%	-1%	-2%	0%	9%	2%	11%
Avg.	–	–	–	–	13.5x	–	–	–	–	–	–	13.5x	–	–	–	–	0%	-1%	-2%	0%	14%	2%	15%

* *on the Americas Conviction List*

Note: All price targets are for a 12-month timeframe, and are based on target 2018E P/E multiples.

Source: FactSet, Company data, Goldman Sachs Global Investment Research

Key risks:

- **BAC:** Downside risks include a slower rise in rates, and slower economic growth.
- **MS:** Risks include a faster/slower rise in rates, and faster/slower economic growth.

Appendix

Exhibit 10: GSe current CCAR vs. SCB

SCB calculation (% / $bn)	Key	BAC CCAR today	BAC SCB	C CCAR today	C SCB	JPM CCAR today	JPM SCB	MS CCAR today	MS SCB	WFC CCAR today	WFC SCB	PNC CCAR today	PNC SCB	USB CCAR today	USB SCB	BK CCAR today	BK SCB	STT CCAR today	STT SCB	NTRS CCAR today	NTRS SCB
CET1 SCB																					
Spot: Regulatory Minimum		4.5%		4.5%		4.5%		4.5%		4.5%		4.5%		4.5%		4.5%		4.5%		4.5%	
Spot: 2.5% Minimum (SCB/CCB)		2.5%		2.5%		2.5%		2.5%		2.5%		2.5%		2.5%		2.5%		2.5%		2.5%	
Spot: G-SIB requirement		2.5%		3.0%		3.5%		3.0%		2.0%		0.0%		0.0%		1.5%		1.5%		0.0%	
Spot: Management buffer		0.5%		1.5%		0.5%		0.5%		1.0%		1.5%		1.5%		1.0%		1.0%		1.5%	
Spot minimum	A	10.0%		11.5%		11.0%		10.5%		10.0%		8.5%		8.5%		9.5%		9.5%		8.5%	
Stressed: Regulatory Minimum		4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Stressed: G-SIB requirement		-	2.5%	-	3.0%	-	3.5%	-	3.0%	-	2.0%	-	0.0%	-	0.0%	-	1.5%	-	1.5%	-	0.0%
Stressed: Capital Lost over the Test		1.8%	1.5%	1.9%	1.9%	1.4%	1.5%	5.3%	5.2%	-0.2%	0.1%	-0.3%	-0.1%	-0.3%	-0.6%	-3.2%	-3.5%	-0.7%	0.2%	-1.6%	-1.8%
Stressed: Capital Lost from RWA Inflation		0.6%	-	0.3%	-	0.3%	-	0.1%	-	0.3%	-	0.3%	-	0.6%		0.5%	-	0.3%	-	0.4%	-
Stressed: Capital Lost from Capital Return		4.2%	0.5%	2.4%	0.3%	2.5%	0.6%	2.5%	0.5%	3.0%	0.6%	2.2%	0.6%	3.5%	0.6%	3.5%	0.8%	3.9%	0.7%	2.7%	0.6%
Stressed: Management buffer		0.5%	0.5%	0.5%	1.5%	0.5%	0.5%	0.5%	0.5%	0.5%	1.0%	0.5%	1.5%	0.5%	1.5%	0.5%	1.0%	0.5%	1.0%	0.5%	0.5%
CET1 - SCB Framework	B	11.5%	9.4%	9.6%	11.2%	9.2%	10.6%	13.0%	13.6%	8.2%	8.2%	7.2%	6.5%	8.8%	6.0%	5.8%	4.3%	8.4%	7.9%	6.6%	3.8%
Binding CET1 ratio	C = max(A, B)	11.5%	10.0%	11.5%	11.5%	11.0%	11.0%	13.0%	13.6%	10.0%	10.0%	8.5%	8.5%	8.8%	8.5%	9.5%	9.5%	9.5%	9.5%	8.5%	8.5%
Change in minimum CET1		*1.5%*		*0.0%*		*0.0%*		*-0.7%*		*0.0%*		*0.0%*		*0.3%*		*0.0%*		*0.0%*		*0.0%*	
4Q18 CET1 (Std)	D	11.4%		12.2%		12.1%		16.6%		12.4%		9.4%		9.1%		11.3%		11.8%		12.0%	
Excess capital (%)	E = D - C	-0.1%	1.4%	0.7%	0.7%	1.1%	1.1%	3.6%	2.9%	2.4%	2.4%	0.9%	0.9%	0.4%	0.6%	0.6%	1.8%	2.3%	2.3%	3.5%	3.5%
Excess capital ($bn)	F	*2.9*	*19.5*	*7.9*	*7.9*	*17.4*	*17.4*	*14.3*	*11.1*	*30.4*	*30.4*	*2.9*	*2.9*	*2.5*	*2.5*	*1.1*	*1.1*	*2.4*	*2.4*	*2.5*	*2.5*
T1 Leverage SCB																					
Spot: Regulatory Minimum		4.0%	-	4.0%	-	4.0%		4.0%		4.0%		4.0%	-	4.0%		4.0%	-	4.0%	-	4.0%	-
Spot: Management buffer		0.2%		0.2%	-	0.2%	-	0.2%	-	0.2%		0.2%		0.2%		0.2%	-	0.2%	-	0.2%	-
Spot T1 Lev Requirements	G	4.2%	-	4.2%		4.2%	-	4.2%		4.2%		4.2%		4.2%		4.2%	-	4.2%	-	4.2%	
Stressed: Regulatory Minimum		4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Stressed: Capital Lost over the Test		1.2%	1.0%	0.5%	0.5%	0.8%	0.8%	1.6%	1.6%	-0.2%	-0.1%	-0.5%	-0.4%	-0.3%	-0.5%	-2.3%	-2.4%	-1.0%	-0.5%	0.9%	-1.1%
Stressed: Capital Lost from B/S Inflation		0.4%	-	0.5%		0.4%	-	0.1%	-	0.5%		0.5%	-	0.6%	-	0.5%	-	0.4%	-	0.6%	
Stressed: Capital Lost from Capital Return		2.8%	0.3%	2.7%	0.2%	2.7%	0.4%	2.0%	0.2%	3.8%	0.4%	3.4%	0.5%	2.8%	0.5%	3.1%	0.4%	3.5%	0.3%	2.9%	0.4%
Stressed: Management buffer		0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Stressed T1 Lev Requirement	H	8.6%	5.4%	7.8%	4.8%	8.1%	5.3%	8.0%	5.9%	8.2%	4.5%	7.6%	4.3%	7.3%	4.2%	5.5%	2.2%	7.0%	4.0%	6.7%	3.4%
Binding T1 Lev ratio	I = max (G, H)	8.6%	5.4%	7.8%	4.8%	8.1%	5.3%	8.0%	5.9%	8.2%	4.5%	7.6%	4.3%	7.3%	4.2%	5.5%	4.2%	7.0%	4.2%	6.7%	4.2%
Change in minimum T1 lev.		*-3.1%*		*-2.7%*		*-2.8%*		*-2.1%*		*-3.7%*		*-3.3%*		*-3.1%*		*-1.4%*		*-2.8%*		*-2.5%*	
4Q18E T1 Leverage Ratio (%)	J	8.6%		8.7%		8.3%		7.5%		9.4%		8.9%		8.5%		6.3%		7.3%		7.4%	
Excess T1 Lev (%)	K = J - I	0.0%	3.2%	0.9%	3.9%	0.2%	3.0%	-0.5%	1.6%	1.2%	4.9%	1.4%	4.7%	1.2%	4.4%	0.8%	4.2%	0.4%	3.4%	0.8%	4.0%
Excess T1 Lev ($bn)	L	*5.1*	*70.3*	*17.2*	*73.0*	*4.4*	*76.8*	*(3.3)*	*13.4*	*20.5*	*95.6*	*4.9*	*18.3*	*7.0*	*21.0*	*3.3*	*14.2*	*(0.3)*	*7.1*	*1.2*	*5.2*
SLR																					
Spot: Regulatory Minimum		3.0%		3.0%		3.0%		3.0%		3.0%		3.0%		3.0%		3.0%		3.0%		3.0%	
Spot: eSLR		2.0%		2.0%		2.0%		2.0%		2.0%		0.0%		0.0%		2.0%		2.0%		0.0%	
Spot: Management buffer		0.2%		0.2%		0.2%		0.2%		0.2%		0.2%		0.2%		0.2%		0.2%		0.2%	
Spot SLR Requirements	M	5.2%		5.2%		5.2%		5.2%		5.2%		3.2%		3.2%		5.2%		5.2%		3.2%	
Stressed: Regulatory Minimum		3.0%	-	3.0%	-	3.0%	-	3.0%	-	3.0%	-	3.0%	-	3.0%	-	3.0%	-	3.0%	-	3.0%	-
Stressed: Capital Lost over the Test		0.9%	-	0.4%	-	0.6%	-	1.3%	-	-0.2%	-	-0.4%	-	-0.2%	-	-2.1%	-	-0.9%	-	-0.8%	-
Stressed: Capital Lost from B/S Inflation		0.3%	-	0.4%	-	0.3%	-	0.1%	-	0.4%	-	0.5%	-	0.5%	-	0.5%	-	0.3%	-	0.5%	-
Stressed: Capital Lost from Capital Return		2.2%	-	2.0%	-	2.1%	-	1.6%	-	3.3%	-	2.9%	-	2.4%	-	2.8%	-	3.1%	-	2.5%	-
Stressed: Management buffer		0.2%	-	0.2%	-	0.2%	-	0.2%	-	0.2%	-	0.2%	-	0.2%	-	0.2%	-	0.2%	-	0.2%	-
Stressed SLR Requirements	N	6.6%	-	5.9%	-	6.2%	-	6.1%	-	6.7%	-	6.1%	-	5.8%	-	4.4%	-	5.7%	-	5.3%	-
Binding SLR ratio	O = max(M, N)	6.6%	5.2%	5.9%	5.2%	6.2%	5.2%	6.1%	5.2%	6.7%	5.2%	6.1%	3.2%	5.8%	3.2%	5.2%	5.2%	5.7%	5.2%	5.3%	3.2%
Change in minimum SLR		*-1.5%*		*-0.8%*		*-1.1%*		*-1.0%*		*-1.5%*		*-3.0%*		*-2.7%*		*0.0%*		*-0.5%*		*-2.2%*	
4Q18E SLR Ratio (%)	P	6.7%		6.6%		6.5%		5.8%		8.2%		7.8%		7.2%		5.8%		6.5%		6.5%	
Excess SLR (%)	Q = P - O	0.1%	1.6%	0.6%	1.4%	0.3%	1.3%	-0.3%	0.7%	1.5%	3.1%	1.7%	4.6%	1.4%	4.1%	0.7%	0.7%	0.8%	1.3%	1.2%	3.3%
Excess SLR ($bn)	R	*8.2*	*45.3*	*16.6*	*35.2*	*8.0*	*43.7*	*(2.4)*	*7.3*	*30.8*	*68.2*	*7.0*	*20.9*	*9.2*	*23.2*	*2.5*	*2.5*	*1.0*	*3.2*	*1.9*	*4.9*
Binding excess capital ($bn)	S = min(F,L,R)	2.9	19.5	7.9	7.9	4.4	17.4	(3.3)	7.3	20.5	30.4	2.9	2.9	2.5	2.5	1.1	1.1	(0.3)	2.4	1.2	2.5
Incremental excess capital ($bn)		16.7		0.0		12.9		10.6		9.9		0.0		0.0		0.0		2.7		1.3	
Binding ratio		CET1, Standardized	CET1, Advanced	CET1, Standardized	CET1, Standardized	T1 Leverage	CET1, Standardized	T1 Leverage	SLR	T1 Leverage	CET1, Standardized	CET1, Standardized	CET1, Standardized	CET1, Standardized	CET1, Standardized	CET1, Advanced	CET1, Advanced	T1 Leverage	CET1, Standardized	T1 Leverage	CET1, Standardized
Binding is Spot / Stress		Stressed	Spot	Spot	SCB	Stressed	SCB	Stressed	Spot	Stressed	SCB	Spot	SCB	Spot	SCB	Spot	SCB	Stressed	SCB	Stressed	SCB
Excess as a % of market cap.		*1%*	*6%*	*4%*	*4%*	*1%*	*5%*	*-3%*	*8%*	*8%*	*12%*	*4%*	*4%*	*3%*	*3%*	*2%*	*2%*	*-1%*	*7%*	*5%*	*11%*
Incr. excess cap as % of mkt cap		*5%*		*0%*		*3%*		*11%*		*4%*		*0%*		*0%*		*0%*		*7%*		*6%*	

Note: red ring indicates bank whose binding capital requirement looks to change under SCB

Source: FactSet, Company data, Goldman Sachs Global Investment Research

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System on behalf of Ranking Member Brown:

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

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

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

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

- Why did the Fed choose not to include the enhanced SLR (eSLR) in the SCB proposal?

The Fed's eSLR proposal would reduce the amount of tier 1 capital required across the lead insured depository institution (IDI) subsidiaries of the GSIBs by approximately $121 billion.[2]

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

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

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

- Please provide firm-by-firm analysis for each domestic GSIB on the combined impact on total distributable capital related to both the SCB and eSLR proposals.

[1] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180410a2.pdf
[2] https://www.gpo.gov/fdsys/pkg/FR-2018-04-19/pdf/2018-08066.pdf

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System
April 19, 2018

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

- Can you elaborate on this idea?3

- Has the Fed considered the potential interaction between this idea, the proposed rule changing the eSLR, and the Fed's intention to make living will submissions required every other year, rather than annually?4

Earlier this year in Tokyo, you gave a speech describing the strength of the U.S. economy, noting growing optimism, solid bank earnings, the tax bill, and the strong labor market.5

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

- Do you agree that pro-cyclical regulation has contributed to past downturns in the economy?

    - If so, why not make bank regulations more stringent during a time when risk appetites in the banking sector are growing?6

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

- Will this at all change if S.2155 is enacted?

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

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

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[3] Response to a question from Congressman Hollingsworth. House Financial Services Committee Hearing. "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System." April 17, 2017.
[4] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171219a.htm
[5] https://www.federalreserve.gov/newsevents/speech/files/quarles20180222a.pdf
[6] https://www.wsj.com/articles/financial-deregulation-throws-fuel-on-already-hot-economy-1524654001#comments_sector.

- In testimony before the House Financial Services Committee, you proposed subjecting CCAR stress scenarios to notice and comment, but noted that a formal process under the Administrative Procedures Act (APA) may be unworkable. How does the Fed contemplate putting CCAR scenarios out for comment without following a formal APA process?7

- What problem would putting CCAR scenarios out for comment solve?

In a speech, you said that the Fed should "revisit" the so-called "advanced approaches" threshold, which identifies certain large banks whose failure could inflict especially significant damage on the U.S. economy.8 In the Senate Banking Committee hearing, you told the Committee that you would hold off on revising the advanced approaches threshold until Congress moves.9

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

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

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

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

    - If so, what is the appropriate threshold?

The Fed in 2016 proposed a rule to limit some of banks' activities in commodities markets, with the rationale being that banks' owning, trading and moving commodities might post a safety and soundness risk to individual banks or to the banking system.10

- Does the Fed plan to finalize the 2016 commodities proposal?

    - If not, why not?

[7] Response to a question from Congressman Barr. House Financial Services Committee Hearing. "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System." April 17, 2017.
[8] https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm
[9] Response to a question from Senator Tillis. Senate Banking, Housing & Urban Affairs Committee Hearing. "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System." April 19, 2017.
[10] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160923a.htm

- o If so, when?

S&P Global warned earlier this month that leveraged lending standards were deteriorating, and that underwriting standards in this $1 trillion market continue to get weaker and weaker.[11] Previously, guidance was in place to protect banking organizations from leveraged lending risks, but while at the OCC, Acting Comptroller Noreika rescinded it. You have also said that this guidance, because it was declared a rule by the GAO, is "not something that should be cited in supervisory action or taken into account by examiner."[12]

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

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

Publicly you asserted that you believe the Volcker Rule has damaged financial markets.[13]

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

- Is there a range of optimal liquidity?

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

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

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[11] https://www.ft.com/content/680953c0-3e2a-11e8-b9f9-de94fa33a81e
[12] https://www.americanbanker.com/news/feds-quarles-to-seek-more-tailoring-of-large-bank-rules
[13] https://www.marketwatch.com/story/volcker-rule-is-harmful-to-capital-markets-feds-top-regulator-says-2018-04-17

April 27, 2018

The Honorable Randal K. Quarles
Vice Chairman of Supervision
Board of Governors of the Federal Reserve System
Constitution Ave NW & 20th Street N.W.
Washington, DC 20551

Dear Mr. Quarles:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs on April 19, 2018 at our hearing entitled, *"The Semiannual Testimony of the Federal Reserve's Supervision and Regulation of the Financial System."* In order to complete the hearing record, we would appreciate your answers to the enclosed questions as soon as possible. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo
Chairman

MC/dr

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

August 16, 2018

The Honorable Blaine Luetkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to question 2 that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. On July 11, 2018, I provided responses to questions 1, and 3 through 6. All copies have been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

2. During the course of the hearing, Chairman Hensarling asked whether Federal Reserve staff had the legal authority to participate in bank board meetings. Please provide an answer to whether or not any Federal Reserve staff have such authority and, if appropriate, the mechanism by which that authority is derived. Have Federal Reserve staff in the past or do any Federal Reserve staff currently participate in bank board meetings?

The Federal Reserve Board (Board) is responsible for examining state member banks and bank holding companies to ensure that they are operated in a safe and sound manner. The Board's supervisory examinations evaluate a broad set of quantitative and qualitative factors to identify material risks to the safety and soundness of the examined institution and the financial stability of the United States.[1]

When an examination is complete, Board examiners may attend certain board meetings, or portions of meetings, to present the supervisors' examination findings and to allow for the exchange of information. A dialogue between examiners and boards of directors is part of the normal interactive supervisory process, and often serves as an opportunity to ensure that the entire board of a banking organization is aware of any supervisory concerns. When I have served on boards in the past, I have generally wanted the opportunity to hear directly from the bank's supervisors concerning their sentiment of an institution's condition. The Board views boards of directors as critical players in supporting the safety and soundness of their institutions and promoting compliance with laws and regulations. The Board's bank holding company rating system (also called the "RFI rating system") provides the framework[2] for communicating supervisory findings to the institution.

The RFI rating system also provides the framework for assessing a bank holding company's overall managerial condition, which is captured under the rating system's risk management component. To conduct the risk management component of the RFI rating system, Board examiners may from time to time attend portions of boards of directors meetings. Risk management examinations generally assess the ability of the bank holding company's board of directors to identify, measure, monitor, and control risk, and evaluates the adequacy and effectiveness of the board's understanding and management of risk inherent in the bank holding company's activities, as well as the general capabilities of management.

[1] Section 5(c)(2)(A) of the Bank Holding Company Act (12 U.S.C. 1844(c)(2)(A)) and section 10(b)(4)(A) of the Home Owners' Loan Act (12 U.S.C. 1467a(b)(4)(A)) authorize the Federal Reserve to write rules to conduct examinations of bank holding companies (BHCs) and savings and loan holding companies (SLHCs), respectively, to assess the financial, operational and other risks that may pose a threat to the safety and soundness of the company, its subsidiaries, or to U.S. financial stability.

[2] SR Letter 04-18, *Bank Holding Company Rating System*, at https://www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm.

In exercising its general examination authority for state member banks[3], the Board uses the Uniform Financial Institutions Rating System (UFIRS). Under UFIRS, which is also used by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, a supervisory assessment of management is made, which generally considers the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of a bank's activities and to ensure a bank's safe, sound, and efficient operation in compliance with applicable laws and regulations.

Consistent with the above, it would not generally be appropriate for examiners or other supervisory personnel to insist on being present during an entire board meeting or at every board meeting or to routinely participate in the deliberations of a board of directors.

[3] Section 9(7) of the Federal Reserve Act (12 U.S.C. 325.) requires, as a condition of membership in the Federal Reserve System, that state member banks to be subject to examinations by the Federal Reserve.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 11, 2018

The Honorable Blaine Leutkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 1, and 3 through 6 that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on May 22, 2018.

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

1. The National Institute of Standards and Technology (NIST) recently released its Cybersecurity Framework Version 1.1, after consulting numerous experts in private industry and government. Financial services firms have told us that this work is the state of the art, and are concerned that they will now have to spend vast amounts of time mapping how compliance with NIST 1.1 satisfies the reams of guidance, handbooks and informal mandates that the banking agencies have issued over the years. Is this an appropriate time for the Federal Reserve and the other agencies to do a zero-based review, and seek public comment on whether any agency standards in addition to NIST 1.1 are necessary?

The Federal Reserve Board (Board) is committed to aligning our guidance to the National Institute of Standards and Technology Cybersecurity Framework Version 1.1 (NIST 1.1) as part of our efforts to reduce potential regulatory burden. NIST 1.1 was published on April 16, 2018, and the Federal Reserve is considering changes to our guidance as appropriate. In addition, the Federal Reserve is working with other regulatory agencies to streamline and harmonize existing cybersecurity guidance across the financial sector in a manner that aligns with the NIST Cybersecurity Framework.

For example, through the Financial and Banking Information Infrastructure Committee, the Federal Reserve, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission are engaged in a cybersecurity regulatory harmonization effort designed to identify opportunities to further coordinate cyber risk supervisory activities for firms subject to the authority of multiple regulators.

The Federal Reserve also works through the Federal Financial Institutions Examination Council (FFIEC), which includes the FDIC, OCC, the National Credit Union Administration and the Consumer Financial Protection Bureau, to promote uniformity in the supervision of financial institutions, including supervisory assessments related to cybersecurity, and to execute examinations in a manner that is consistent across entities supervised by FFIEC member agencies.

3. The availability of cleared markets for end-users like farmers and manufacturers is being discouraged by the lack of an off-set for client margin in the supplemental leverage ratio. How do you propose to deal with this issue specifically?

The Board is carefully evaluating its regulatory capital framework to ensure that its post-crisis regulations do not create unintended consequences and do not create undue regulatory burden, including for the provision of central clearing services. In 2017, the Board and the federal banking agencies issued supervisory guidance on the treatment of certain centrally-cleared trades that are conducted under a new settle-to-market model, which has provided regulatory capital relief for certain trades. The Board also is actively engaged with the domestic and international standard-setters in discussing the impact of the regulatory capital rules, including the supplementary leverage ratio, on the provision of the central clearing services. In April of 2018, the Board and OCC issued a proposal that would recalibrate the enhanced supplementary leverage ratio (eSLR) standards to further tailor leverage ratio requirements to the business activities and risk profiles of the largest domestic firms. The proposed recalibration may provide firms with additional flexibility to reallocate some of their regulatory capital to central clearing and other business lines if they choose to do so. In addition, the Board is participating in a review of the impact of the leverage ratio on clearing services being conducted at the Basel Committee on Banking Supervision (BCBS).

4. The Federal Reserve proposal to reduce the enhanced supplementary leverage ratio impacts only the nation's 8 largest banks. What additional steps will you take to encourage other banks to return to providing clearing services and thus improve competition in the cleared markets?

As noted in the response to question 3, the Board is participating in the BCBS leverage ratio monitoring exercise to address potential unintended consequences of the leverage ratio on client clearing. The exercise is focused on monitoring the impact of the leverage ratio's treatment of client cleared derivative transactions and reviewing the impact of the leverage ratio on banks' provision of clearing services and its effect on central counterparty clearing. The review involves surveying client clearing market participants to understand the impact of the leverage ratio on incentives to centrally clear over-the-counter derivatives.

5. Since 2008, policymakers and regulators have determined that cleared markets improve the safety of the financial system as a whole as well as safety for customers. How does your proposal to reduce the enhanced supplementary leverage ratio improve incentives to clear when the exposure reducing nature of initial client margin is still not recognized?

The purpose of the eSLR proposal is to recalibrate the Board's capital standards for banking organizations such that the ratio generally serves as a backstop to risk-based capital requirements and not as a binding constraint. Over the past few years, concerns have arisen that, in certain cases, the supplementary leverage ratio has become a generally binding constraint rather than a backstop to the risk-based requirements. Thus, under the eSLR proposal, a clearing-focused firm may have additional capacity to engage in centrally cleared transactions. We recognize that the treatment of initial client margin is an additional question to address and we are doing so through the mechanisms described in questions 3 and 4 above.

6. If the enhanced supplementary leverage ratio proposal is finalized, the U.S. will be more in line with the global standard on its calibration. However, the European Union is in the process of recognizing client initial margin by providing an offset under the leverage ratio. Until the time the U.S. provides such an offset, European banks continue to have a competitive advantage over U.S. banks. Do you plan to take steps to look at providing U.S. banks such an offset for client initial margin?

As noted in the response to questions 3 and 4, the Board is participating in the BCBS leverage ratio monitoring exercise. The results of that exercise would in part inform any additional adjustments to the leverage ratio that we would consider.

Questions for the Record
Rep. Blaine Luetkemeyer (MO-03)
"Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System"
Committee on Financial Services
April 17, 2018

1. The National Institute of Standards and Technology (NIST) recently released its Cybersecurity Framework Version 1.1, after consulting numerous experts in private industry and government. Financial services firms have told us that this work is the state of the art, and are concerned that they will now have to spend vast amounts of time mapping how compliance with NIST 1.1 satisfies the reams of guidance, handbooks and informal mandates that the banking agencies have issued over the years. Is this an appropriate time for the Federal Reserve and the other agencies to do a zero-based review, and seek public comment on whether any agency standards in addition to NIST 1.1 are necessary?

2. During the course of the hearing, Chairman Hensarling asked whether Federal Reserve staff had the legal authority to participate in bank board meetings. Please provide an answer to whether or not any Federal Reserve staff have such authority and, if appropriate, the mechanism by which that authority is derived. Have Federal Reserve staff in the past or do any Federal Reserve staff currently participate in bank board meetings?

3. The availability of cleared markets for end-users like farmers and manufacturers is being discouraged by the lack of an off-set for client margin in the supplemental leverage ratio. How do you propose to deal with this issue specifically?

4. The Federal Reserve proposal to reduce the enhanced supplementary leverage ratio impacts only the nation's 8 largest banks. What additional steps will you take to encourage other banks to return to providing clearing services and thus improve competition in the cleared markets?

5. Since 2008, policymakers and regulators have determined that cleared markets improve the safety of the financial system as a whole as well as safety for customers. How does your proposal to reduce the enhanced supplementary leverage ratio improve incentives to clear when the exposure reducing nature of initial client margin is still not recognized?

6. If the enhanced supplementary leverage ratio proposal is finalized, the U.S. will be more in line with the global standard on its calibration. However, the European Union is in the process of recognizing client initial margin by providing an offset under the leverage ratio. Until the time the U.S. provides such an offset, European banks continue to have a competitive advantage over U.S. banks. Do you plan to take steps to look at providing U.S. banks such an offset for client initial margin?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 12, 2018

The Honorable John Delaney
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

1. In a recent speech you noted that, "The fundamental premise of the Volcker rule is simple: banks with access to the federal safety net--Federal Deposit Insurance Corporation insurance and the Federal Reserve discount window--should not engage in risky, speculative trading for their own account." Or to put it another way, the Volcker Rule is intended to limit banks from using subsidized funds from getting so big that their speculative trading creates the hazard of systemic risk to our banking system - a point I wholeheartedly agree with.

You have also been very public in your belief that the Federal Reserve and the other regulators tasked with implementing the Volcker Rule need to revisit the rule to reduce its complexity. With that in mind, I wanted to raise one point as it relates to the free flow of capital.

In today's modern banking system, we are seeing a growing number of firms looking at different avenues to serve their customers with traditional banking products, including through bank-fintech partnerships or an industrial loan company charter, both of which have an element of deposit insurance and thus have restrictions related to the Volcker Rule. At the end of the day, I believe you and I share the goal of ensuring depository institutions are run in a responsible manner that does not put the Deposit Insurance Fund at risk, and I am confident that the FDIC will take whatever steps necessary to ensure that remains the case. However, I have been made aware of circumstances where the Volcker Rule could restrict the availability of equity capital and certain investment activities unrelated to the insured depository institution.

- **Is this something you are also aware of, and do you anticipate addressing this type of issue in your future rulemaking related to the Volcker Rule?**

Section 13 of the Bank Holding Company Act (commonly referred to as the "Volcker Rule") applies by its terms to banking entities, the definition of which includes insured depository institutions and their affiliates. Accordingly, the Volcker Rule's restrictions cover certain entities, such as non-bank subsidiaries of bank holding companies, which are not insured by the Federal Deposit Insurance Corporation, but which are affiliated with insured depository institutions. The Federal Reserve Board (Board) and other implementing agencies recently issued a notice of proposed rulemaking that would make changes intended to streamline and simplify the requirements of the implementing regulation. Some of these proposed changes are expected to improve the ability of banking entities to provide market liquidity and facilitate capital formation consistent with the requirements of the statute.

- **Given the complexity of the Volcker Rule, are you committed to having Federal Reserve staff, as appropriate, engage directly with companies that may have unique circumstances related to Volcker Rule in order to assist those companies with understanding their obligations under the rule?**

Board staff regularly engage with firms with respect to unique circumstances that come up related to the application of the Volcker Rule to various aspects of their businesses. I am committed to ensuring that this process continues, and to ensuring that Board staff provides as much clarity and transparency as possible so that firms can operate with certainty that their activities are consistent with their obligations under the rule.

- **In the Fed's planned future rulemaking on Volcker, do you intend to have an open and transparent rulemaking process and duly consider all submitted comments?**

Yes. The agencies recently issued a joint notice of proposed rulemaking that would revise the Volcker Rule implementing regulation. The Board and the other agencies are requesting public comment on the proposed rule and will carefully consider all comments.

Questions from Representative Delaney

In a recent speech you noted that, "The fundamental premise of the Volcker rule is simple: banks with access to the federal safety net--Federal Deposit Insurance Corporation insurance and the Federal Reserve discount window--should not engage in risky, speculative trading for their own account." Or to put it another way, the Volcker Rule is intended to limit banks from using subsidized funds from getting so big that their speculative trading creates the hazard of systemic risk to our banking system - a point I wholeheartedly agree with.

You have also been very public in your belief that the Federal Reserve and the other regulators tasked with implementing the Volcker Rule need to revisit the rule to reduce its complexity. With that in mind, I wanted to raise one point as it relates to the free flow of capital.

In today's modern banking system, we are seeing a growing number of firms looking at different avenues to serve their customers with traditional banking products, including through bank-fintech partnerships or an industrial loan company charter, both of which have an element of deposit insurance and thus have restrictions related to the Volcker Rule. At the end of the day, I believe you and I share the goal of ensuring depository institutions are run in a responsible manner that does not put the Deposit Insurance Fund at risk, and I am confident that the FDIC will take whatever steps necessary to ensure that remains the case. However, I have been made aware of circumstances where the Volcker Rule could restrict the availability of equity capital and certain investment activities unrelated to the insured depository institution.

- Is this something you are also aware of, and do you anticipate addressing this type of issue in your future rulemaking related to the Volcker Rule?
- Given the complexity of the Volcker Rule, are you committed to having Federal Reserve staff, as appropriate, engage directly with companies that may have unique circumstances related to Volcker Rule in order to assist those companies with understanding their obligations under the rule?
- In the Fed's planned future rulemaking on Volcker, do you intend to have an open and transparent rulemaking process and duly consider all submitted comments?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 11, 2018

The Honorable Joyce Beatty
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to questions 1 and 3 that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

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

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

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

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

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

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

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

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

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

Following up on the work of the task forces and other efforts to advance both the desired outcomes (focused on speed, security, efficiency, international payments, and collaboration) outlined in the Strategies Paper, the Federal Reserve published, in September 2017, a paper

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

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

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

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

presenting refreshed strategies and tactics that the Federal Reserve is employing in collaboration with payment system stakeholders.[5]

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

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

QUESTIONS FOR THE RECORD
CONGRESSWOMAN JOYCE BEATTY (OH-03)
FINANCIAL SERVICES COMMITTEE FULL COMMITTEE
HEARING, APRIL 17, 2018
"SEMI-ANNUAL TESTIMONY ON THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF THE FINANCIAL SYSTEM"

Question #1

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

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

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

Question #2

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

Question #3

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

Question #4

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

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

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

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

If so, what was the nature of those conversations?

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

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

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

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

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 11, 2018

The Honorable Keith Rothfus
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

1. Mr. Quarles, thank you for your thoughtful response to my questions regarding the supervision of insurance savings and loan holding companies ("ISLHCs"). I appreciate your commitment to resolving this issue your sense of urgency around it. As you know, currently the Federal Reserve Board treats ISLHCs over $50 billion as "large banking organizations" under SR 12-17. This has led to an inappropriate, bank-like supervisory regime that is disproportionate to the risk to the taxpayers posed by these institutions. Will you immediately suspend SR 12-17 while you are undertaking your important review of the supervisory regime for ISLHCs?

Our principal supervisory objectives for insurance savings and loan holding companies (ISLHCs), reflecting a baseline of consolidated supervision that accompanies insured bank ownership, include protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions, which serves to safeguard the taxpayer-backed federal safety net. In applying our consolidated supervision, we should work to ensure that rules, supervisory guidance, and expectations are appropriately tailored to account for the unique complexities and characteristics of ISLHCs. We remain committed to tailoring our supervision of ISLHCs to the firms and their insurance operations, as well as conducting our consolidated supervision of these firms in coordination with state insurance regulators.

The framework set forth in Supervision and Regulation Letter 12-17 (SR 12-17) is designed to be general and flexible enough to be applied to large financial institutions supervised by the Federal Reserve Board, as well as support a tailored supervisory approach that accounts for the unique risk characteristics of each firm. I believe we can make better use of the flexibility permitted in SR 12-17 to tailor our supervisory program for ISLHCs to each firm's size, structure, risk profile, and business model as well as the size and scale of banking and other non-insurance activities. The Federal Reserve also seeks to protect the subsidiary insured depository institution (IDI) from risks related to nonbanking activities, including insurance, as well as intercompany transactions between the parent and IDI to ensure that the IDI is not adversely affected. To avoid duplication, we also rely on the state insurance departments to the greatest extent possible, including their supervision of the business of insurance.

In applying SR 12-17 while we further tailor our supervisory framework (including, as relevant, SR 12-17), we will review and adjust our supervisory expectations to ensure that they are appropriate for the ISLHCs' business models and structures. We remain committed to tailoring our approach to supervising ISLHCs and welcome feedback on ways we can improve our supervision.

2. Recently, there has been interest both domestically and internationally in developing an "activities-based approach" (ABA) to regulating systemic risk in the insurance industry. Such an approach, if not properly tailored, could result in significant, unwarranted regulation that will make it harder for Americans to obtain affordable financial security products. To ensure that such an approach does not result in overregulation, do you believe that an ABA should look broader than an insurer's activities in isolation and consider

whether an insurer's activities are also sufficiently connected to the larger financial markets so that they could actually increase systemic risk?

It is important for an activities-based approach to look broader than a firm's activities in isolation and take into account the firm's activities in relation to the wider economy. The Federal Reserve aims to promote financial stability through, among other things, working with domestic agencies directly and through the Financial Stability Oversight Council (FSOC), and engaging with the global community in relation to monitoring, supervision, and regulation. A central tenet of the Federal Reserve's efforts in promoting financial stability is an approach that accounts for the stability of the financial system as a whole, in addition to a micro-prudential approach that focuses on the safety and soundness of individual institutions. In the development of the activities-based approach in the International Association of Insurance Supervisors, the Federal Reserve continues to advocate the broader use of cross-sectoral comparison of insurers against banks and other financial intermediaries, reflecting an approach grounded in risk exposures together with their associated transmission channels. The analysis of the FSOC also reflects activities of a firm that could pose threats to U.S. financial stability, including through a firm's connections to financial markets as a channel for systemic risk.

Questions for the Record

April 17, 2018 hearing on "the Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System" with the Honorable Randal Quarles, Vice Chairman for Supervision

Congressman Keith Rothfus

1. Mr. Quarles, thank you for your thoughtful response to my questions regarding the supervision of insurance savings and loan holding companies ("ISLHCs"). I appreciate your commitment to resolving this issue your sense of urgency around it. As you know, currently the Federal Reserve Board treats ISLHCs over $50 billion as "large banking organizations" under SR 12-17. This has led to an inappropriate, bank-like supervisory regime that is disproportionate to the risk to the taxpayers posed by these institutions. Will you immediately suspend SR 12-17 while you are undertaking your important review of the supervisory regime for ISLHCs?

2. Recently, there has been interest both domestically and internationally in developing an "activities-based approach" (ABA) to regulating systemic risk in the insurance industry. Such an approach, if not properly tailored, could result in significant, unwarranted regulation that will make it harder for Americans to obtain affordable financial security products. To ensure that such an approach does not result in overregulation, do you believe that an ABA should look broader than an insurer's activities in isolation and consider whether an insurer's activities are also sufficiently connected to the larger financial markets so that they could actually increase systemic risk?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

August 17, 2018

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to questions 7h and 11 that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. On August 16, 2018, I provided responses to questions 1i, 2c, 3e, 4e, 4h, 6c, 6h, 7f, 9a. Additionally, on August 2, 2018, I provided responses to questions 1a-h, 1j-k, 2a-b, 2d, 3a-d, 4a-d, 4f-g, 4i, 5, 6a-b, 6d-g, 6i-j, 7a-e, 7g, 7i, 8, 9b-c, 10, and 12-19. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

7. Capital and Leverage Rules for the Largest Banks

- **(h) Why should Wells Fargo be rewarded after harming millions of consumers by reducing their capital requirements by 17 percent at a time while at the same time, the Federal Reserve Board capped the bank's size in light of their misdeeds?**

As you know, I am recused from issues related specifically to Wells Fargo. In general, the Federal Reserve Board's (Board) proposal to modify the enhanced supplementary leverage ratio (eSLR) requirement (proposal) would apply to a number of large financial firms, including all U.S. global systemically important banks (GSIBs). The proposal is based on the principle that leverage capital requirements, such as the eSLR, generally should serve as a backstop to risk-based capital requirements, rather than as a binding constraint. As noted, if a leverage ratio becomes a binding constraint, it can create incentives for banking organizations to engage in riskier activities. As indicated in the proposal, Federal Reserve analysis suggests that the proposal would reduce the amount of consolidated capital required across all U.S. GSIBs, including Wells Fargo, by approximately $400 million. That figure is approximately 0.04 percent of the amount of consolidated capital held by all U.S. GSIBs as of the third quarter of 2017.

11. Foreign Banks

There has been much discussion about how foreign banks would be treated under S. 2155, the Senate financial deregulatory bill pending in the House. Under current rules, the enhanced prudential regime applies to foreign banking organizations that have more than $50 billion in *global* assets and operate in the United States. However, the Fed's implementing regulations have imposed significantly lower requirements on foreign banks with less than $50 billion in *U.S.* non-branch assets compared to those with more than $50 billion in U.S. non-branch assets.

- **(a) What assurances can you give this Committee that stringent rules for large foreign banks that operate in the U.S. that are applied in the exact same manner, and at the exact same threshold, as they are today will not be changed, even if S. 2155 becomes law?**

Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directs the Board to establish enhanced prudential standards for large banking organizations. In applying section 165 to foreign banks, the Dodd-Frank Act directs the Board to take into consideration principles of national treatment, equality of competitive opportunity, and the extent to which the foreign bank is subject to prudential regulation by its home country. Accordingly, as you note, the Board has tailored the application of the enhanced prudential standards to foreign banks based, in part, on size and nature of a foreign bank's activities in the United States. The intermediate holding company requirement applies to foreign banks with total global consolidated assets that meet the threshold for application of section 165, and with at least $50 billion in U.S. non-branch assets. The Economic Growth, Regulatory

Relief, and Consumer Protection Act (EGRRCPA) raises the threshold for application of section 165, but does not affect the threshold for the application of the intermediate holding company requirement. The existing population of foreign banks that have intermediate holding companies in the United States also have total global consolidated assets in excess of $250 billion.

The amendments made by EGRRCPA provide for additional tailoring of section 165 while maintaining the authority of the federal banking agencies to ensure the safety and soundness of depository institutions and their holding companies and to apply enhanced prudential standards to large banking organizations address financial stability.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

August 16, 2018

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to questions 1i, 2c, 3e, 4e, 4h, 6c, 6h, 7f, 9a that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. On August 2, 2018, I provided responses to questions 1a-h, 1j-k, 2a-b, 2d, 3a-d, 4a-d, 4f-g, 4i, 5, 6a-b, 6d-g, 6i-j, 7a-e, 7g, 7i, 8, 9b-c, 10, and 12-19. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

1. **Fair Lending**

- **(i) Will the Federal Reserve Board consider holding public hearings across the country on any new CRA proposal you consider to better ensure you get the maximum amount of feedback, especially from the communities that CRA was intended to help. If so, what would the timetable be of such hearings? What other steps will the Federal Reserve Board take to ensure you receive the maximum amount of input on proposed CRA changes?**

The Federal Reserve participated in interagency public hearings on the Community Reinvestment Act (CRA) in 2010 and in the interagency public outreach meetings related to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 in 2014 and 2015, in which CRA was one of many regulations discussed. The agencies with responsibility for CRA rule writing have not yet determined whether and, if so, when to hold public hearings. In the meantime, the Federal Reserve will continue to collect feedback through roundtables and listening sessions with banks, community groups, and other stakeholders.

2. **Diversity at the Fed and in the Financial Sector**

- **(c) How closely do you work with the Fed's Office of Diversity and Inclusion?[1] Please give examples of how your work leverages the office's expertise in carrying out the Federal Reserve Board's regulatory, supervisory and enforcement work.**

In addition to the Director of the Office of Minority and Women Inclusion (OMWI) reporting to our Chairman, I too meet with to the Office of Minority and Women Inclusion (OMWI) director to discuss cultivating diversity and inclusion in all aspects of employment. The OMWI director is involved in the appointment process of official staff to ensure that the Federal Reserve Board's (Board) leadership nomination criteria and process are inclusive. Additionally, a meeting schedule has been established for the OMWI Director and the Deputy Director for Policy of the Supervision and Regulation Division to discuss regulations that may disproportionally affect minority-owned and women-owned businesses. The OMWI Director also participates with Division Directors, senior staff, and Board Members in an internal work stream at the Board established to coordinate economic inclusion and diversity efforts. The group focuses on initiatives not just at the Board, but also more broadly throughout the Federal Reserve System. Board Members meet regularly with the staff to discuss initiatives and progress.

3. **Fintech, Payments and Digital Currency**

- **(e) What are your views on "open banking"? Other countries seem to be pursuing this approach to ensure consumers have full access and control of their personal information, and can use new mobile applications to do a better job shopping for the**

[1] The Office of Diversity and Inclusion fulfills the See https://www.federalreserve.gov/publications/files/omwi-report-20180330.pdf for the Fed's 2018 Report to the Congress on the Office of Minority and Women Inclusion.

best financial products and services. What are the pros and cons of promoting "open banking" in the United States?

"Open banking" is an approach that allows third parties to access a financial institution's data and systems in order to build applications and services around the financial institution. There are important distinctions between the United States and other countries that are exploring open banking. Open banking regulations in other countries mitigate the attendant data-security and consumer-protection risks with a number of measures that, by and large, are not readily available policy options in the United States, where banking regulators have different and overlapping statutory authorities. For example, under the European Union's Revised Payment Systems Directive (PSD2), third parties with access to bank accounts will be subject to licensing and registration requirements, as well as associated capital and insurance requirements. PSD2 also requires that electronic payments will be authorized by two-factor authentication--for example "something you know" and "something you are." Further, many jurisdictions that are exploring open banking frameworks feature far fewer banks than the United States. The open banking mandates in these other jurisdictions are often forwarded by regulators that have competition mandates, in addition to prudential and conduct authorities. In the United States, by contrast, banking regulators' statutory mandates generally do not extend to competition issues.

Given these distinctions, the United States is likely to address these issues in a different way, at least initially, given that regulatory authorities are more broadly distributed, and the relevant statutory language predates these technological developments. Safety and soundness regulation--and with it, concerns about data security, cyber security, and vendor risk management--is distributed among a number of regulators. Accordingly, we are actively collaborating with other regulators and monitoring the rapidly-changing data aggregation space, recognizing that a variety of actors (e.g., large banks, small banks, core system providers, fintech developers, data aggregators, and regulators) are working through the different ways that banks can facilitate connectivity to outside developers. Regarding interpretation of statutory language, the Consumer Financial Protection Bureau (CFPB), for instance, issued a Request for Information last fall to explore issues surrounding consumers' granting access to account information to third parties under Section 1033 of the Dodd-Frank Act.

Of particular concern is a current open banking practice whereby data aggregators log onto a bank's online consumer website as if they were the actual consumers and extract information. This practice of "screen scraping" raises concerns about creating large repositories of consumers' on-line banking logins and passwords. This is particularly concerning because most data aggregation companies are generally not subject to bank-like examinations by regulators at a state or federal level for data security or consumer compliance.

But even when screen scraping is not involved, it is not clear the extent to which banks understand (or have input into) the criteria used by data aggregators in choosing which developers the data aggregators will provide data obtained from the banks. Similarly, it is not clear if banks are even aware of which developers receive the data – much less what limitations those developers have on the use, preservation, or dissemination of the data they receive.

From a consumer protection perspective, it is unclear if consumers understand that they are entering into agreements with data aggregators when using third-party applications. Log-in screens used by screen scrapers may feature the logos of banks, making it difficult for consumers to discern whether or not their bank has an underlying agreement with a developer or aggregator. Consumers may not understand the extent to which their liability for erroneous and fraudulent transactions may change when they are using a data aggregator. And many aggregators use contractual provisions that limit their liability to consumers and prevent consumers from seeking relief in court or as a class. Consumers also may not understand that data aggregators may continue to access their bank accounts well after consumers have stopped using or even deleted the fintech "apps" that created the data aggregation relationship in the first place.

4. Lessons from the Financial Crisis and the Benefits of Dodd-Frank

- **(e) Do you believe the Fed failed, as many of us do, at implementing and enforcing our consumer financial protections laws prior to the creation of the Consumer Financial Protection Bureau?**

Before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010, the Board had responsibility for writing regulations to implement many consumer protection laws. The financial crisis revealed the need to address fundamental problems across the financial system in both the private and public sectors, including failures of risk management in many financial firms, and deficiencies in government regulation of financial institutions and markets. Congress enacted the Dodd-Frank Act to address the weaknesses that had emerged in various areas of the mortgage market, including underwriting standards, capitalization, and securitization, as well as consumer protection. To that end, the Dodd-Frank Act transferred most of the Federal Reserve's rulewriting responsibilities pertaining to consumer protection to the CFPB, as well as considerably expanding its consumer protection statutory authorities for supervision and enforcement, and granting the CFPB broad authorities to promulgate consumer protections regulations covering banks and non-banking entities.

Although the Board no longer has rulewriting authority for most consumer protection regulation, we remain committed as we have for over 40 years to strong consumer protection to promote a fair and transparent financial marketplace. We carry out this commitment through the Board's Division of Consumer and Community Affairs (DCCA), which is solely dedicated to consumer compliance supervision, community development, and consumer-focused research, analysis, and outreach. The DCCA facilitates our oversight of the Federal Reserve System's supervision and examination policies and programs for the approximately 800 banks we supervise to ensure consumer financial protection and promote community reinvestment.

The Federal Reserve supervises all state member banks for compliance with the Fair Housing Act and Equal Credit Opportunity Act, as well as for other consumer protection rules for state member banks of $10 billion or less. Federal Reserve staff coordinate with the prudential regulators and the CFPB as part of the supervisory coordination requirements under the Dodd-Frank Act to ensure that consumer compliance risk is appropriately incorporated into the consolidated risk-management program of the approximately 135 bank and financial holding companies with assets over $10 billion.

Additionally, we have addressed unfair and deceptive practices through public enforcement actions that have collectively benefited hundreds of thousands of consumers and provided millions of dollars in restitution, and our examiners evaluate fair lending risk at every consumer compliance exam. Pursuant to the Equal Credit Opportunity Act, if we determine that a bank has engaged in a pattern or practice of discrimination, we refer the matter to the Department of Justice (DOJ). Federal Reserve referrals have resulted in DOJ public actions in critical areas, such as redlining and mortgage-pricing discrimination.

The Board also provides oversight for the Reserve Bank consumer compliance supervision and examination through our policy development, examiner training, and supervision oversight programs. A number of critical areas are included in these programs, such as banks' performance under the CRA; consumer compliance in bank holding company matters; compliance with and enforcement of a wide range of consumer protection laws and regulations including those related to fair lending, unfair or deceptive acts or practices, and flood insurance; analysis of bank and bank holding company applications related to consumer protection, convenience and needs, and the CRA; and processing of consumer complaints. We also monitor trends in consumer products to inform the risk-based and enterprise-wide supervision.

- **(h) What has Dodd-Frank's new derivatives oversight framework provided to FSOC? Since the Fed serves on FSOC, does this oversight of the derivatives market help the FSOC to better monitor and mitigate potential threats to financial stability?**

The Financial Stability Oversight Council (FSOC) designates systemically important financial market utilities (FMUs) and, when needed, facilitates coordination among the regulatory agencies involved in overseeing the designated FMUs (DFMUs).[2] To date, the FSOC has designated three derivatives-clearing organizations - the Chicago Mercantile Exchange, ICE Clear Credit, and the Options Clearing Corporation - as systemically important.

Prior to the creation of the FSOC, the U.S. financial supervisory framework focused largely on individual institutions and markets, and no single regulator had the responsibility for monitoring and assessing overall risks to financial stability. The FSOC provides a forum for members to share information and analysis related to a broad range of financial institutions and markets, including over the counter derivatives markets. In our experience, this information-sharing and coordination helps members to identify and address potential gaps and weaknesses.

At various times since the FSOC's inception, FSOC working groups and committees have received presentations on developments in derivatives markets and the use of derivatives by classes of institutions. Typically, these presentations have been developed internally by individual FSOC member agencies or the Office of Financial Research and shared with other FSOC members after supporting confidential data have been appropriately aggregated and anonymized. For example, the FSOC Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee (FMU Committee) supports the FSOC in fulfilling its responsibilities related to FMUs and payment, clearing and settlement (PCS) activities under Title VIII of the Dodd-Frank Act. The FMU Committee has focused primarily on conducting

[2] Dodd-Frank Act section 804 requires the FSOC to designate FMUs or PCS activities that the FSOC determines are, or are likely to become, systemically important such that "a disruption to the[ir] functioning…could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system in the United States."

analyses and providing recommendations to the FSOC related to designations of FMUs, consulting with supervisory agencies regarding risk management standards applicable to DFMUs pursuant to Dodd-Frank Act section 805, educating members on FMUs, and discussing products and risks relevant to clearing.

Further, section 809 of the Dodd-Frank Act authorizes broad information-sharing between the FSOC and Title VIII Supervisory Agencies, and, if necessary, authorizes the FSOC and the Board to collect reports or data from a DFMU to assess the safety and soundness of the DFMU and the systemic risk the DFMU's operations pose to the financial system. To date, FSOC has not requested any information using this authority.

6. Large Bank Supervision and Enforcement

- **(c) The Federal Reserve Board, under former Chair Yellen, capped Wells Fargo's size until it can demonstrate it cleaned up its act. Has the Federal Reserve Board taken a similar action against other banks in the past? If so, please list each instance the Federal Reserve Board took such an action.**

The Federal Reserve has not previously used its formal enforcement authority to restrict the asset growth of an institution until it sufficiently makes required improvements. Before my becoming a member of the Board, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), under their resolution planning authority, imposed restrictions on the growth of international and non-bank activities (as opposed to asset size) of one domestic banking organization until the firm remedied deficiencies identified in its resolution plan.

- **(h) The New York Fed is relocating its bank examination staff so it is not prone to regulatory capture. Do you agree this is the right approach? Do you disagree with Comptroller Otting's decision to leave OCC examiners permanently on-site at national banks? Why or why not?**

The Federal Reserve is constantly looking for ways to improve the effectiveness of our supervision. To that end, we are in the midst of a change that enhances our ability to look at the largest banking organizations from a cross-firm perspective. To further facilitate that, the Federal Reserve Bank of New York (FRBNY) has moved their dedicated teams of examiners back to FRBNY headquarters where they can more readily interact with colleagues from other teams and compare and contrast firm practices, processes, and risks.

Examiners will continue to have regular and consistent interactions with firms, including with their senior management and directors, and access to relevant data facilitated by technology. Additionally, the FRBNY will maintain space at the firms for at least six months as we evaluate what arrangement will be most productive over time for purposes that include accommodating examiners' needs during on-site exams, interacting with the firms, and other supervisory work.

7. Capital and Leverage Rules for the Largest Banks

- **(f) What is your view of the Federal Reserve Bank of Minneapolis's work on too big to fail, and their set of recommendations included in their plan? Do you agree or disagree with their recommendations? Why or why not?**

As Vice Chairman for Supervision, I believe that it is beneficial to have a robust public debate on how to best ensure and maintain the strength and resiliency of the financial sector. In that regard, I welcome all contributions to this ongoing debate.

With regard to the question of the optimal capital in the banking system, this issue has been addressed in a number of studies, including the paper from the Federal Reserve Bank of Minneapolis. These studies aim to quantify the costs and benefits of bank capital. The studies generally find that higher bank capital requirements (up to a point) are good for long-term credit availability and economic growth, but that with levels of capital beyond that point, social welfare is reduced. While the optimal level of capital varies between studies, in part because the studies use different underlying assumptions, the basic framework is the same. I believe the overall level of risk-based capital in the banking system is appropriate at the present time.

9. "Too Big to Fail"

Mr. Quarles, last November, Chairman Powell responded to a question from Senator Kennedy about whether any U.S. bank was still "too big to fail."[3] He initially responded by saying, "We've made a great deal of progress on that." When the Senator pressed for an answer, Chairman Powell said, "I would say no to that."

- **(a) Do you agree that no U.S. bank is "too big to fail"? Why or why not?**

U.S. regulators have indeed made a great deal of progress in our work to address the issue of "too big to fail." Notably, the statutory framework established by Congress and the efforts of the U.S. regulators have made the largest banking firms more resilient and have significantly improved their resolvability. In particular, for the largest, most systemically important firms, we have increased the quantity and quality of capital that they maintain, have established capital surcharges that are scaled to each firm's systemic risk footprint, have required our largest banks have more stable liquidity risk profiles, and have required them to carry long-term debt that can be converted to equity as part of a resolution.

In this regard, I believe it is much more likely than before that the failure of one of our most systemically important financial institutions, while undoubtedly posing a severe shock to the economy, could be resolved without critically undermining the financial stability of the United States. Moreover, more of the losses from such a failure would fall on the firm's shareholders and bondholders, not the FDIC or taxpayers. Investors have recognized this progress and the major rating agencies have removed the government support rating benefit that they once ascribed to the largest bank holding companies. Financial institutions and markets are always evolving, however, so it is important to remain vigilant regarding changing systemic risks.

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[3] https://www.bloomberg.com/news/articles/2017-11-29/trump-s-pick-to-run-the-fed-says-no-u-s-banks-are-still-too-big-to-fail.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

August 2, 2018

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to questions 1a-h, 1j-k, 2a-b, 2d, 3a-d, 4a-d, 4f-g, 4i, 5, 6a-b, 6d-g, 6i-j, 7a-e, 7g, 7i, 8, 9b-c, 10, and 12-19 that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

1. **Fair Lending**

As we discussed during the hearing, the Center for Investigative Reporting published several disturbing articles after a yearlong investigation of 31 million records publicly available under the Home Mortgage Disclosure Act (HMDA) to identify lending disparities.[1]

- **(a) I appreciate your initial reaction, but I would ask you to review the materials, and provide a detailed written assessment of the reporting. What lessons, if any, should the Federal Reserve and Congress bear in mind as we explore ways to address modern-day redlining and end pervasive discriminatory practices in the financial sector?**

As we mark the 50th anniversary of the Fair Housing Act (FHA), at the Federal Reserve, we believe the fair lending laws remain critical to addressing discrimination, including redlining, as well as fostering vibrant communities and a fair and transparent consumer financial services marketplace. We share the vital goal of promoting a fair and transparent marketplace for financial services, which is crucial for advancing economic opportunity and inclusion. Our economy is stronger when everyone has a chance to contribute fully and share in our national prosperity. Our fair lending laws help us realize a founding notion of our country--that this is a place where opportunity, innovation, and productivity are encouraged and rewarded.

The recent study of publicly-available Home Mortgage Disclosure Act (HMDA) data highlights serious concerns about racial disparities in lending. This study of HMDA data conducted by the Center for Investigative Reporting and published by Reveal News concluded that African Americans, Latinos, and other individuals of color were more likely to be denied conventional loans for home purchases and home remodeling than white borrowers.[2] Studies such as these put much-needed focus on racial disparities and Federal Reserve staff is carefully reviewing them.

However, HMDA data have limitations. These data do not include important underwriting criteria, such as credit scores and loan-to-value ratios. If concerns arise regarding a Federal Reserve-regulated institution, we will request additional data beyond the publicly-available HMDA data to fully evaluate whether applicants with similar characteristics received different underwriting outcomes on a prohibited basis (for example, on the basis of race), or whether legitimate underwriting criteria can explain the differences.

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[1] The reporting is available online at: https://www.revealnews.org/article/for-people-of-color-banks-are-shutting-the-door-to-homeownership/, https://www.revealnews.org/article/gentrification-became-low-income-lending-laws-unintended-consequence/, https://www.revealnews.org/article/8-lenders-that-arent-serving-people-of-color-for-home-loans/, https://www.revealnews.org/article/how-we-identified-lending-disparities-in-federal-mortgage-data/, and https://s3-us-west-2.amazonaws.com/revealnews.org/uploads/lending_disparities_whitepaper_180214.pdf.

[2] We note that the study excluded FHA/VA and other government program loans. These loans can be an important resource for lower-income borrowers.

- **(b) You discussed the ongoing work that the Federal Reserve is engaged with the Office of the Comptroller of the Currency (OCC) and other regulators with respect to modernizing the Community Reinvestment Act (CRA). To that end, does the Federal Reserve plan to adopt a change the OCC made last October to its CRA examination policies that has weakened CRA enforcement by easing the consequences for banks that violate fair lending laws and harm consumers? Will this kind of CRA reform benefit megabanks, like Wells Fargo, which has repeatedly harmed consumers?**

The Community Reinvestment Act (CRA) establishes an affirmative obligation on banks to help meet the credit needs of their entire community, including low-and moderate-income (LMI) communities. We have not changed our approach to considering violations involving discrimination or other illegal credit practices when assigning CRA ratings. When illegal credit practices are identified, we follow the examination procedures and consider whether such practices should result in a ratings downgrade.

- **(c) As we discussed, the Treasury Department issued a memorandum regarding CRA modernization on April 3, 2018, addressed to the U.S. banking regulators, including the Federal Reserve Board, and made 15 recommendations in the areas of CRA assessment areas, examination clarity and flexibility, examination process, and performance.[3] You generally seemed favorable toward Treasury's CRA recommendations in your testimony and responses to questions. Please note whether you agree or disagree with each recommendation, along with an explanation and assessment of the public policy pros and cons of each recommendation.**

The Federal Reserve Board (Board) staff is continuing to review the U.S. Department of Treasury's recommendations to modernize the CRA. I share the Treasury Department's goal of improving the current supervisory and regulatory framework for CRA based on feedback from industry and community stakeholders. I agree that many of the issues and potential solutions they raise are worthy of consideration.

The Board is open to considering ways to make the CRA more effective and believes there are ways to expand the areas where we can evaluate a bank's CRA performance without losing the regulation's focus on the unique role banks play in meeting local credit needs.

I agree that it is time to review changes to the definition of a bank's "assessment area," which is the area in which its CRA performance is evaluated. The banking environment has changed since CRA was enacted and the current CRA regulation was adopted. Banks may now serve consumers in areas far from their physical branches. Therefore, it is sensible for the agencies to consider expanding the assessment area definition to reflect the local communities that banks serve, while retaining a consideration of place.

[3] https://home.treasury.gov/sites/default/files/2018-04/4-3-18%20CRA%20memo.pdf.

- **(d) Would you review the National Community Reinvestment Coalition's (NCRC) analysis of Treasury's recommendations,[4] and consider their perspective in responding to the question above?**

Any change we make to the CRA implementing regulation will be proposed through the rulemaking process. The Federal Reserve takes every comment it receives about its regulations into consideration. Board staff will consider the National Community Reinvestment Coalition's (NCRC) analysis you mention and other public comments we expect will be submitted through the rulemaking process.

We agree with the analysis that it is time to consider updating the CRA to reflect changes in the banking industry. Among the many suggestions offered by NCRC, the Federal Reserve is reviewing their suggestions for updates to the assessment area definition to include areas with branches and other areas where banks gather deposits or conduct substantial business, as well as their suggestion to establish more real time communication among banks, regulators, community groups, and advocates to promote more objective measures of performance.

As with other stakeholders, the Federal Reserve seeks input from NCRC on a regular basis. NCRC will be meeting with the Chair and Federal Reserve staff very soon. This meeting will be an opportunity for NCRC to share their analysis in more detail with the Board.

- **(e) Previously, NCRC submitted a letter to Treasury on CRA reform efforts on February 5, 2018.[5] Would you please review NCRC's letter and recommendation, and provide responses if you agree or disagree with their recommendations along with any analysis supporting your views?**

The Board staff has also reviewed the NCRC letter to the Treasury Department and will be taking their perspective into consideration as we receive public comments through the rulemaking process. As stated previously, we agree with the NCRC that it is time to consider updating the CRA to reflect changes in the banking industry.

The NCRC letter refers to a number of topics with regard to CRA reform efforts including: expanding CRA to nonbank subsidiaries; updating assessment areas to capture outside lending; maintaining the threshold for small bank test and fair lending; standardizing CRA exams across the agencies; continuing to focus the definition of community development on LMI; and not shortening merger approval timelines for banks earning a rating of outstanding on a CRA exam. The Federal Reserve will review each of these ideas as we consider each aspect of the CRA regulation under review.

- **(f) Based on the Center for Investigative Reporting on discriminatory lending practices and other evidence, are there ways the Federal Reserve Board can utilize CRA or other tools to incentivize banks to lend on affordable terms and invest in communities that are being ignored and underserved?**

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[4] NCRC's analysis is available at: https://ncrc.org/ncrc-analysis-of-cra-treasury-report/.

[5] The letter is available at: https://ncrc.org/letter-to-treasury/.

The research conducted by the Center for Investigative Reporting and published by Reveal News lamented the lack of progress in the 50 years since Congress enacted the Fair Housing Act. We note the study analyzed 2015 and 2016 publicly-available HMDA data on 31 million mortgage applications in 409 geographies for conventional loans and concluded that African Americans, Latinos, and other individuals of color were more likely to be denied loans for home purchases and home remodeling than white borrowers in 61 of those geographies.

As I noted above, studies based on publicly-available HMDA data have limitations. Irrespective of that, the financial regulators must ensure that we continue to act consistently with the purpose of CRA and provide incentives for banks to remain engaged in local community and economic development initiatives. We will also continue to identify promising practices of banks that offer deposit and credit products to help rent-burdened customers save for homeownership and that support underserved communities. Even with an improved economy, LMI areas have significant hurdles remaining, which is why I believe that the CRA is more important than ever.

- **(g) To the extent the Federal Reserve Board considers expanding options for banks to receive CRA credit, how do you ensure these adjustments are done in an efficient and robust manner so they don't otherwise water down the CRA grading system in light of the fact that 99% of banks get high marks even though discriminatory lending remains pervasive?**

The Federal Reserve takes its CRA obligations very seriously and any update to the regulation will seek to maintain the integrity of examinations. The Federal Reserve's highest interest is to see credit flowing to consumers and businesses in all communities consistent with safe and sound lending. This includes meeting credit needs in LMI areas and furthering economic development and financial inclusion. The Federal Reserve consumer examiners are specially-trained and solely dedicated to conducting CRA reviews and consumer compliance examinations, which include fair lending. As with any regulatory change, we will provide examiners training and tools to ensure that they are able to conduct rigorous reviews of the institutions that we supervise.

- **(h) What is the timetable for any new regulations or guidance that we should expect the Federal Reserve Board to issue on CRA reforms?**

The Federal Reserve has been in discussions with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) on how to approach revisions to the CRA regulations. Unfortunately, I am not in a position to announce a timetable at this point.

- **(j) Do you have any legislative recommendations with respect to strengthening CRA, and how the Federal Reserve Board can better fulfill the intent and purpose of the law?**

The Federal Reserve recognizes the importance of basic banking services to meeting the financial needs of LMI areas and people. We believe that revisions to the regulations should be sufficient to address concerns that the CRA has not kept pace with changes in the banking industry.

- **(k) Beyond CRA, are there other legislative or regulatory reforms that policymakers should consider to end pervasive discriminatory practices in the financial sector?**

Discrimination has no place in the financial marketplace. Beyond the CRA, there are already legislative and regulatory protections in place to address discrimination in the financial sector. For all state member banks, we enforce the federal Fair Housing Act, which prohibits discrimination in mortgages, including redlining, pricing, and underwriting discrimination. For state member banks of $10 billion dollars or less in assets, we also enforce the Equal Credit Opportunity Act, which prohibits discrimination in any credit product. Together, these laws prohibit discrimination on the basis of race, color, national origin, sex, religion, marital status, familial status, age, handicap/disability, receipt of public assistance, and the good faith exercise of rights under the Consumer Credit Protection Act. We believe that enforcing existing legislative and regulatory protections is critical to addressing pervasive discrimination.

With respect to other legislative reforms, we stand ready to consult with Congress as appropriate.

2. Diversity at the Fed and in the Financial Sector

- **(a) Democrats have repeatedly pushed the Federal Reserve and other regulators to do their part to promote diversity in its work. As the Vice Chair of Supervision, what steps have you taken to promote diversity with the Fed's supervisory, regulatory and enforcement staff?**

The Board approved the Diversity and Inclusion Strategic Plan 2016-2019 which reflects the Board's strategic initiative on diversity, inclusion, and equality. The implementation of the plan involves the active involvement of senior leaders throughout the Board. In support of the Board's strategic objectives and commitment to attract, hire, develop, promote and retain a highly diverse workforce, each functional division is required to establish a diversity and inclusion scorecard. The purpose of the scorecard provides a process that helps us organize and develop a systematic effort in support of the diversity and inclusion strategic plan. I am firmly committed to the achievement of these goals.

- **(b) What steps can the Fed take to promote diversity within the financial system, especially with respect to the firms the Fed regulates?**

As directed by section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Board continues to request a submission from the entities we regulate containing information that supports the diversity policies and practices of their institutions. The assessment of submissions provides an opportunity to strengthen and promote transparency of organizational diversity and inclusion within the entities' U.S. operations and provide opportunities to discuss leading practices and challenges in addressing the lack of diversity in the financial services industry. The Board and the financial regulatory agencies are collaborating to develop symposiums, webinars and other support initiatives to address what is needed to advance diversity.

- **(d) What legislative recommendations do you have for how Congress could strengthen efforts to promote diversity and inclusion at the Federal Reserve Board, as well as the firms you regulate?**

The Board continues to be committed to cultivating diversity in all aspects of employment and recognizes the value of building and sustaining an inclusive work environment. This includes a commitment to the letter and spirit of all current law. While we have made progress implementing section 342 of the Dodd-Frank Act, we continue to focus on areas of opportunity where there is more to be done. We continue to encourage firms we regulate, to provide assessments of their diversity and inclusion practices in order to promote transparency and identify opportunities for improvement. Additional outreach initiatives regarding submission of self-assessments as well as meetings to discuss diversity strategies needed to increase diversity are continuing.

3. Fintech, Payments and Digital Currency

- **(a) What is your view of the rapid growth of financial technology, or fintech, in the financial services marketplace? What are your top priorities at the Fed with respect to fintech?**

The Federal Reserve views developments in financial technology through the lens of our long-standing public policy goals of safety and soundness of financial institutions, consumer protection, safety and efficiency for the payment system, financial stability more broadly, and an innovative financial system that provides widely shared benefits to the public over time.

Overall, the Federal Reserve is supportive of private-sector innovation in the financial services industry. At the same time, because of the transformative potential of financial technology in the financial services marketplace, we attach considerable importance to the Federal Reserve actively researching and monitoring these digital innovations. With this objective in mind, we have been evaluating developments in financial technology through a multidisciplinary lens, combining information technology and policy analysis to study the potential implications of digital innovations for payments policy, supervision and regulation, financial stability, monetary policy, and the provision of financial services. In its research, the Federal Reserve is working to identify both the benefits of various digital innovations as well as challenges associated with their implementation.

Almost all fintech innovations rely on connections to banks for: (1) access to consumer deposits or related account data; (2) access to the payment system; or (3) credit origination. Accordingly, when considering the Federal Reserve's role as a bank supervisor, first and foremost, we have a responsibility to ensure that the institutions subject to our supervision are operated safely and soundly and that they comply with applicable statutes and regulations and sound principles of consumer protection as they explore advances in financial technology.

Within that framework, we have an interest in encouraging socially beneficial and financially sound innovations to flourish, while ensuring the risks that they may present are appropriately identified and managed. I believe we should allow responsible innovations to develop, which can benefit consumers and small businesses through expanded access to financial services or greater efficiency, convenience, and reduced transaction costs. If the marketplace and regulators can support responsible connectivity between fintech firms and supervised entities, such integration could benefit banks, particularly community banks, which may be able to more readily outsource the development of more efficient digital consumer interfaces, mobile apps, digital wallets, or lending products.

The Federal Reserve System's (System) approach in the payments, clearing, and settlement space is similar. Board and System staff have been monitoring developments related to cryptocurrencies, central bank-issued digital currencies, wholesale digital tokens, and distributed ledger technology. Staff have found that although cryptocurrencies are innovative and may provide benefits related to automation and validation, they also pose challenges associated with speculative dynamics, investor and consumer protections, money-laundering risks, and governance. In addition, although central bank-issued digital currencies may be able to overcome some of the particular vulnerabilities that cryptocurrencies face, they too have significant challenges related to cybersecurity, money laundering, and the retail financial system. Even so, digital tokens for wholesale payments and some applications of distributed ledgers – the key technology underlying cryptocurrencies – may hold promise for strengthening traditional financial instruments and markets.

- **(b) GAO issued a recent report making a series of recommendations that the Fed and other regulators coordinate better on fintech issues.[6] What steps is the Fed taking to respond to these recommendations, and coordinate better with other regulators?**

The Federal Reserve recognizes the importance of working collaboratively with other regulators when determining how best to encourage socially beneficial innovation in the marketplace, while ensuring a safe and sound financial system and that consumers' interests are protected. Even prior to the U.S. Government Accountability Office (GAO) report, the Federal Reserve and other regulators had already committed to coordinating on these issues in a variety of fora, including the Federal Financial Institutions Examination Council (FFIEC) Task Force on Supervision, the FFIEC Task Force on Consumer Compliance, and the Interagency Fintech Discussion Forum. This calendar year, the Federal Reserve has also organized a number of meetings with industry actors, trade associations, and consumer advocates in a variety of fintech areas, which have included joint participation from a number of relevant regulators, like the OCC, FDIC, Consumer Financial Protection Bureau (CFPB), and several Federal Reserve Banks.

With regard to the GAO report's recommendation that the Board invite the National Credit Union Administration (NCUA) to participate in the Board's Interagency Fintech Discussion Forum, we agree that the NCUA's oversight of credit unions provides it with experiences and perspectives that are relevant to the group's collaborative work on fintech consumer protection issues. Accordingly, Board staff has invited NCUA staff to take part in future meetings of the Interagency Fintech Discussion Forum.

Similarly, staff at the Federal Reserve Banks of Atlanta and Boston have discussed with staff at the Federal Communications Commission (FCC) the benefits of the FCC's participation in the 2018-2019 Federal Reserve's Mobile Payments Industry Working Group (MPIW). FCC representatives advise that they plan to attend the next occurring MPIW meeting.

[6] https://www.gao.gov/products/GAO-18-254.

Among other efforts that focus on financial innovation, the Federal Reserve System has recently organized two System-wide teams of experts tasked with monitoring fintech and related emerging technology trends as they relate to our supervisory and payment system responsibilities, respectively. The new teams include representation from all of the Federal Reserve Banks, with Board staff providing leadership. The teams' critical objectives include ensuring that fintech-related information is shared across the System and informs relevant supervisory, policy, and outreach strategies.

We will continue to facilitate and engage in collaborative discussions with other relevant financial regulators in these and other settings to address in the context of the Federal Reserve's supervisory and regulatory responsibilities the important issues raised by the GAO report.

- **(c) The United States continues to have an outdated payment system, especially compared to other countries that have real-time payment systems. What steps is the Fed taking to modernize our payments system?**

The Federal Reserve plays many roles in the payment system, including payment system operator, supervisor of financial institutions and systemically important financial market utilities, regulator, researcher, and catalyst for improvement. Acting primarily in its catalyst role, the Federal Reserve encouraged payments stakeholders to join together to improve the payment system in the United States in its "Strategies for Improving the U.S. Payment System" paper (Strategies Paper), issued in January 2015.[7] The strategies outlined in the Strategies Paper included the creation of task forces focused on faster payments and payment security, both of which have provided a forum for diverse industry participants to collaborate on an ongoing basis since they were established in mid-2015.

The Faster Payments Task Force (FPTF) had the mission to identify and assess alternative approaches for implementing safe, ubiquitous, faster payments capabilities in the United States. In support of this mission, the FPTF created the Faster Payments Effectiveness Criteria to assess faster payments solutions and as a guide for innovation in the payments industry.[8] The FPTF also designed a process for which faster payment solution proposals could be submitted for assessment against these Effectiveness Criteria.

The FPTF released the first part of its final report in January 2017. The second part of the final report, released in July 2017, reflected the FPTF's perspectives on challenges and opportunities with implementing faster payments in the United States, outlined its recommendations for next steps, and included the proposals and assessments for the 16 proposers that opted to be included in the final report.[9] The FPTF recommendations identified the need for ongoing industry collaboration to address infrastructure gaps; develop models for governance, rules and standards; and consider actions and investments that will contribute to a healthy and sustainable payments

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

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

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

ecosystem. A number of recommendations called for Federal Reserve support to facilitate this ongoing collaboration.

The mission of the Secure Payments Task Force (SPTF) was to provide a forum for stakeholders to advise the Federal Reserve on payment security matters, and identify and promote actions that could be taken by payment system participants collectively or by the Federal Reserve System. The SPTF worked to advance understanding of the industry's most pressing payment system security issues: identity management, data protection, and fraud and risk information sharing. The SPTF concluded its efforts in March 2018, following publication of its final deliverables.[10]

Following the work of the task forces and other efforts to advance both the desired outcomes (focused on speed, security, efficiency, international payments, and collaboration) outlined in the Strategies Paper, the Federal Reserve published, in September 2017, a paper presenting refreshed strategies and tactics that the Federal Reserve is employing in collaboration with payment system stakeholders.[11]

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

- **(d) What concerns, if any, do you have about Bitcoin and the use of other virtual currency in the U.S. financial system? Should banks promote or discourage their use? What protections are needed to ensure these cryptocurrencies can't be used to evade anti-money laundering laws?**

The Board does not currently have financial stability concerns related to virtual currencies because their current levels of adoption and near-term potential for scalability of virtual currencies are limited. The Board is concerned about some of the consumer protection, Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT), governance and payment risk issues that have emerged and are linked to these virtual currencies and the exchanges where they are traded.

Banks have, to date, taken a very cautious stance with respect to the use and promotion of the use of virtual currencies; many have been reluctant to even provide banking services to virtual currency-related businesses.

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

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

With regard to AML/CFT issues, cryptocurrencies and virtual currencies have features that make them a potential vehicle for money laundering and terrorist financing. Many cryptocurrencies store in their ledger little to no information about the identity of owners of the cryptocurrency. Further, cryptocurrencies are easy to transfer across international borders. Indeed, a cryptocurrency that mimics a bearer instrument and provides significant privacy in transactions could raise significant money-laundering and terrorist-financing concerns. For example, large amounts of an electronic instrument could be easily transferred and peer-to-peer transactions outside of the United States could be very challenging to prevent and detect. Where a banking organization supervised by the Federal Reserve provides services to a business or individual that deals in a crypto-asset, the Federal Reserve seeks to ensure that the banking organization fully complies with all applicable AML/CFT requirements, under the Bank Secrecy Act (BSA) and Office of Foreign Assets Control (OFAC) regulations, and is adequately addressing risks posed by this type of activity.

Considerable work is being done domestically and internationally to understand and potentially to address some of the concerns mentioned, including evasion of AML laws. However, it is too early to say what steps need to be taken to address all of these concerns, as these currencies and their usage is changing rapidly. Board staff support international cooperation to study and monitor crypto-assets, through venues such as the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructure, the Financial Stability Board (FSB) and others. Because crypto-asset trades do not respect international borders, international cooperation is likely to be crucial to any steps taken to address concerns.

4. Lessons from the Financial Crisis and the Benefits of Dodd-Frank

Mr. Quarles, you have repeatedly said that since it has been a decade since the 2008 financial crisis, it is time to review and revisit all of the post-crisis financial rules to seek improvements.

- **(a) Will these modifications to post-crisis reforms be one-sided with a focus on deregulating the financial industry?**

The regulatory reforms that were put in place in the wake of the financial crisis have helped to make the U.S. financial system stronger and more resilient. As I have stated publicly on several occasions, I believe that the core regulatory reforms -- heightened capital and liquidity standards, stress testing, and resolution planning -- should be preserved.

My focus is not deregulation. Rather, my goals are to match the character of our regulation and supervision to the risk characteristics of firms and to find ways to reduce unnecessary burdens while maintaining the safety and soundness of the financial system. I also support exploring whether our supervisory and regulatory objectives can be met in a way that is more transparent, efficient, and simple, while still ensuring that the financial system remains resilient.

- **(b) Do you think lessons from the financial crisis have faded in the minds of some policymakers?**

I certainly hope that policymakers have not forgotten the material adverse impact that the financial crisis had on families, businesses, and the broader economy. The core reforms that were put in place in the wake of the crisis -- notably, higher capital and liquidity requirements, stress testing, and resolution planning -- were aimed at reducing the risk that bank failures or distress will have such a harmful impact on economic growth in the future.

- **(c) What is your diagnosis for the causes of the financial crisis?**

The causes of the financial crisis are complex and will be studied for years, but there are things that we can say, in general terms, about the causes at present. In the years leading up to the crisis, there was a buildup of financial vulnerabilities that left our financial system in a fragile state by late 2007. Financial institutions, households, and many businesses were highly leveraged. At financial institutions this vulnerability was compounded by a mismatch between the maturity of the assets held and the maturity of the borrowing that supported those assets. In many cases the assets were long-term and illiquid, like housing, while the funding was short-term and could be called at a moment's notice. This buildup of vulnerabilities was not limited to the United States, and many foreign financial systems experienced similar conditions.

As a result of these domestic and international vulnerabilities, the financial system -- which lacked sufficient capital and liquidity, particularly at the largest and most complex firms -- was not able to handle the unexpected downturn in U.S. asset values. When that occurred, these vulnerabilities amplified the effect of the initial shock, and the result was the financial crisis.

- **(d) What Dodd-Frank requirements do you think have helped address the numerous problems exposed by the crisis?**

While a number of post-crisis reforms addressed problems that were exposed during the financial crisis, I would point to several that were particularly valuable.

Stronger capital requirements. Maintaining the safety and soundness of the largest U.S. banks is fundamental to maintaining the stability of the U.S. financial system and the broader economy. To be safe and sound financial institutions, these firms must be well-capitalized. The U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system. In fact, since the crisis, capital has increased by approximately $800 billion.

Stress testing. The capital adequacy of the largest U.S. banking firms has been further bolstered by the annual stress testing and Comprehensive Capital Analysis and Review (CCAR) exercises, which consider the losses these firms would suffer under adverse economic scenarios on a forward-looking basis. In doing so, these programs help determine firms' capital needs in a serious economic downturn.

Enhanced liquidity requirements. The financial crisis demonstrated that large global banks had outsized liquidity risks that were insufficiently constrained by the existing regulatory framework. These liquidity risks often led to the failure of the firm or to substantial dependence by the firm on liquidity support from the federal government. The federal banking agencies have subsequently required large banking firms to substantially reduce their liquidity risk through stronger regulatory and supervisory requirements. Liquidity positions within the U.S. banking system have improved substantially since the financial crisis.

Resolution planning. The focus of resolution planning is for firms to structure their operations in normal times to facilitate orderly resolution in bankruptcy to mitigate the systemic risks of a firm's failure. The resolution planning process has caused the largest U.S. banking firms to substantially improve their internal structures, governance, information collection systems, and allocation of capital and liquidity in ways that promote resolvability.

- **(f) Was it important to impose enhanced prudential standards on the nation's largest banks, including requiring more capital, more liquidity and less leverage?**

Yes. As I noted above, I consider these to be among the most valuable post-crisis reforms. Stronger risk-based capital and liquidity regulations for large banking organizations, together with our stress testing program, have helped to ensure that banking organizations are better positioned to continue lending through periods of economic stress and market turbulence.

- **(g) Has the Financial Stability Oversight Council, or FSOC, helped to eliminate regulatory gaps in our financial regulatory system? Should FSOC maintain broad tools to deal with the next crisis?**

Prior to the creation of the Financial Stability Oversight Council (FSOC), the U.S. financial regulatory framework focused narrowly on individual institutions and markets, and no single regulator had the responsibility for monitoring and assessing overall risks to financial stability, which could involve different types of financial firms operating across multiple markets.

Importantly, the FSOC established a venue to facilitate regulatory information sharing and coordination to help minimize potential regulatory gaps and weaknesses. A key component of this is the FSOC's annual financial stability report, signed by the voting members. Past reports have highlighted vulnerabilities such as prime money market mutual funds that benefit investors who withdraw their funds first – with the potential for destabilizing runs of the kind that stressed the financial system in September 2008. Subsequent reports have noted that the Securities and Exchange Commission's (SEC) regulatory reforms, which took effect in late 2016, were instituted to mitigate the risk of runs on money funds, and led to significant structural changes in the industry, with assets flowing to funds that held only assets guaranteed by the federal government.

The creation of FSOC was valuable and necessary to fill the regulatory gaps that contributed to the financial crisis. Of course, the regulatory community has learned from the experiences of the past several years, and there may be ways to improve the processes currently followed by the FSOC. However, we learned from the experience of the financial crisis that an excessively narrow focus can lead to regulatory gaps, and that it is necessary to deal with vulnerabilities before they grow sufficiently material to leave the financial system too weak to handle bad financial shocks.

- **(i) Do you support the Volcker Rule's prohibition on proprietary trading so that banks that benefit from the federal safety net do not gamble with deposits?**

The objective of the Volcker Rule is simple: banks with access to the federal safety net should not engage in risky, speculative trading for their own account.

However, we are now at a point where it is both relevant and timely to examine the post-crisis reforms and identify areas where we can achieve our regulatory objectives with improved efficiency, transparency, and simplicity. The recently issued proposal by the Board and the other Volcker Rule agencies, which I support, includes best first efforts to further tailor the regulatory requirements and reduce burdens and costs, all in a manner consistent with the statute. That proposal is an important step in comprehensive Volcker Rule reform, and the Board looks forward to receiving comments from the public.

5. Stronger Regulations and Enforcement

- **(a) As you lead the Fed's efforts to revisit the post-crisis financial rulebook, what regulatory areas do you think need to be strengthened instead of rolled back?**

After spending almost a decade building the post-crisis regulatory regime, the bulk of the work of post-crisis regulation is complete. We and the other banking agencies have recently implemented or are in the process of implementing the final outstanding post-crisis measures to strengthen the regulatory framework.

The Board voted on June 14 to adopt a final rule to establish single-counterparty credit limits. This rule applies to the largest banking organizations, placing limits on a firm's credit exposures to a single counterparty, with exposures between systemically important firms subject to the most stringent limitations. These limits address risks to the economy that are created when large banking organizations have significant exposures to one another. The Board believes that this rule will improve the stability of the financial system by limiting exposures between financial firms.

The banking agencies are also working to finalize the net stable funding ratio (NSFR) rule. As a longer-term, standardized quantitative liquidity metric and requirement, the NSFR rule provides an important complement to the liquidity coverage ratio (LCR) rule and the internal liquidity stress testing and liquidity risk management requirements the Board established starting in 2012 and 2014. By improving banking organizations' ability to prepare for and absorb shocks arising from financial and economic stress, these measures will help to promote a more resilient banking sector and financial system.

- **(b) The Treasury Department, as you know, has released several extensive reports that include dozens and dozens of recommendations to revise financial regulations.[12]**
  - **Do you support the recommendations Treasury made that the Fed take that were included in its first report focused on banks and credit unions? Which, if any, recommendations did you disagree with?**
  - **Are you concerned that few to no recommendations made by Treasury would result in stronger oversight of the largest, most complex financial firms?**

The Treasury Department's regulatory report acknowledged that regulatory policies implemented since the financial crisis have improved the safety and soundness of the financial system and noted that the U.S. banking system is significantly better-capitalized as a result of post-crisis regulatory capital requirements and stress testing. The report also made a series of

[12] https://home.treasury.gov/top-priorities/regulatory-reform.

recommendations for the U.S. regulatory agencies to consider in order to reduce regulatory costs for the banking system.

As I said in my testimony to the Committee, I am committed to maintaining the core elements of the post-crisis framework that have been put in place to protect the financial system's strength and resiliency, while also seeking ways to enhance its effectiveness. We will continue to evaluate the effects of regulation on financial stability and on the broader economy and where appropriate make adjustments. I am also committed to enhancing the simplicity, transparency and efficiency with which the Federal Reserve supervises and regulates firms under our jurisdiction.

- **(c) While there was some discussion of insurance savings and loan holding companies (SLHCs) and the Federal Reserve's approach to regulating them during the hearing, it is worth noting the Office of Thrift Supervision (OTS) was roundly criticized for its weak oversight, including of AIG, leading up to the 2008 financial crisis. Given that the supervision of SLHCs were transferred from the OTS to the Federal Reserve Board, what steps is the Federal Reserve Board taking to improve oversight of all SLHCs and not repeat past mistakes?**

The Office of Thrift Supervision's supervisory activities at insurance savings and loan holding companies (ISLHCs) focused on assessing the condition of the subsidiary thrift(s) with a minimal review of non-banking activities, including insurance. In contrast, the Federal Reserve's ISLHC supervisory program focuses on consolidated risk management and an overall assessment of the safety and soundness of the ISLHC. The Federal Reserve also employs a number of insurance specialists at both the Board and the Reserve Banks who are directly responsible for overseeing the ISLHCs.

The Federal Reserve conducts ISLHC inspections on an annual basis and tailors the supervisory program to each firm's size, structure, risk profile, and business model as well as the size and scale of banking and other non-insurance activities. Supervisory emphasis is placed on assessing an ISLHC's consolidated risk management framework, material non-insurance subsidiaries, and the potential impact the firm's activities may have on its subsidiary insured depository institution (IDI). The Federal Reserve also seeks to protect the IDI from risks related to nonbanking activities, including insurance, as well as intercompany transactions between the parent and IDI to ensure that the IDI is not adversely affected.

In light of the McCarran-Ferguson Act, we rely on the state insurance departments (DOIs) to supervise the business of insurance including the DOIs' assessment of risk and the financial condition of insurance operations. Discussions with the DOIs are held on a regular basis to understand the risks associated insurance activities that could affect the bank or the consolidated condition of the ISLHC, such as those that led to the developments at AIG. The Federal Reserve also meets routinely with the DOIs to share supervisory information and coordinate supervisory approaches.

6. Large Bank Supervision and Enforcement

While you are recused from Wells Fargo matters, you play a critical role at the Federal Reserve Board with respect to large bank supervision and enforcement. Wells Fargo is a repeat offender with a terrible track record of harming consumers, including opening millions of fraudulent accounts without their customers' consent. Wells Fargo deserves the punishment that former Chair Yellen handed down to cap the bank's size until it cleans up its act while several bank directors stepped down. Yellen's action must be vigorously implemented, and more should be done by regulators to use existing tools to crack down on repeated violations of the law by megabanks. Fines won't cut it any more, they are just the cost of doing business. That is why I introduced the Megabank Accountability and Consequences Act last year to require the banking regulators to fully utilize existing authorities—such as the ability to shut down a megabank and ban culpable executives from working again in the industry—to stop megabanks like Wells Fargo that clearly and repeatedly engage in practices that harm consumers.

- **(a) Would you please review a Democratic Committee staff report issued in September 2017,[13] and H.R. 3937, the Megabank Accountability and Consequences Act,[14] I subsequently introduced, and list the full range of enforcement tools the Federal Reserve Board has to ensure the largest banks are following the law and sufficiently deterred from repeatedly breaking the law and harming consumers?**

Congress has conferred on the Federal Reserve and the other bank regulators a broad array of both informal and formal enforcement tools to be exercised at appropriate points throughout the course of the supervisory process. Enforcement measures may escalate depending on the severity or difficulty of the problem. If a problem requires a more detailed resolution than can be addressed through the normal examination process or is more pervasive at an institution, the Federal Reserve may enter into a memorandum of understanding (MOU) with the financial institution in which the board of directors commits to specific actions to correct potentially unsafe and unsound banking practices or possible violations of laws or regulations. These are private supervision matters.

The Federal Reserve also confronts situations where an institution engages in an unsafe or unsound practice or alleged violation of law that is more widespread or more serious so that MOUs or other informal supervisory methods are not appropriate or sufficient. In these cases, the Federal Reserve will begin more formal types of enforcement action against the regulated financial institution and its institution-affiliated parties, such as current or former employees.

As described in the Democratic Committee Report, these more formal remedies include entering into formal written agreements or imposing orders directing the financial institution or its institution-affiliated parties to cease and desist from engaging in the improper or prohibited conduct, directing the firm to take certain actions to return to safe and sound banking practices and, where appropriate, requiring the firm to make restitution or provide reimbursement, indemnification, or guaranty to third parties harmed by the wrongful conduct. The Federal Reserve may also remove an institution-affiliated party from the banking institution and prohibit the party from participating in banking at other financial institutions. Finally, we may

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[13] https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=400807.

[14] https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=400815.

determine that the assessment of civil money penalties is appropriate against either the offending institution or an institution-affiliated party.

- **(b) Does the Federal Reserve Board use different enforcement tools depending on the size of the bank holding company?**

The enforcement tools available to the Federal Reserve and other federal banking agencies are applicable to the institutions we supervise regardless of size. In each case where the Federal Reserve assesses whether an enforcement action is warranted, the Federal Reserve considers whether the relevant legal standards for seeking the proposed remedy are supported by the facts and circumstances. These standards generally do not refer to the size of the institution involved. However, when imposing a civil money penalty, the Federal Reserve is required, by law, to consider the size and financial resources of the institution, in addition to whether it acted in good faith, the gravity of the violation, the history of previous violations, and other matters as justice may require.[15] As evidenced by its public enforcement actions, the Federal Reserve has used its enforcement tools against institutions of a wide range of asset sizes.[16]

- **(d) While some of my colleagues suggested the Federal Reserve Board does not have the authority to oversee board of directors of a bank holding company, do you agree the law is clear that the Federal Reserve Board indeed has such authority, and can remove certain directors if not ban them from working again in the industry? Please list each instance the Federal Reserve Board has taken such a step in the last 20 years, along with the size of the bank holding company when such an action was taken?**

As part of its examination of regulated institutions, the Federal Reserve regularly reviews the performance of the boards of directors and senior managers of these institutions and may take action against an institution-affiliated party under specific circumstances.[17] In determining whether to remove or prohibit an institution-affiliated party, the Federal Reserve must consider whether each of three statutory criteria are met: misconduct (typically, a violation of law, unsafe and sound practice, or breach of fiduciary duty), culpability (the individual must knowingly or recklessly participate in the conduct or the conduct must evidence personal dishonesty) and effect (the misconduct caused or is likely to cause financial loss or other damage to the institution, prejudiced the interests of depositors, or resulted in financial gain to the individual).[18] An individual is also prohibited by law from participating in the affairs of any banking organization if the individual is convicted of a felony or any criminal offense involving dishonesty, breach of trust or money laundering.

The attachment in Appendix A is a chart that includes the prohibition actions the Federal Reserve has taken in the last 20 years, both contested and consent actions, and the asset size of the bank holding company or foreign bank parent company of the relevant institution at or around the time of the action, where available. The highlighted prohibition actions represent

[15] *See* 12 U.S.C. § 1818(i)(2)(G).
[16] Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/apps/enforcementactions/search.aspx (last visited Jun. 21, 2018).
[17] *See* 12 U.S.C. § 1818(e).
[18] *Id.*

instances where an individual was a member of the board of directors of the relevant institution. Note that, in these instances, an individual may also have had an additional role at the institution, such as a bank officer.

- **(e) Will the Fed consider taking similar action – capping their size – if other megabanks are found to repeatedly break the law?**

The Federal Reserve takes seriously its responsibility to ensure the safety and soundness of the nation's banking and financial system and will continue to use all available tools where warranted.

- **(f) Will the Fed Board hold a vote before it uncaps Wells Fargo's size constraints? Why or why not?**

As noted in one of your previous questions, I am recused from this matter. As Chairman Powell stated in a letter sent in May to Senator Warren, the Board will vote on any decision to terminate the asset growth restriction the Federal Reserve imposed on Wells Fargo in the Consent Order issued earlier this year.

- **(g) The Government Accountability Office (GAO) issued a report last year entitled, "Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence."[19] GAO made six recommendations to the Federal Reserve Board in the report. What are the status of the Federal Reserve Board's efforts to address those recommendations?**

Thank you for the opportunity to provide an update regarding the steps taken by the Board to address the recommendations related to the Board's Large Institution Supervision Coordinating Committee (LISCC) made by the GAO in its report titled: *Large Bank Supervision: Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence* (GAO-18-118). As noted in the Board's prior updates to the GAO regarding these recommendations, we believe that we are effectively managing the risks of regulatory capture in the supervision of large financial institutions. A summary of the status relating to each of the GAO's findings is below.

Develop ERM Framework to Include a Component to Identify and Assess Risks of Regulatory Capture across the LISCC Program

With respect to the first recommendation, the enterprise risk management (ERM) framework being developed by the Board will not significantly alter the management processes that the Board and System have in place under the LISCC program that continue to work effectively. Since the report's issuance, the Board has continued to develop the ERM framework by establishing a Board Risk Committee comprised of senior leaders, which serves as the central forum for Board-wide risk issues and oversight of the ERM program. Additionally, a number of

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[19] https://www.gao.gov/products/GAO-18-118.

strategic components of the ERM framework have begun to be implemented throughout the Board.

Finalize and Implement Program-wide Guidance for the LISCC Reserve Banks on Implementing LISCC Policies

Since the Federal Reserve's last update on the recommendations made in the GAO's report, the LISCC supervisory program has continued its efforts to address the GAO's second recommendation that the Federal Reserve "finalize and implement program-wide guidance for the LISCC Reserve Banks on implementing LISCC policies." The Federal Reserve has memorialized all aspects of the LISCC supervisory program within a comprehensive LISCC program manual.[20] The LISCC program manual remains in a near-final form pending completion of a proposal to revise the Federal Reserve's supervisory ratings system, which the Federal Reserve anticipates being finalized by year-end 2018.[21] Despite the manual's near-final status, the LISCC supervisory program has operated under the manual's guidelines since January 1, 2018, thereby satisfying the spirit of the GAO's recommendation to "finalize and implement program-wide guidance."

In addition to the LISCC program manual, the LISCC Office of the Operating Committee has continued its work with the core programs and Reserve Banks' dedicated supervisory teams to refine and develop operating policies, procedures, and guidance for the conduct of supervisory activities. When concluded, each core program and dedicated supervisory team will have established operating standards that will include (1) documentation and deliverable requirements, including for the vetting of supervisory findings, assessments, and ratings; (2) automated storage requirements for horizontal and firm-specific documentation; and (3) supervisory cycle timing, planning, and deliverable requirements.

It is the Federal Reserve's expectation that the LISCC program manual, as well as the core program and dedicated supervisory teams' operating manuals, will be completed by fall 2019. This additional time will help to ensure we are able to incorporate lessons learned from the LISCC supervisory program's first year of operations under the LISCC core program model. Once completed, this program-wide guidance will help to ensure the consistent and effective implementation of LISCC program requirements and will aid in mitigating threats to independence by ensuring the Federal Reserve's supervisory conclusions remain transparent and based on sound evidence.

Monitor and Assess Implementation of LISCC Policies and Procedures

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[20] The LISCC core programs are (1) capital, (2) liquidity, (3) recovery and resolution, (4) governance and controls, and (5) monitoring and analysis. The LISCC program manual provides detailed guidance on the core programs' (1) governance structure and roles and responsibilities; (2) focus for the year-round horizontal activities and ongoing firm-specific supervisory work; (3) expected role that the dedicated supervisory teams have in relation to the execution of the core program work; (4) documentation and deliverable requirements for activities and supervisory work, including electronic storage requirements; (5) vetting, divergent views, and decision-making process; (6) ratings process; and (7) external communication requirements.

[21] Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. 158, 39049 (proposed Aug. 17, 2017) (to be codified at 12 C.F.R. pts. 211 and 238).

The GAO's report acknowledged that internal reviews have been effective in identifying some issues regarding implementation of the LISCC program and recommended that the Federal Reserve finalize and implement a mechanism to monitor and regularly assess Reserve Banks' implementation of LISCC policies and procedures. The Federal Reserve currently assesses the effectiveness of Reserve Bank supervision functions, including their adherence to System guidance, through a continuous oversight program. The Federal Reserve has recognized that the GAO recommendation to formalize the monitoring and assessment of the LISCC program would provide greater assurance regarding the implementation of LISCC guidance. As noted in the GAO's report, the Federal Reserve has implemented changes to augment the oversight program through the development in the first half of 2018 of a LISCC-specific oversight framework that encompasses all Board and Reserve Bank LISCC activities and provides for a comprehensive assessment of program effectiveness. In the second half of 2018, staff have identified further targeted review and oversight activities employing and testing the LISCC-specific oversight framework.

Streamline Conflicts of Interest Reviews

The GAO's report recommended that the Federal Reserve streamline its conflict-of-interest disclosure review process for participants in the LISCC program by, for example, storing disclosure information in compatible electronic systems. The report indicated that different parties involved in the conflicts review process have different means of collecting and storing information, which may hinder how efficiently and effectively this information is used in the review process.

As described in the report, our objective is to effectively identify and manage conflicts of interest when supervisory staff join the Federal Reserve, during their tenure as supervisors, and when they leave the organization. We appreciate the observations provided in the report and are exploring options for streamlining our approach, including, among other things, assessing the feasibility of integrating existing systems. We have drafted guidance that develops a LISCC-specific conflicts-of-interest and examiner credential program that will seek to ensure consistency in the interpretation and application of conflicts-of-interest rules for all staff, both at the Board and the Reserve Banks, that participate in the LISCC supervisory program. We plan to issue this guidance and begin implementation of a more consistent and centralized disclosure review approach in 2018. In addition, we have begun collecting and storing conflicts-of-interest disclosure information for all LISCC participants, including Board LISCC staff, in one electronic system. We have also provided initial training to Board LISCC staff on the disclosure review process and the electronic system to ensure consistent collection of conflicts-of-interest data for all LISCC participants.

Systematically Collect Pre- and Post-Employment Data

The Federal Reserve has implemented policies intended to mitigate the risk that an employee may be influenced by prior employment or the prospect of future employment and place his or her private interests ahead of the organization's supervisory mission. For instance, the Federal Reserve recently broadened the scope of post-employment restrictions applicable to senior examiners. According to the GAO's report, the Federal Reserve could do more to mitigate this risk, specifically by systematically collecting pre-and post-employment information from supervisory employees. We agree that "revolving door" risk can pose a threat to supervisory objectivity and have begun discussions to develop a more systematic approach to collect and monitor pre- and post-employment data through the use of an electronic system. The updated electronic system is scheduled to be released, for both Board and Reserve Banks' use, in 2019. With respect to the collection of post-employment information, it is important to note that departing employees have no obligation to identify their future employer.

Conduct a Periodic Self-assessment of Ethics Programs, Policies, and Procedures That Apply to LISCC Program Participants

Board Ethics Program staff and Supervision and Regulation division staff are jointly assessing the current programs, policies, and procedures applicable to LISCC program participants. Within the next year, we expect to finalize and implement new conflicts-of-interest policies and procedures applicable to LISCC participants.

- **(i) What other priorities do you have as the Vice Chair of Supervision to strengthen oversight and enforcement relating to the largest bank holding companies?**

I am very supportive of the steps that the Federal Reserve has taken since the financial crisis to strengthen its supervision, particularly at the largest firms. Notably, our supervision of these firms is aimed at ensuring that they have sufficient capital and liquidity, and we have substantially raised our expectations for how well these firms manage their risks, maintain internal controls, and exercise governance. In addition, to improve our supervision of the largest systemically important firms, we have created the LISCC, which helps us look at firms both individually and collectively.

Going forward, we are looking for ways to potentially make our supervision of firms of all sizes more efficient, transparent, and simple. In doing so, however, I believe that we should not weaken the stringency of our supervisory programs. Moreover, I strongly support continued tailoring of our supervisory programs relative to the size, complexity, and risk profile of the firms we supervise, with the highest expectations for the most systemically important firms.

- **(j) Unlike the Savings and Loan crisis when more than 1,000 bank executives were prosecuted, there was no similar accountability following the worst financial crisis since the Great Depression.**
  - **Do you believe such a result was a just outcome?**
  - **Do you believe any bank holding company is "too big to jail"?**
  - **What steps can the Federal Reserve Board take to ensure full accountability for individuals who work at entities you regulate that break the law?**
  - **Do deferred prosecution agreements (DPA) with bank holding companies weaken individual accountability? Why or why not?**

The decision to file criminal charges in a particular case is solely within the discretion of the Department of Justice (DOJ) and state prosecutors who alone have the authority to press criminal charges. As I have said before, no institution or individual is above the law.

The Federal Reserve has exercised its civil enforcement authority where warranted to address unsafe or unsound conduct or illegal activity that occurred during the recent financial crisis. Since the start of the financial crisis in 2008, the Federal Reserve has assessed civil money penalties and restitution payments against institutions under the Federal Deposit Insurance Act totaling more than $5.7 billion. In addition, our investigations of persons employed by or affiliated with supervised institutions have led the Federal Reserve to seek the permanent ban or suspension of more than 72 individuals from the banking industry, including senior officers and directors who failed to protect consumers and those who engaged in irresponsible banking practices that led to the crisis.[22]

Because the Federal Reserve does not have authority with respect to criminal prosecutions, we are not in a position to comment on whether the tools available to the DOJ to address corporate misconduct, including the use of deferred prosecution agreements, are effective.

7. Capital and Leverage Rules for the Largest Banks

Chair Powell recently said that the Fed's requirements for the largest banks are "very high and they're going to remain very high."[23] He continued, "As you look around the world, U.S. banks are competing very, very successfully. They're very profitable. They're earning good returns on capital. Their stock prices are doing well. So I'm looking for the case, for some kind of evidence that — and I'm open to this — some kind of evidence that regulation is holding them back, and I'm not really seeing that case as made at this point."[24] I agree, which is why I'm confused why the Fed, along with the OCC, proposed to slash the leverage ratio and reduce tier 1 capital for our largest banks by more than $120 billion, according to the FDIC. JPMorgan, Citigroup, Bank of America, Goldman Sachs, Morgan Stanley, State Street and Bank of New York Mellon would all benefit, and while it varies, they could see their capital reduced by as much as $34 billion, or a reduction as high as 37.5 percent of their current tier 1 capital. This would likely result in more stock buybacks, not more loans. Wells Fargo, the recidivist megabank whose size has been capped by the Fed, could see their tier 1 capital requirements reduced by more than $20 billion.

Instead of lowering the leverage ratio so it not a binding constraint, the Fed could *raise* risk-based capital levels to achieve this objective. In fact, the Fed's own research notes current capital levels are too low, and should be raised to somewhere between 13 and 26 percent.[25] And the Minnesota Fed has proposed an even more aggressive risk-based capital ratio of 23.5 percent and a leverage ratio of 15 percent as a first step to end too big to fail.[26]

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[22] See Appendix A.

[23] https://www.federalreserve.gov/newsevents/speech/powell20180406a.htm.

[24] Politico Pro, "Powell doesn't see need to loosen rules on biggest banks," April 6, 2018, https://www.politicopro.com/financial-services/whiteboard/2018/04/powell-doesnt-see-need-to-loosen-rules-on-biggest-banks-967593.

[25] Simon Firestone, Amy Lorenc and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S. (PDF)," Finance and Economic Discussion Series 2017-034 (Washington: Board of Governors of the Federal Reserve System), available at: https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf.

[26] https://www.minneapolisfed.org/publications/special-studies/endingtbtf/final-proposal.

- **(a) Mr. Quarles, do you disagree with Chair Powell that there is no evidence that regulation is holding big banks back? Why or why not?**

Maintaining the safety and soundness of the largest banking firms is fundamental to maintaining the stability of the U.S. financial system and the broader economy. To be safe and sound financial institutions, these firms must be well-capitalized. The Board and the other federal banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system. Indeed, large banking firms have roughly doubled their capital positions from before the crisis to today, making them significantly more resilient, as well as better able to support lending and financial intermediation in times of financial stress. These improvements have helped to build a more resilient financial system, one that is well-positioned to meet American consumers', businesses' and communities' credit needs, even under challenging economic conditions.

At the same time, I am mindful that, just as there is a strong public interest in the safety and soundness of the financial system, there is a strong public interest in the efficiency of the financial system. Thus, the Board is assessing the effects on the economy and large banking firms of our recent regulatory efforts, including whether they are having any unintended results and whether they can be revised to accomplish the same goals in a more efficient manner.

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

I do not believe that the enhanced supplementary leverage ratio (eSLR) proposal would materially change the amount of capital held by U.S. global systemically important bank holding companies (GSIBs). The $121 billion figure noted in the eSLR proposal represents the potential reduction in tier 1 capital required across the lead insured depository institution subsidiaries of the GSIBs; however, these entities all are wholly-owned by their parent holding companies. On a consolidated basis, GSIBs would continue to be subject to risk-based capital requirements, supervisory stress testing constraints, and other limitations applicable at the holding company level that would restrict the amount of capital that such firms may distribute to third-party investors. Due to these limitations at the holding company level, the GSIBs would be required to retain nearly all of the $121 billion amount and would not be able to distribute it to third parties. Indeed, the Board estimates that the eSLR proposal would reduce the amount of tier 1 capital required across the GSIBs on a consolidated basis by only approximately $400 million. That amount is approximately 0.04 percent of the amount of tier 1 capital held by the GSIBs as of the first quarter of 2018.

- **(c) With banks doing so well, why would the Fed propose to reduce capital in a significant way that diminishes protections for taxpayers and the economy? What research does the Federal Reserve Board have that any reduction in capital requirements will result in more lending as opposed to more stock buybacks, dividend payments, or bonuses for executives?**

As noted above, I do not believe that the eSLR proposal would materially change the amount of capital required to be held by U.S. GSIBs. As noted, any capital released at the depository institution level would be nearly all unavailable for distribution to third-party investors.

- **(d) Will you provide the Federal Reserve Board's estimate for how your proposed changes to the eSLR and stress capital buffer would impact each U.S. global systemically important banks (G-SIBs), both at the holding company level and at the primary insured depository institution subsidiary?**

As a general matter, the Federal Reserve believes that leverage requirements should serve as a backstop to risk-based capital requirements in order to reduce incentives for firms to increase their exposure to riskier assets. The Board's stress capital buffer (SCB) proposal would extend the proposed stress buffer concept to the leverage ratio, but not to the supplementary leverage ratio. The Board is seeking comment on the advantages and disadvantages of this specific aspect of the SCB proposal (see question 3 in the preamble of the proposed SCB rulemaking).

Due to the sensitive nature of the supervisory data and assumptions included in the impact assessment of the eSLR proposal, the Board has made only aggregate impact data publicly available. The impact of the eSLR proposal would vary across firms based on their individual risk profiles and planned distributions and would vary across time based on the severely adverse stress scenario used in the supervisory stress test. While the discussion in the SCB proposal and the eSLR proposal reflects the estimated impact of those individual proposals relative to current requirements, in developing the proposals, the combined impact was also considered. Factoring the relatively immaterial estimated reduction in required tier 1 capital across GSIBs under the eSLR proposal ($400 million, as noted above in response to question 4b) into the estimated impact of the SCB proposal across GSIBs does not meaningfully affect the estimates provided in the proposals.

- **(e) Do you disavow the Federal Reserve Board's own research on the need to raise capital requirements for the nation's largest banks? Why or why not?**

As noted above, U.S. banking firms have roughly doubled their capital positions from before the crisis to today, making them significantly more resilient, as well as able to support lending and financial intermediation in times of financial stress. A number of studies have examined the relative costs and benefits of bank capital requirements.

- These studies use data and assumptions on the cost and severity of financial crises and the costs of increasing capital requirements to estimate the level of capital requirements that results in the largest net benefit to the economy.
- Such studies have been conducted by economists affiliated with the Basel Committee on Banking Supervision (2010), The Bank of England (2015), the Federal Reserve Bank of Minneapolis (2016), as well as economists at the Federal Reserve Board (2017).
- Some of these studies produce results that are consistent with current levels of capital for the GSIBs, while others call for more capital. This range in capital levels among the different studies reflects varying assumptions and data sources.

A different and perhaps preferable way to assess capital adequacy is through stress testing. All U.S. GSIBs demonstrated their ability to survive a shock more severe than the most recent global financial crisis while still continuing to supply credit and maintaining their recent dividends. Firms whose proposed additional capital payouts were not supported by their current capital bases were required to scale back their requests or take steps to reduce risk; in addition, they are expected to improve their capital positions this year.

- **(g) During your testimony, you focused on the fact that the SLR has become the binding constraint for many banks, and how that produces perverse outcomes. Would not raising risk-based capital levels while maintaining the current leverage ratios produce the same outcome, while also being responsive to research from the Federal Reserve Board and other organizations that capital requirements should be increased?**

The purpose of the eSLR proposal is to recalibrate the Board's capital standards for banking organizations such that the ratio generally serves as a backstop to risk-based capital requirements and not as a binding constraint. At this time, I believe that the substantial gains to the overall resilience of the financial system, as well as the minimal capital release that is likely to occur if the eSLR proposal were to be finalized, support the Board and the OCC's narrow approach to recalibrating the eSLR standards.

- **(i) What impact will the Federal Reserve Board's efforts to weaken capital and leverage rules, or other prudential rules, for the nation's largest banks mean for community banks? Won't this accelerate consolidation trends in the industry?**

Community banks benefit from the financial stability that results from increased standards that apply to the U.S. GSIBs. The eSLR proposal would not materially change the amount of capital held by U.S. GSIBs, therefore I do not believe this will have an appreciable effect on financial stability, the overall composition of the banking industry in the United States, or on competition among community banks and GSIBs. Taking into account the capital constraints imposed by the Board's supervisory stress testing requirements, as well as the Board's regulatory capital rules, we estimate that the eSLR proposal would reduce the amount of tier 1 capital required across the GSIBs by approximately $400 million. That figure is approximately 0.04 percent of the amount of tier 1 capital held by the GSIBs as of third quarter of 2017. The Board's recent eSLR and SCB proposals would only apply to relatively large banking organizations and would not directly impact community banks.

8. Custodial Assets

Congress has proposed exempting custodial assets from the denominator of the leverage ratio rules, in part, to deal with the concern that the leverage rules could inadvertently make it harder for custodial banks, like Bank of New York Mellon, to accept a rapid increase in such deposits when there is a flight to safe assets in a crisis, and make it harder for central banks, like the Federal Reserve, to respond. Notably, the Basel Committee on Banking Supervision (Basel Committee) suggested a more targeted proposal than the one Congress is considering that would provide for a temporary exemption of central bank reserves from a country's leverage ratio to the extent the amount of reserves is disclosed

and that the bank would have to make offsetting changes to its balance sheet to remain safe and sound.

- **(a) The Fed serves on the Basel Committee and was a party to the December 2017 Basel III end game agreement[27] that included that recommendation. Do you support the proposed narrower adjustment over a more sweeping exemption that has been proposed by Congress?**

Since this question was posed, Congress passed, and the President signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). The EGRRCPA requires the Board, for purposes of calculating total leverage exposure, to exclude the funds of a custodial bank that are deposited with a central bank.

- **(b) What would the effect of the Federal Reserve's proposed changes to eSLR be if they occurred in addition to Section 402 of S. 2155 to fully exempt central bank deposits from the leverage ratio for custodial banks was signed into law? Does the Federal Reserve Board have the flexibility to implement these proposals in a manner that is more akin to the more targeted proposal put forward by the Basel Committee?**

The proposed recalibration to the eSLR standards assumed that the components of the supplementary leverage ratio use the capital rule's current definitions of tier 1 capital and total leverage exposure. If the changes to total leverage exposure in the EGRRCPA were taken together with the Board's proposal, the removal of central bank reserves from total leverage exposure would generally increase supplementary leverage ratios for firms that are predominantly engaged in custodial services. The Board is considering the proposed recalibration in light of the statutory mandate to exclude central bank deposits from total leverage exposure for certain firms, taking into account safety and soundness of these firms as well as the resilience of the financial system.

9. "Too Big to Fail"

- **(b) Do you support the Treasury Department's report recommending the preservation of Dodd-Frank's Orderly Liquidation Authority?[28] Will "too big to fail" return if Dodd-Frank's tools are rolled back or eliminated, including Dodd-Frank's Orderly Liquidation Authority as the Chairman and other Republicans have advocated?**

The Treasury Report on Orderly Liquidation Authority (OLA) and Bankruptcy Reform is thoughtful about the strengths and weaknesses of the current regimes for handling the resolution of a failing financial firm. While I believe that bankruptcy should be the preferred resolution framework for a failing firm, given the uncertainties around how financial crises unfold, I understand the argument presented in the Treasury Report that it remains prudent to keep OLA as a backstop resolution framework. As the Treasury Report recognizes, OLA provides an

[27] https://www.bis.org/bcbs/publ/d424_hlsummary.pdf.
[28] https://home.treasury.gov/news/press-release/sm0295.

alternative to bankruptcy in those circumstances where bankruptcy may not be feasible due to current limitations of the bankruptcy code.

- **(c) The Dodd-Frank Act gives financial regulators, especially the Fed, a number of authorities to address this issue. This includes enhanced capital requirements, and authorities that are activated -- including breaking up the largest banks -- if living wills cannot credibly demonstrate a firm can be safely resolved through the Bankruptcy Code, or if the Fed determines a megabank poses a grave threat to financial stability. Will you commit to fully utilizing these and other Dodd-Frank tools to end too big to fail?**

We have made great strides with the FDIC through the living wills process to make our largest banking firms easier to resolve under the current Bankruptcy Code. In addition, we have increased the quantity and quality of capital maintained by the largest banks and imposed requirements to help ensure that our largest banks have more stable liquidity risk profiles. As stated previously, financial institutions and markets are always evolving, however, so it is important to remain vigilant regarding changing systemic risks. I will continue to consider all of the Board's authorities in response.

10. Restrictions on Bank Activities

- **(a) In the last election, the Republican party platform called to reimpose the Glass-Steagall firewall between commercial and investment banking. Has the Trump Administration given up on pursuing reimposing Glass-Steagall? Do you support reimposing Glass-Steagall? Why or why not?**

The central provisions of the Glass Steagall Act – section 16 which prohibits a bank from engaging in the securities business and section 21 which prohibits securities firms from taking deposits - have never been repealed and remain the law of the land. The Gramm-Leach-Bliley Act of 1999 rescinded two ancillary provisions dealing with the activities of some affiliates and certain restrictions on directors, but in addition to leaving in place the core Glass Steagall provisions also left in place the provisions of the Federal Reserve Act and other fundamental provisions of banking law that limit the ability of such affiliates to interact with insured banks. I am not aware that the Administration has proposed to re-impose these ancillary provisions, and – because of the retention of the core provisions of Glass Steagall and the limitations on interaction between banks and their affiliates – I am not convinced that the repeal of these ancillary provisions contributed materially to the financial crisis of 2008-2009. In the crisis, the most notable failures were of specialized financial firms that did not materially combine investment banking and commercial banking, such as AIG, Washington Mutual, Countrywide, Bear Stearns and Lehman Brothers. I think that the fundamental lesson from the crisis is that the largest, most interconnected financial firms need to hold substantially more capital, take substantially less liquidity risk, and face an effective orderly resolution regime if they fail. Consistent with its statutory authorities, the Board has endeavored to implement a regulatory framework that accomplishes these objectives.

- **(b) Should banks be in the business of owning warehouses full of copper or other commodities? The Federal Reserve has a pending rule that would curb the strange**

bank business of owning, trading and moving commodities. Do you support that proposal and when should we expect it to be finalized?

The Board began its review of the physical commodities activities of financial holding companies after a substantial increase in these activities among financial holding companies during the financial crisis. In January 2014, the Board invited public comment on a range of issues related to these activities through an advance notice of proposed rulemaking. In response, the Board received a large number of comments from a variety of perspectives. The Board considered those comments in developing the proposed rulemaking that was issued in September 2016. After providing an extended comment period (150 days) to allow commenters time to understand and address the important and complex issues raised by the proposal, the Board again received a large number of comments from a variety of perspectives, including Members of Congress, academics, users and producers of physical commodities, and banking organizations. The Board continues to consider the proposal in light of the many comments received and to monitor the physical commodities activities of financial holding companies.

- **(c) The Federal Reserve has previously proposed, pursuant to the Dodd-Frank Section 620 report, several legislative changes regarding banks.[29] They proposed that Congress:**
  - **repeal the authority of Financial Holding Companies (FHCs) to engage in merchant banking activities;**
  - **repeal the grandfather authority for certain FHCs to engage in commodities activities under section 4(o) of the BHC Act;**
  - **repeal the exemption that permits corporate owners of industrial loan companies (ILC) to operate outside of the regulatory and supervisory framework applicable to other corporate owners of insured depository institutions; and**
  - **repeal the exemption for grandfathered unitary SLHCs from the activities restrictions applicable to all other SLHCs.**

With respect to the merchant banking and section 4(o) grandfather authorities of the Bank Holding Company Act, the Board has issued an advance notice of proposed rulemaking in 2014 and a notice of proposed rulemaking in 2016 to consider appropriate actions that the Board may take to address these matters. The Board continues to consider the proposals in light of the many comments received and to monitor activities under these authorities.

Unlike merchant banking and section 4(o) grandfather authorities, the exemptions for grandfathered unitary savings and loan holding companies and owners of industrial loan companies (ILCs) place institutions under these exemptions outside of the Board's supervision and regulation. Therefore, the Board may not directly address the concerns with these exemptions that the 620 Report describes (e.g., affiliation of commercial and financial entities, lack of consolidated supervision and regulation, competitive advantage).

- **(d) Do you support any of these recommendations? Why or why not?**

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[29] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160908a.htm.

The Board's report to Congress and the FSOC pursuant to section 620 of the Dodd-Frank Act raises a number of complex issues that I believe merit further consideration. I have the report under review and look forward to completing that consideration.

12. Executive Compensation

The Wells Fargo fraudulent account scandal, and its incentive-based cross-selling strategy that fueled it, is a stark reminder how important it is for financial regulators to finalize executive compensation rules. As you know, Section 956 of the Dodd-Frank Act directed regulators, including the Fed, to adopt joint rules aimed at prohibiting incentive compensation arrangements that might encourage inappropriate risks at financial institutions. The regulators made an initial proposal in 2011, then reworked the proposal and issued a new plan in 2016. The proposal increases in stringency based on the financial company's asset size with enhanced requirements for senior executive officers and significant risk-takers.

- **(a) Given that this is not a discretionary requirement, what steps are you taking to implement and enforce this provision of the law?**

After the Board, OCC, FDIC, SEC, NCUA, and Federal Housing Finance Agency (the agencies), jointly published and requested comment on the revised proposed rule in June 2016, the agencies received over one hundred comments. These comments raised many important and complicated questions. The agencies are considering the comments. Compensation practices are, and will remain, a core element that we examine as part of our regular supervisory engagement with each firm.

13. International Coordination on Financial Regulations

Mr. Quarles, there have been news reports suggesting that the Treasury Department is pushing for you to be considered as a candidate to lead the Financial Stability Board (FSB).[30]

- **(a) Are you interested in the job leading the FSB? When will such a decision be made?**

The FSB is one of the important international bodies created since the crisis that promotes financial stability. I am a candidate for the FSB chairmanship because I believe that the global reach of the banking industry means that financial stability is necessarily a global undertaking. When rightly structured, our participation in these groups makes our financial system significantly stronger by ensuring that the U.S. perspective is part of the discussions and reflected in agreed-to standards. Further, many financial vulnerabilities arise abroad, so having a global forum where those vulnerabilities can be discussed is critical to ensuring that we are aware of developments abroad that have the potential to adversely affect the stability of our own financial system. U.S. consumers and businesses are more secure and prosperous because the FSB helps make sure that all countries are doing their share in promoting financial stability and not gaining an unfair advantage. While I cannot speak directly to the conclusion of the decision-

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[30] https://www.ft.com/content/846d7b00-27b3-11e8-b27e-cc62a39d57a0.

making process, I would expect a successor would be in place when the current FSB chairman's term expires later this year.

- **(b) How do you assess FSB's record at promoting global financial stability through international coordination?**

The FSB promotes international financial stability by monitoring international developments related to financial stability and providing its members a forum to coordinate their work developing strong regulatory, supervisory, and other financial sector policies.

Since the financial crisis, the members of the FSB have emphasized four priorities for reform: building the resilience of financial institutions, ending "too big to fail," increasing the safety of derivatives markets, and transforming shadow banking to transparent and resilient market-based financing.[31] In addition, they regularly review and update a set of Key Standards for Sound Financial Systems.[32] The key standards currently cover three policy areas: macroeconomic policy and data transparency, financial regulation and supervision, and institutional and market infrastructure.

In his most recent letter to the G-20 leaders, FSB Chairman Mark Carney highlighted the following improvements in the financial system:

- Banks are stronger, more liquid, and more focused;
- A number of steps have been taken to eliminate "toxic forms of shadow banking and transforming it into resilient market-based finance;" and
- Changes to derivatives markets resulted in a more transparent system that reduces dangerous exposures.

With the post-crisis reform era coming to an end, FSB members will shift focus towards monitoring the implementation of reforms, beginning with country peer reviews and an annual survey of the status of implementation in each member jurisdiction. Of course, the FSB will continue to be an important forum for monitoring emerging global risks and coordinating discussion on cross-border stability issues.

- **(c) What would your priorities be at the FSB?**

In terms of my priorities, monitoring emerging financial stability risks is at the top of my list. Given the scope of its membership, the FSB is uniquely positioned to identify emerging risks. In addition, now that the body of post-crisis regulation is largely complete, I would also support the FSB examining the effects that reforms and standards are having. Finally, I would support improving the transparency of the FSB's operations.

- **(d) The largest banks have complained about so-called "gold-plating" of prudential rules, like capital or leverage, where U.S. regulators implemented a standard that is more stringent than what an international body, like the Basel Committee, agreed to. But some observers have suggested "gold-plating" has helped the U.S. push**

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[31] http://www.fsb.org/what-we-do/policy-development/.

[32] http://www.fsb.org/what-we-do/about-the-compendium-of-standards/key_standards.

other jurisdictions to raise their standards. Do you believe when the U.S. leads by example by raising the bar on financial regulation, it makes it harder for other countries to ignore that record and lower their standards?

By design, international standards are a minimum, and countries are expected to implement more stringent standards when justified by national circumstances. In some cases, we have implemented standards above these minimums. We are cognizant that once standards are implemented, there may be effects that are greater than or different from those anticipated. For this reason, we believe it is important to monitor the implementation of new standards carefully and initiate adjustments where appropriate. Thus, with the revised regulatory framework and a more resilient system in place, the Board is assessing the effects of those efforts, and examining whether they are having unintended results and whether they can be revised to accomplish the same goals in a more efficient manner.

- **(e) Last December, the Fed and other U.S. regulators finalized the so-called Basel III "end game" with your international counterparts. But based on the Fed and the OCC's proposal last week to lower the eSLR, it seems as if you are using the international agreement to roll back important U.S. regulations. By changing course, is the Fed leading other financial regulators around the world in a new race to the bottom, deregulating a global financial industry that caused significant damage not only to the U.S. economy, but the global economy?**

The proposed recalibration of the eSLR standards is an example of the Board's efforts to ensure that the post-crisis financial regulations are working as intended. Core aspects of post-crisis financial regulation have resulted in critical gains to the stability of the financial system, including higher and better quality capital, an innovative stress testing regime, new liquidity regulation, and improvements in the resolvability of large firms. The financial system is stronger and more resilient as a result, helping banks to lend through the business cycle. With the revised regulatory framework in place, the Board is assessing the effect of those efforts. In undertaking this review and assessment, the Board is mindful of the need for regulations not only to be effective for maintaining safety and soundness and financial stability, but also to be efficient, transparent, and simple.

- **(f) What, if any, global financial standards currently do not go far enough and need to be made more stringent?**

The Board, along with the other U.S. banking agencies, has made substantial progress working within the Basel Committee to develop stronger regulatory and supervisory standards since the global financial crisis, especially with respect to the largest and most systemic firms. These improved standards have helped to build a more resilient financial system, one that is well positioned to provide American consumers, businesses and communities access to the credit they need, even under challenging economic conditions. In promulgating regulations, the Board determined that it was appropriate to impose requirements that are more stringent than the standards of the Basel Committee on several occasions when we determined, based on national circumstances, it was warranted to ensure the safety and soundness of U.S. banks and of the broader financial system.

14. Cost-Benefit Analysis

According to the Federal Reserve Board's website and as was discussed at the hearing, there is a new "Policy Effectiveness and Assessment section" which "focuses on understanding the economics of financial regulation. Section staff work on conducting ex ante analysis of the costs and benefits of pending regulations as well as the ex post assessment of existing regulations. Section economists also engage in academic research on topics related to banking and financial regulation."

- **(a) Under what statutory authority did the Federal Reserve Board establish this unit? What is the unit's mandate and priorities?**

The Board is committed to evaluating the economic impact of and costs and benefits associated with its rulemakings. To the extent possible, the Board attempts to minimize regulatory burden in its rulemakings consistent with the effective implementation of the Board's statutory responsibilities. Increasingly, the Board has published discrete quantitative analyses in connection with its rulemakings. Recent examples include the analysis conducted in conjunction with the Board's GSIB surcharge rule, single-counterparty credit limit rule, and long-term debt rule. To further these efforts, the Board established an office and hired economists and additional staff to focus on analyzing the costs and benefits associated with its rulemakings. Section 11 of the Federal Reserve Act authorizes the Board to "employ such attorneys, experts, assistants, clerks, or other employees as may be necessary to conduct the business of the Board." 12 U.S.C. 248(l).

- **(b) As of April 25, 2018, there were three individuals listed as working in the unit. How many staff does the Federal Reserve Board expect to hire for this unit? What is its budget? How will this unit interact with other divisions and units at the Federal Reserve Board?**

Currently, the Policy Effectiveness and Assessment section consists of a manager (an economist by training), a small number of Ph.D. economists and support staff. We recently hired additional Ph.D. economists to fill out staffing and these individuals will be joining in the coming months. The section is funded through the overall budget of the Division of Supervision and Regulation. In carrying out its responsibilities, the section staff will collaborate with economists and staff with specialized skills in other divisions and sections at the Board as appropriate.

- **(c) As you know, predicting the benefits from financial regulations preventing a future financial crisis are extremely difficult. How will this unit and the Federal Reserve Board include those considerations in any cost-benefit analysis of any regulation?**

There exists a significant body of work that examines the benefit of reducing the probability and severity of a financial crisis that has been carried out by academic economists and staff at the Federal Reserve and other financial regulators. Section staff will incorporate this knowledge into the evaluation of the benefits of any regulation.

- **(d) There has been a wide range of studies that have attempted to analyze the cost of the 2008 financial crisis. Given its significance in any cost-benefit analysis the**

Federal Reserve Board may engage in, I would ask this unit conduct its own analysis of the cost of the financial crisis to the U.S. economy and its citizens, including taxpayers, consumers, investors and homeowners. Will you ask this unit to conduct such an analysis and provide that analysis to the Committee?

As shown in the existing literature, the causes and consequences of financial crises in history can be varied. A comprehensive reassessment of the underlying causes of the 2008 financial crisis and cost-benefit analysis of the entire package of reforms would not be feasible in the near-term given the priorities of the section and its planned focus in the near-term. However, section staff will take a holistic approach for every topic in the work plan that is informed by past experience including, but not limited to, the recent financial crisis.

15. Racial Disparities in the Labor Market

- **(a) African-Americans in particular continue to suffer from overt employment discrimination. Indeed, the unemployment experience for better-educated African-Americans is on average worse than the unemployment rate for less educated whites.[33] To what extent can and should the Fed take such discrimination into account as it sets monetary policy? What policy recommendations can you offer for overcoming this persistent discrimination?**

Despite continued improvement in the labor market that has seen the unemployment rate for African Americans drop to an historic low of 5.9 percent in May, joblessness for African Americans remains well above that for white Americans. This long-term disparity in economic outcomes for African Americans is concerning. The best way for the Federal Reserve to promote the economic welfare of African Americans is to do our utmost to fulfill our dual mandate of maximum employment and price stability. However, even at maximum employment, structural disparities will likely remain. Addressing these disparities will require policy tools beyond those available to the Federal Reserve.

16. Wages

- **(a) Despite progress in reducing the overall level of unemployment, wage growth has largely remained low and stagnant for the vast majority of American families. What are the key factors in your view that explain why a tighter labor-market has yet to translate into higher pay for most families? Do you believe that the general rule in economics that a tight U.S. labor market will produce higher wages for U.S. workers will hold, or are there other factors at play that will continue to depress the income earned by U.S. workers?**

Most measures of wage growth remain below rates seen in previous strong labor markets. The most important factor contributing to this slower wage growth is the slowdown in productivity growth over the past decade or so. Since 2007, productivity growth has averaged only a little over 1 percent, well below the average of 2¼ percent seen since 1950. When productivity growth is lower, employers are not able to increase wages by as much as otherwise. I believe that tighter labor markets do lead to higher wage growth. Indeed, we have seen most measures

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[33] http://financialservices.house.gov/uploadedfiles/hhrg-114-ba19-wstate-wspriggs-20160907.pdf.

of wage growth increase modestly over the past few years, as the labor market has continued to tighten.

17. Normalization of the Fed's Balance Sheet

- **(a) Last October the Federal Reserve began the process gradually reducing its securities holdings in order to normalize the size of its balance sheet. Simultaneously policy makers at the Federal Reserve have outlined their intention to slowly lift the federal funds rate target. Can you discuss how these two normalization strategies are working in tandem? How is the Fed taking into effect the contractionary effects of balance sheet normalization in conjunction with its rate hikes?**

The Federal Open Market Committee's (Committee) monetary policy decisions take into account that its program of gradual reduction in the Federal Reserve's securities holdings is removing policy accommodation. This is because the program's removal of policy accommodation is one of the factors affecting the Committee's assessment of the economic outlook, and the Committee's decisions regarding the federal funds rate are based on that assessment.

Since October 2017, the Committee has been implementing a program of gradual reduction in the Federal Reserve's securities holdings. Against this backdrop, the Committee remains able to respond to economic developments and to adjust monetary policy in light of changes in the economic outlook, as it makes decisions at every FOMC meeting on the setting of its primary monetary policy tool, the federal funds rate. One of the considerations entering these decisions is the Committee's view that changes in its securities holdings affect overall financial conditions and U.S. economic activity. Consequently, its assessment of the economic outlook is informed by its best estimate of the effect of its balance sheet normalization program on financial conditions and the economy. If the economic outlook changes as the balance sheet normalization program proceeds, the Committee will be able to make appropriate adjustments to the stance of monetary policy by changing the current level and future path of the target range for the federal funds rate.

18. Banks Hoarding Interest Income as the Fed Raises Rates

- **(a) Since the Fed began raising interest rates, banks have seen a significant jump in net interest income and charged consumers more for loans, all while keeping the interest rate paid on customer deposits relatively flat. Can you discuss why depositors seem to be getting short changed as the Fed raises the rate it pays banks on their reserves?**

The market for bank deposits remains competitive, and consumers have choices on where to place their savings, including amongst brick-and-mortar bank branches, online banks, credit unions and money market mutual funds. Some banks have been paying higher deposit rates on certain types of accounts to maintain those deposit accounts in light of higher short-term interest rates, and some banks have been offering higher interest rates and other incentives to depositors to open new accounts. Many depositors also receive other services from banks where they maintain deposit accounts. Many customers choose to keep their deposits in low-interest-bearing accounts for convenience factors, such as check-writing ability, access to ATMs and physical branches, as well as access to other financial services. For customers seeking a higher return on their savings relative to that paid on deposit accounts, banks and other financial institutions do offer higher interest rate products, such as certificates of deposit and money market funds.

19. GOP Tax Plan

- **(a) Would you agree that the amount in compensation companies have provided their workers following the enactment of the GOP tax law, is only a small fraction of what corporations will return to shareholders and pay corporate executives in under the new law? Would you agree that the stimulative economic effects of the GOP tax law will be much smaller than had the tax law provided a larger share to lower and middle income families?**

Assessing the net effects of such a large and complicated set of tax policy changes as those in the Tax Cut and Jobs Act (TCJA) is very challenging and subject to considerable uncertainty. Indeed, a number of analysts have produced estimates of the demand-side and supply-side effects of the tax cuts, and there is a wide range of views. While there is a fairly broad view that lower corporate taxes can potentially induce greater economic output, wages, and profits, there is no consensus on the magnitude of those effects nor the distribution of those potential benefits. For example, in the Congressional Budget Office's (CBO) recent April 2018 report, The Budget and Economic Outlook: 2018 to 2028, the effects of the TCJA on the CBO's economic projections and a comparison of those effects to available estimates from other organizations is presented.[34]

Many analysts think that lower-income families are likely to spend more of their tax cut than higher-income families, which suggests that the demand-side effects can vary depending on the distribution of the tax cut. And I suspect that is true, but the degree of the difference is not well understood. Moreover, potential differences between higher- and lower-income households of any supply-side response through changes in labor supply and in investment are quite uncertain and subject to alternative views.

[34] See Appendix B in the report, pp. 105-130, https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf.

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
Prohibition Actions - Bank Holding Companies or Foreign Parent Banks with $250 Billion or Greater in Assets				
1	Michael Wachs	Chase Manhattan Corporation, New York, NewYork	2/2/1998	JP Morgan Chase & Co.
2	Edward DeRosa	Rabobank Nederland, New York, New York	5/9/2002	Cooperatieve Rabobank U.A.
3	Eduardo Del Rio	Deutsche Bank, New York, New York	11/15/2002	Deutsche Bank AG
4	Stephanie Edmond	First Tennessee Bank, N.A., Memphis, Tennessee, and Bank of America N.A., Charlotte, North Carolina	6/17/2004	Bank of America Corporation
5	Matthew T. Stromgren	J.P. Morgan Chase & Co., New York, New York	6/28/2005	JP Morgan Chase & Co.
6	Hanspeter Walder	UBS AG New York Branch, New York, New York	9/14/2005	UBS Group AG
7	Michelle M. Moore	RBC Centura Bank, Rocky Mount, North Carolina	8/8/2007	Royal Bank of Canada
8	Susan M. West	Compass Bank, Birmingham, Alabama	6/19/2008	BBVA
9	Donald W. Linville	Compass Bank, Birmingham, Alabama	9/25/2008	BBVA
10	David Lee	Bank of Montreal, Toronto, Canada	11/17/2008	Bank of Montreal Financial Group
11	Silvia Estevez	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	10/7/2009	Wells Fargo & Co.
12	Rodolfo Dopico	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	10/7/2009	Wells Fargo & Co.

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
13	Endy Maldonado	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	10/7/2009	Wells Fargo & Co.
14	Christopher Pazos	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	10/7/2009	Wells Fargo & Co.
15	Hansel Pintos	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	11/18/2009	Wells Fargo & Co.
16	Pranav A. Merchant	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	11/25/2009	Wells Fargo & Co.
17	Deepak Sharma	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	11/25/2009	Wells Fargo & Co.
18	Alexandra M. Gams	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	11/25/2009	Wells Fargo & Co.
19	Scott P. Misiaszek	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	11/25/2009	Wells Fargo & Co.
20	Francesco Rusciano	UBS AG, Zurich, Switzerland	11/25/2009	UBS Group AG
21	Angela M. Leibrand-Pelaez	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	12/30/2009	Wells Fargo & Co.
22	Andrew Lopez, Jr.	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	12/30/2009	Wells Fargo & Co.
23	Sandy Abbas	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	2/18/2010	Wells Fargo & Co.

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
24	Steven T. Dukiet	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	2/18/2010	Wells Fargo & Co.
25	Antonio Garcia-Adanez	Standard Chartered Bank International (Americas) Limited, New York, New York	5/13/2010	Standard Chartered PLC
26	Jason Maguire	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	5/20/2010	Wells Fargo & Co.
27	Walter Simon	Skandinaviska Enskilda Banken, Stockholm, Sweden	5/20/2010	Skandinaviska Enskilda Banken
28	Bernardo Castaneda	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	6/11/2010	Wells Fargo & Co.
29	James Buckley Saunders	Wells Fargo Financial Inc., Des Moines, Iowa, Wells Fargo & Company, San Francisco, California	8/26/2010	Wells Fargo & Co.
30	Tyrone Green	Bank of Nova Scotia, New York Agency, New York, New York	12/31/2011	Bank of Nova Scotia
31	Michele Bergantino	Credit Suisse AG, Zurich, Switzerland	5/4/2015	Credit Suisse Group AG
32	Roger Schaerer	Credit Suisse AG, Zurich, Switzerland	5/4/2015	Credit Suisse Group AG
33	Susanne D. Ruegg Meier	Credit Suisse AG, Zurich, Switzerland	5/4/2015	Credit Suisse Group AG
34	Marco Parenti Adami	Credit Suisse AG, Zurich, Switzerland	5/4/2015	Credit Suisse Group AG
35	Markus Walder	Credit Suisse AG, Zurich, Switzerland	5/4/2015	Credit Suisse Group AG
36	Rohit Bansal	Goldman Sachs & Co., New York, New York	11/5/2015	Goldman Sachs Group, Inc.

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
37	Matthew Gardiner	Barclays Bank, PLC, London, United Kingdom	7/19/2016	Barclays PLC
38	Joseph Jiampietro	Goldman Sachs & Co., New York, New York	8/3/2016	Goldman Sachs Group, Inc.
39	Stuart Scott	HSBC Bank PLC, London, United Kingdom	10/5/2016	HSBC Holdings PLC
40	Mark Johnson	HSBC Bank PLC, London, United Kingdom	10/5/2016	HSBC Holdings PLC
41	Jason Katz	Barclays Bank, PLC, London, United Kingdom	1/4/2017	Barclays PLC
42	Timothy Fletcher	J.P. Morgan Securities (Asia Pacific) Limited, Central, Hong Kong, China	3/9/2017	JPMorgan Chase and Co.
43	Fang Fang	J.P. Morgan Securities (Asia Pacific) Limited, Central, Hong Kong, China	3/9/2017	JPMorgan Chase and Co.
44	Christopher Ashton	Barclays Bank, PLC, London, United Kingdom	5/19/2017	Barclays PLC
45	Michael Weston	Barclays Bank, PLC, London, United Kingdom	7/24/2017	Barclays PLC
46	Eric Scott Darty	Compass Bank, Birmingham, Alabama	2/8/2018	BBVA
47	Peter Little	Barclays Bank, PLC, London, United Kingdom	2/16/2018	Barclays PLC
Prohibition Actions - Bank Holding Companies or Foreign Parent Banks with Assets Between $50 Billion and $250 Billion				
48	Cynthia Rowe	Key Bank, N.A., Cleveland, Ohio	02/13/2003	KeyCorp
49	Kenneth L. Coleman	PNC Bank, Pittsburgh, Pennsylvania, and Mellon Bank, N.A., Pittsburgh, Pennsylvania	3/1/2005	PNC Financial Services Group, Inc.
50	Stefanie Milmine	Fifth Third Bank, Grand Rapids, Michigan	7/14/2005	Fifth Third Bancorp

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
51	Jessica Faris	SunTrust Bank, Atlanta, Georgia	9/28/2005	SunTrust Bank
52	Trampas B. Riggs	Regions Bank, Birmingham, Alabama	6/19/2006	Regions Financial Corporation
53	Matthew Censoplano	Capital One Bank, Glen Allen, Virginia	8/30/2006	Capital One Financial Corporation
54	Roslyn Y. Terry	SunTrust Bank, Atlanta, Georgia	8/29/2008	Suntrust Bank
55	Julianne L. Gingrich	SunTrust Bank, Atlanta, Georgia	12/3/2008	Suntrust Bank
56	Kelly M. Dulaney	Fifth Third Bank, Grand Rapids, Michigan	12/15/2008	Fifth Third Bancorp
57	Michael J. Willoughby	Regions Bank, Birmingham, Alabama	6/25/2014	Regions Financial Corporation
58	Jeffrey C. Kuehr	Regions Bank, Birmingham, Alabama	6/25/2014	Regions Financial Corporation
59	Thomas A. Neely, Jr.	Regions Bank, Birmingham, Alabama	10/19/2015	Regions Financial Corporation
60	Phillip Cooper	Regions Bank, Birmingham, Alabama	12/20/2016	Regions Financial Corporation
61	Richard Henderson	Regions Bank, Birmingham, Alabama	12/20/2016	Regions Financial Corporation
62	Richard Henderson	Regions Bank, Birmingham, Alabama	6/7/2017	Regions Financial Corporation
63	Daniel X. Brennan	Regions Bank, Birmingham, Alabama	8/30/2017	Regions Financial Corporation
64	Jacob Harrison	Regions Bank, Birmingham, Alabama	12/31/2017	Regions Financial Corporation
65	Jeffrey Garrison	Regions Bank, Birmingham, Alabama	3/26/2018	Regions Financial Corporation

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
66	Nathaniel Frazier	Regions Bank, Birmingham, Alabama	3/26/2018	Regions Financial Corporation
67	Gayle Kendrick	Regions Bank, Birmingham, Alabama	4/25/2018	Regions Financial Corporation
Prohibition Actions - Bank Holding Companies or Foreign Parent Banks with Assets Between $10 Billion and $50 Billion				
68	Lawrence Michaelessi	The Bank of New York, New York	6/9/2000	Mellon Financial Corporation
69	John H. Lohmeier	Hinsbrook Bank and Trust, Willowbrook, Illinois	10/1/2008	Wintrust Financial Corporation
70	James M. Riley	Four Oaks Bank and Trust Company, Fuquay-Varina, North Carolina	8/29/2017	United Community Banks, Inc.
71	Raysol Villalobos	Frost Bank, San Antonio, Texas	3/22/2018	Cullen/Frost Bankers Inc.
Prohibition Actions - Bank Holding Companies or Foreign Parent Banks with Assets Under $10 Billion				
72	Michael A. Lindahl	The Heartland Bank, Croton, OH	2/3/1998	Heartland BancCorp
73	Putra Masagung	The San Fracisco Company, San Francisco, California	11/30/1998	First Banks, Inc.
74	John H. Ahn	Hanmi Bank, Los Angelese, California	1/21/1999	Hanmi Financial Corporation
75	Craig J. Fahrner	Hinsbrook Bank and Trust, Willowbrook, Illinois	8/5/1999	Wintrust Financial Corporation
76	Carolyn D. Nelson	Lone Star National Bank, Pharr, Texas	9/29/2000	Lone Star National Bancshares - Texas Inc.
77	Nelly Kann de Gouverneur	Banco Mercantil, C.A., S.A.C.A., New York Agency, New York, New York	6/14/2001	Mercantil Servicios Financier
78	Kenneth M. Matzdorff	Garden City Bancshares, Inc., Garden City, Missouri	8/23/2004	Lead Financial Group, Inc.

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
79	Donald K. McKinney	American National Bank, Wichita Falls, Texas	5/31/2005	AmeriBancShares, Inc.
80	Walter C. Cleveland	First National Bank, Lubbock, Texas	8/17/2005	First Community Bancshares, Inc.
81	William R. Kahler	Primebank, LeMars, Iowa	10/20/2005	Primebank, Inc.
82	Perry D. Lane	Exchange Bank of Missouri, Fayette, Missouri	1/30/2007	Northern Missouri Bancshares, Inc.
83	Tracey A. Schroeder	First Interstate Bank, Bozeman, Montana	4/3/2007	First Interstate BancSystem Inc.
84	Bonnie C. Milne	First Interstate Bank, Casper, Wyoming	4/24/2007	First Interstate BancSystem Inc.
85	Cheryl McMillan	Bank of Durango, Durango, Colorado	4/27/2007	First Bancorp of Durango, Inc.
86	Josephine Wang	Asian Bank, Philadelphia, Pennsylvania	7/24/2007	Asian Financial
87	Richard N. DeLong	Mid America Bank and Trust Company, Dixon, Missouri	8/1/2007	Reliable Community Bancshares Inc.
88	Aldo N. Morales	Coconut Grove Bank, Miami, Florida	1/23/2008	Coconut Grove Bankshares Inc.
89	Russell K. Henry	FNB Southeast, Reidsville, North Carolina	2/28/2008	F.N.B. Corporation
90	G. Craig Chupik	PlainsCapital Bank, Lubbock, Texas	3/19/2009	Hilltop Holdings
91	Ronnie A. Jenkins	Middleburg Bank, Middleburg, Virginia	7/27/2009	Access National Corporation
92	Gregory L. Fankhauser	Heritage Bank, Topeka, Kansas	6/3/2010	Heritage Bancshares
93	Max Grunhof	First Pryority Bank, Pryor, Oklahoma	9/27/2011	First Pryor Bancorp Inc.

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
94	Bryan Posey	Security Bank, Tulsa, Oklahoma	11/16/2011	Pawnee Holding Company Inc.
95	Darryl Woods	Calvert Financial Corporation, Ashland Missouri, and Mainstreet Bank, Ashland, Missouri	4/15/2014	Connections Bancshares, Inc.
96	T. Mark Huston	Columbus Junction State Bank, Columbus Junction, Iowa	7/27/2016	W.S.B., Inc.
97	Thomas H. Huston	Columbus Junction State Bank, Columbus Junction, Iowa	7/27/2016	W.S.B., Inc.
98	Angela Asbell	First State Bank, Commerce, Oklahoma	12/13/2017	SSB Holdings, Inc.
Prohibition Actions - Bank Holding Companies or Foreign Parent Banks N/A*				
99	Stephen R. Koury	First Western Trust Services Company, New Castle, Pennsylvania	2/2/1998	N/A
100	Robert A. Altman	BCCI, Karachi, Pakistan	2/2/1998	N/A
101	Faisal Saud Al-Fulaij	BCCI, Karachi, Pakistan	5/21/1998	N/A
102	Lois A. Brigham	Towne Bank, Perrysbury, Ohio and Towne Bancorp, Inc. Perrysburg, Ohio	10/13/1998	N/A
103	Jerome C. Bechstein	Towne Bank, Perrysburg, Ohio and Towne Bancorp, Inc. Perrysburg, Ohio	10/13/1998	N/A
104	Fred J. Smilek	Chemical Bank, New York, New York	12/14/1998	N/A
105	Ricardo Carrasco	BankBoston International, Coral Gables, Florida	12/16/1998	N/A
106	Bob L. Sellers	First National Summit Bankshares, Crestd Butte, Colorado and First National Summit Bank, Gunnison, Colorado	1/13/1999	N/A

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
107	Christopher J. Woods	Midwest Bank and Trust Company, Elmwood Park, Illinois	1/18/2000	N/A
108	George J. Peterson	Foxdale Bancorp, Inc., South Elgin, Illinois and Foxdale Bank, South Eglin, Illinois	11/1/2000	N/A
109	Marian L. Butler	CoreStates Financial, Philadelphia, Pennsylvania	2/13/2003	N/A
110	Terry Frierson	MSB Shares, Inc., Jonesboro, Arkansas	3/3/2003	N/A
111	Susan Diehl McCarthy	Six Rivers National Bank, Eureka, California	10/14/2003	N/A
112	Gene Ulrich	Six Rivers National Bank, Eureka, California	10/14/2003	N/A
113	Garfield C. Brown, Jr.	Mellon Bank, N.A., Pittsburg, Pennsylvania	11/21/2003	N/A
114	Scott Smolinski	James Monroe Bank, Arlington, Virginia	1/7/2004	N/A
115	Charles Kushner	The NorCrown Trust, Livingston, New Jersey	8/23/2004	N/A
116	Carl V. Thomas	First Western Bank, Cooper City, Florida	6/7/2005	N/A
117	Frank G. Caton	Farmers Bank of Maryland, Annapolis, Maryland	6/17/2005	N/A
118	Brian Bonetti	National City Bank, Cleveland, Ohio	9/20/2005	N/A
119	Mayra Cuellar	Gulf Bank, Miami, Florida	2/6/2006	N/A
120	Oyeacholem Moseri	First North American National Bank, Kennesaw, Georgia	3/23/2006	N/A
121	David Cronin	Allfirst Bank, Baltimore, Maryland	4/20/2006	N/A

Seq.	Name of Institution Affiliated Party	Relevant Institution	Issued Date	Bank Holding Company or Foreign Parent Bank
122	Robert Ray	Allfirst Bank, Baltimore, Maryland	4/20/2006	N/A
123	Yolanda Salido	Gulf Bank, Miami, Florida	5/18/2006	N/A
124	Seresa Morgan	Civitas BankGroup Inc., Franklin, Tennessee	2/22/2007	N/A
125	Joy McClard	Cumberland Bank, Franklin, Tennessee	6/13/2007	N/A
126	Rick W. Bouse	Progress Bank of Missouri, Sullivan, Missouri	7/18/2007	N/A
127	Adam L. Benarroch	Midwest Bank and Trust Company, Elmwood Park, Illinois	3/12/2010	N/A
128	Angel P. Guerzon, Jr.	Orion Bank, Naples, Florida	11/7/2011	N/A
129	Thomas B. Hebble	Orion Bank, Naples, Florida	11/7/2011	N/A
130	Jerry J. Williams	Orion Bank, Naples, Florida	6/12/2012	N/A
131	Lowell W. McCoy	NBRS Financial, Rising Sun, Maryland	12/13/2017	N/A
132	Jacob H. Goldstein	NBRS Financial, Rising Sun, Maryland	2/5/2018	N/A

*N/A denotes institutions that either failed or were acquired by another institution.

The highlighted prohibition actions represent instances where an individual was a member of the board of directors of the relevant institution.

Questions for Vice Chair Randy Quarles from Ranking Member Waters
Hearing on Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System
April 17, 2018

Fair Lending

As we discussed during the hearing, the Center for Investigative Reporting published several disturbing articles after a yearlong investigation of 31 million records publicly available under the Home Mortgage Disclosure Act (HMDA) to identify lending disparities.[1]

- I appreciate your initial reaction, but I would ask you to review the materials, and provide a detailed written assessment of the reporting. What lessons, if any, should the Federal Reserve and Congress bear in mind as we explore ways to address modern-day redlining and end pervasive discriminatory practices in the financial sector?
- You discussed the ongoing work that the Federal Reserve is engaged with the Office of the Comptroller of the Currency (OCC) and other regulators with respect to modernizing the Community Reinvestment Act (CRA). To that end, does the Federal Reserve plan to adopt a change the OCC made last October to its CRA examination policies that has weakened CRA enforcement by easing the consequences for banks that violate fair lending laws and harm consumers? Will this kind of CRA reform benefit megabanks, like Wells Fargo, which has repeatedly harmed consumers?
- As we discussed, the Treasury Department issued a memorandum regarding CRA modernization on April 3, 2018, addressed to the U.S. banking regulators, including the Federal Reserve Board, and made 15 recommendations in the areas of CRA assessment areas, examination clarity and flexibility, examination process, and performance.[2] You generally seemed favorable toward Treasury's CRA recommendations in your testimony and responses to questions. Please note whether you agree or disagree with each recommendation, along with an explanation and assessment of the public policy pros and cons of each recommendation.
- Would you review the National Community Reinvestment Coalition's (NCRC) analysis of Treasury's recommendations,[3] and consider their perspective in responding to the question above?
- Previously, NCRC submitted a letter to Treasury on CRA reform efforts on February 5, 2018.[4] Would you please review NCRC's letter and recommendation, and provide responses if you agree or disagree with their recommendations along with any analysis supporting your views?
- Based on the Center for Investigative Reporting on discriminatory lending practices and other evidence, are there ways the Federal Reserve Board can utilize CRA or other tools to incentivize banks to lend on affordable terms and invest in communities that are being ignored and underserved?

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[1] The reporting is available online at: https://www.revealnews.org/article/for-people-of-color-banks-are-shutting-the-door-to-homeownership/, https://www.revealnews.org/article/gentrification-became-low-income-lending-laws-unintended-consequence/, https://www.revealnews.org/article/8-lenders-that-arent-serving-people-of-color-for-home-loans/, https://www.revealnews.org/article/how-we-identified-lending-disparities-in-federal-mortgage-data/, and https://s3-us-west-2.amazonaws.com/revealnews.org/uploads/lending_disparities_whitepaper_180214.pdf.

[2] https://home.treasury.gov/sites/default/files/2018-04/4-3-18%20CRA%20memo.pdf

[3] NCRC's analysis is available at: https://ncrc.org/ncrc-analysis-of-cra-treasury-report/.

[4] The letter is available at: https://ncrc.org/letter-to-treasury/.

- To the extent the Federal Reserve Board considers expanding options for banks to receive CRA credit, how do you ensure these adjustments are done in an efficient and robust manner so they don't otherwise water down the CRA grading system in light of the fact that 99% of banks get high marks even though discriminatory lending remains pervasive?
- What is the timetable for any new regulations or guidance that we should expect the Federal Reserve Board to issue on CRA reforms?
- Will the Federal Reserve Board consider holding public hearings across the country on any new CRA proposal you consider to better ensure you get the maximum amount of feedback, especially from the communities that CRA was intended to help. If so, what would the timetable be of such hearings? What other steps will the Federal Reserve Board take to ensure you receive the maximum amount of input on proposed CRA changes?
- Do you have any legislative recommendations with respect to strengthening CRA, and how the Federal Reserve Board can better fulfill the intent and purpose of the law?
- Beyond CRA, are there other legislative or regulatory reforms that policymakers should consider to end pervasive discriminatory practices in the financial sector?

Diversity at the Fed and in the Financial Sector

- Democrats have repeatedly pushed the Federal Reserve and other regulators to do their part to promote diversity in its work. As the Vice Chair of Supervision, what steps have you taken to promote diversity with the Fed's supervisory, regulatory and enforcement staff?
- What steps can the Fed take to promote diversity within the financial system, especially with respect to the firms the Fed regulates?
- How closely do you work with the Fed's Office of Diversity and Inclusion?[5] Please give examples of how your work leverages the office's expertise in carrying out the Federal Reserve Board's regulatory, supervisory and enforcement work.
- What legislative recommendations do you have for how Congress could strengthen efforts to promote diversity and inclusion at the Federal Reserve Board, as well as the firms you regulate?

Fintech, Payments and Digital Currency

- What is your view of the rapid growth of financial technology, or fintech, in the financial services marketplace? What are your top priorities at the Fed with respect to fintech?
- GAO issued a recent report making a series of recommendations that the Fed and other regulators coordinate better on fintech issues.[6] What steps is the Fed taking to respond to these recommendations, and coordinate better with other regulators?
- The United States continues to have an outdated payment system, especially compared to other countries that have real-time payment systems. What steps is the Fed taking to modernize our payments system?
- What concerns, if any, do you have about Bitcoin and the use of other virtual currency in the U.S. financial system? Should banks promote or discourage their use? What

[5] The Office of Diversity and Inclusion fulfills the See https://www.federalreserve.gov/publications/files/omwi-report-20180330.pdf for the Fed's 2018 Report to the Congress on the Office of Minority and Women Inclusion.
[6] https://www.gao.gov/products/GAO-18-254

protections are needed to ensure these cryptocurrencies can't be used to evade anti-money laundering laws?
- What are your views on "open banking"? Other countries seem to be pursuing this approach to ensure consumers have full access and control of their personal information, and can use new mobile applications to do a better job shopping for the best financial products and services. What are the pros and cons of promoting "open banking" in the United States?

Lessons from the Financial Crisis and the Benefits of Dodd-Frank

Mr. Quarles, you have repeatedly said that since it has been a decade since the 2008 financial crisis, it is time to review and revisit all of the post-crisis financial rules to seek improvements.

- Will these modifications to post-crisis reforms be one-sided with a focus on deregulating the financial industry?
- Do you think lessons from the financial crisis have faded in the minds of some policymakers?
- What is your diagnosis for the causes of the financial crisis?
- What Dodd-Frank requirements do you think have helped address the numerous problems exposed by the crisis?
- Do you believe the Fed failed, as many of us do, at implementing and enforcing our consumer financial protections laws prior to the creation of the Consumer Financial Protection Bureau?
- Was it important to impose enhanced prudential standards on the nation's largest banks, including requiring more capital, more liquidity and less leverage?
- Has the Financial Stability Oversight Council, or FSOC, helped to eliminate regulatory gaps in our financial regulatory system? Should FSOC maintain broad tools to deal with the next crisis?
- What has Dodd-Frank's new derivatives oversight framework provided to FSOC? Since the Fed serves on FSOC, does this oversight of the derivatives market help the FSOC to better monitor and mitigate potential threats to financial stability?
- Do you support the Volcker Rule's prohibition on proprietary trading so that banks that benefit from the federal safety net do not gamble with deposits?

Stronger Regulations and Enforcement

- As you lead the Fed's efforts to revisit the post-crisis financial rulebook, what regulatory areas do you think need to be strengthened instead of rolled back?
- The Treasury Department, as you know, has released several extensive reports that include dozens and dozens of recommendations to revise financial regulations.[7]
  - Do you support the recommendations Treasury made that the Fed take that were included in its first report focused on banks and credit unions? Which, if any, recommendations did you disagree with?
  - Are you concerned that few to no recommendations made by Treasury would result in stronger oversight of the largest, most complex financial firms?
- While there was some discussion of insurance savings and loan holding companies (SLHCs) and the Federal Reserve's approach to regulating them during the hearing, it is worth noting the Office of Thrift Supervision (OTS) was roundly criticized for its weak

[7] https://home.treasury.gov/top-priorities/regulatory-reform

oversight, including of AIG, leading up to the 2008 financial crisis. Given that the supervision of SLHCs were transferred from the OTS to the Federal Reserve Board, what steps is the Federal Reserve Board taking to improve oversight of all SLHCs and not repeat past mistakes?

Large Bank Supervision and Enforcement
While you are recused from Wells Fargo matters, you play a critical role at the Federal Reserve Board with respect to large bank supervision and enforcement. Wells Fargo is a repeat offender with a terrible track record of harming consumers, including opening millions of fraudulent accounts without their customers' consent. Wells Fargo deserves the punishment that former Chair Yellen handed down to cap the bank's size until it cleans up its act while several bank directors stepped down. Yellen's action must be vigorously implemented, and more should be done by regulators to use existing tools to crack down on repeated violations of the law by megabanks. Fines won't cut it any more, they are just the cost of doing business. That is why I introduced the Megabank Accountability and Consequences Act last year to require the banking regulators to fully utilize existing authorities—such as the ability to shut down a megabank and ban culpable executives from working again in the industry—to stop megabanks like Wells Fargo that clearly and repeatedly engage in practices that harm consumers.

- Would you please review a Democratic Committee staff report issued in September 2017,[8] and H.R. 3937, the Megabank Accountability and Consequences Act,[9] I subsequently introduced, and list the full range of enforcement tools the Federal Reserve Board has to ensure the largest banks are following the law and sufficiently deterred from repeatedly breaking the law and harming consumers?
- Does the Federal Reserve Board use different enforcement tools depending on the size of the bank holding company?
- The Federal Reserve Board, under former Chair Yellen, capped Wells Fargo's size until it can demonstrate it cleaned up its act. Has the Federal Reserve Board taken a similar action against other banks in the past? If so, please list each instance the Federal Reserve Board took such an action.
- While some of my colleagues suggested the Federal Reserve Board does not have the authority to oversee board of directors of a bank holding company, do you agree the law is clear that the Federal Reserve Board indeed has such authority, and can remove certain directors if not ban them from working again in the industry? Please list each instance the Federal Reserve Board has taken such a step in the last 20 years, along with the size of the bank holding company when such an action was taken?
- Will the Fed consider taking similar action – capping their size – if other megabanks are found to repeatedly break the law?
- Will the Fed Board hold a vote before it uncaps Wells Fargo's size constraints? Why or why not?
- The Government Accountability Office (GAO) issued a report last year entitled, "Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence."[10] GAO made six recommendations to the Federal Reserve Board in the

[8] https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=400807
[9] https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=400815
[10] https://www.gao.gov/products/GAO-18-118

report. What are the status of the Federal Reserve Board's efforts to address those recommendations?
- The New York Fed is relocating its bank examination staff so it is not prone to regulatory capture. Do you agree this is the right approach? Do you disagree with Comptroller Otting's decision to leave OCC examiners permanently on-site at national banks? Why or why not?
- What other priorities do you have as the Vice Chair of Supervision to strengthen oversight and enforcement relating to the largest bank holding companies?
- Unlike the Savings and Loan crisis when more than 1,000 bank executives were prosecuted, there was no similar accountability following the worst financial crisis since the Great Depression.
  - Do you believe such a result was a just outcome?
  - Do you believe any bank holding company is "too big to jail"?
  - What steps can the Federal Reserve Board take to ensure full accountability for individuals who work at entities you regulate that break the law?
  - Do deferred prosecution agreements (DPA) with bank holding companies weaken individual accountability? Why or why not?

Capital and Leverage Rules for the Largest Banks

Chair Powell recently said that the Fed's requirements for the largest banks are "very high and they're going to remain very high."[11] He continued, "As you look around the world, U.S. banks are competing very, very successfully. They're very profitable. They're earning good returns on capital. Their stock prices are doing well. So I'm looking for the case, for some kind of evidence that — and I'm open to this — some kind of evidence that regulation is holding them back, and I'm not really seeing that case as made at this point."[12] I agree, which is why I'm confused why the Fed, along with the OCC, proposed to slash the leverage ratio and reduce tier 1 capital for our largest banks by more than $120 billion, according to the FDIC. JPMorgan, Citigroup, Bank of America, Goldman Sachs, Morgan Stanley, State Street and Bank of New York Mellon would all benefit, and while it varies, they could see their capital reduced by as much as $34 billion, or a reduction as high as 37.5 percent of their current tier 1 capital. This would likely result in more stock buybacks, not more loans. Wells Fargo, the recidivist megabank whose size has been capped by the Fed, could see their tier 1 capital requirements reduced by more than $20 billion.

Instead of lowering the leverage ratio so it not a binding constraint, the Fed could *raise* risk-based capital levels to achieve this objective. In fact, the Fed's own research notes current capital levels are too low, and should be raised to somewhere between 13 and 26 percent.[13] And the Minnesota Fed has proposed an even more aggressive risk-based capital ratio of 23.5 percent and a leverage ratio of 15 percent as a first step to end too big to fail.[14]

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[11] https://www.federalreserve.gov/newsevents/speech/powell20180406a.htm

[12] Politico Pro, "Powell doesn't see need to loosen rules on biggest banks," April 6, 2018, https://www.politicopro.com/financial-services/whiteboard/2018/04/powell-doesnt-see-need-to-loosen-rules-on-biggest-banks-967593.

[13] Simon Firestone, Amy Lorenc and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S. (PDF)," Finance and Economic Discussion Series 2017-034 (Washington: Board of Governors of the Federal Reserve System), available at: https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf.

[14] https://www.minneapolisfed.org/publications/special-studies/endingtbtf/final-proposal

- Mr. Quarles, do you disagree with Chair Powell that there is no evidence that regulation is holding big banks back? Why or why not?
- Why did the Fed issue a proposal last week that would revise the enhanced Supplementary Leverage Ratio (eSLR) and, according to the FDIC, would reduce bank capital by more than $120 billion at the nation's largest banks?
- With banks doing so well, why would the Fed propose to reduce capital in a significant way that diminishes protections for taxpayers and the economy? What research does the Federal Reserve Board have that any reduction in capital requirements will result in more lending as opposed to more stock buybacks, dividend payments, or bonuses for executives?
- Will you provide the Federal Reserve Board's estimate for how your proposed changes to the eSLR and stress capital buffer would impact each U.S. global systemically important banks (G-SIBs), both at the holding company level and at the primary insured depository institution subsidiary?
- Do you disavow the Federal Reserve Board's own research on the need to raise capital requirements for the nation's largest banks? Why or why not?
- What is your view of the Federal Reserve Bank of Minneapolis's work on too big to fail, and their set of recommendations included in their plan? Do you agree or disagree with their recommendations? Why or why not?
- During your testimony, you focused on the fact that the SLR has become the binding constraint for many banks, and how that produces perverse outcomes. Would not raising risk-based capital levels while maintaining the current leverage ratios produce the same outcome, while also being responsive to research from the Federal Reserve Board and other organizations that capital requirements should be increased?
- Why should Wells Fargo be rewarded after harming millions of consumers by reducing their capital requirements by 17 percent at a time while at the same time, the Federal Reserve Board capped the bank's size in light of their misdeeds?
- What impact will the Federal Reserve Board's efforts to weaken capital and leverage rules, or other prudential rules, for the nation's largest banks mean for community banks? Won't this accelerate consolidation trends in the industry?

Custodial Assets

Congress has proposed exempting custodial assets from the denominator of the leverage ratio rules, in part, to deal with the concern that the leverage rules could inadvertently make it harder for custodial banks, like Bank of New York Mellon, to accept a rapid increase in such deposits when there is a flight to safe assets in a crisis, and make it harder for central banks, like the Federal Reserve, to respond. Notably, the Basel Committee on Banking Supervision (Basel Committee) suggested a more targeted proposal than the one Congress is considering that would provide for a temporary exemption of central bank reserves from a country's leverage ratio to the extent the amount of reserves is disclosed and that the bank would have to make offsetting changes to its balance sheet to remain safe and sound.

- The Fed serves on the Basel Committee and was a party to the December 2017 Basel III end game agreement[15] that included that recommendation. Do you support the proposed

[15] https://www.bis.org/bcbs/publ/d424_hlsummary.pdf

narrower adjustment over a more sweeping exemption that has been proposed by Congress?

- What would the effect of the Federal Reserve's proposed changes to eSLR be if they occurred in addition to Section 402 of S. 2155 to fully exempt central bank deposits from the leverage ratio for custodial banks was signed into law? Does the Federal Reserve Board have the flexibility to implement these proposals in a manner that is more akin to the more targeted proposal put forward by the Basel Committee?

"Too Big to Fail"

Mr. Quarles, last November, Chairman Powell responded to a question from Senator Kennedy about whether any U.S. bank was still "too big to fail."[16] He initially responded by saying, "We've made a great deal of progress on that." When the Senator pressed for an answer, Chairman Powell said, "I would say no to that."

- Do you agree that no U.S. bank is "too big to fail"? Why or why not?
- Do you support the Treasury Department's report recommending the preservation of Dodd-Frank's Orderly Liquidation Authority?[17] Will "too big to fail" return if Dodd-Frank's tools are rolled back or eliminated, including Dodd-Frank's Orderly Liquidation Authority as the Chairman and other Republicans have advocated?
- The Dodd-Frank Act gives financial regulators, especially the Fed, a number of authorities to address this issue. This includes enhanced capital requirements, and authorities that are activated -- including breaking up the largest banks -- if living wills cannot credibly demonstrate a firm can be safely resolved through the Bankruptcy Code, or if the Fed determines a megabank poses a grave threat to financial stability. Will you commit to fully utilizing these and other Dodd-Frank tools to end too big to fail?

Restrictions on Bank Activities

- In the last election, the Republican party platform called to reimpose the Glass-Steagall firewall between commercial and investment banking. Has the Trump Administration given up on pursuing reimposing Glass-Steagall? Do you support reimposing Glass-Steagall? Why or why not?
- Should banks be in the business of owning warehouses full of copper or other commodities? The Federal Reserve has a pending rule that would curb the strange bank business of owning, trading and moving commodities. Do you support that proposal and when should we expect it to be finalized?
- The Federal Reserve has previously proposed, pursuant to the Dodd-Frank Section 620 report, several legislative changes regarding banks.[18] They proposed that Congress:
    - repeal the authority of Financial Holding Companies (FHCs) to engage in merchant banking activities;
    - repeal the grandfather authority for certain FHCs to engage in commodities activities under section 4(o) of the BHC Act;

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[16] https://www.bloomberg.com/news/articles/2017-11-29/trump-s-pick-to-run-the-fed-says-no-u-s-banks-are-still-too-big-to-fail

[17] https://home.treasury.gov/news/press-release/sm0295

[18] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160908a.htm

- repeal the exemption that permits corporate owners of industrial loan companies (ILC) to operate outside of the regulatory and supervisory framework applicable to other corporate owners of insured depository institutions; and
- repeal the exemption for grandfathered unitary SLHCs from the activities restrictions applicable to all other SLHCs.

Do you support any of these recommendations? Why or why not?

Foreign Banks

There has been much discussion about how foreign banks would be treated under S. 2155, the Senate financial deregulatory bill pending in the House. Under current rules, the enhanced prudential regime applies to foreign banking organizations that have more than $50 billion in *global* assets and operate in the United States. However, the Fed's implementing regulations have imposed significantly lower requirements on foreign banks with less than $50 billion in *U.S.* non-branch assets compared to those with more than $50 billion in U.S. non-branch assets.

- What assurances can you give this Committee that stringent rules for large foreign banks that operate in the U.S. that are applied in the exact same manner, and at the exact same threshold, as they are today will not be changed, even if S. 2155 becomes law?

Executive Compensation

The Wells Fargo fraudulent account scandal, and its incentive-based cross-selling strategy that fueled it, is a stark reminder how important it is for financial regulators to finalize executive compensation rules. As you know, Section 956 of the Dodd-Frank Act directed regulators, including the Fed, to adopt joint rules aimed at prohibiting incentive compensation arrangements that might encourage inappropriate risks at financial institutions. The regulators made an initial proposal in 2011, then reworked the proposal and issued a new plan in 2016. The proposal increases in stringency based on the financial company's asset size with enhanced requirements for senior executive officers and significant risk-takers.

- Given that this is not a discretionary requirement, what steps are you taking to implement and enforce this provision of the law?

International Coordination on Financial Regulations

Mr. Quarles, there have been news reports suggesting that the Treasury Department is pushing for you to be considered as a candidate to lead the Financial Stability Board (FSB).[19]

- Are you interested in the job leading the FSB? When will such a decision be made?
- How do you assess FSB's record at promoting global financial stability through international coordination?
- What would your priorities be at the FSB?
- The largest banks have complained about so-called "gold-plating" of prudential rules, like capital or leverage, where U.S. regulators implemented a standard that is more stringent than what an international body, like the Basel Committee, agreed to. But some observers have suggested "gold-plating" has helped the U.S. push other jurisdictions to raise their standards. Do you believe when the U.S. leads by example by raising the bar on financial regulation, it makes it harder for other countries to ignore that record and lower their standards?

[19] https://www.ft.com/content/846d7b00-27b3-11e8-b27e-cc62a39d57a0

- Last December, the Fed and other U.S. regulators finalized the so-called Basel III "end game" with your international counterparts. But based on the Fed and the OCC's proposal last week to lower the eSLR, it seems as if you are using the international agreement to roll back important U.S. regulations. By changing course, is the Fed leading other financial regulators around the world in a new race to the bottom, deregulating a global financial industry that caused significant damage not only to the U.S. economy, but the global economy?
- What, if any, global financial standards currently do not go far enough and need to be made more stringent?

Cost-Benefit Analysis
According to the Federal Reserve Board's website and as was discussed at the hearing, there is a new "Policy Effectiveness and Assessment section" which "focuses on understanding the economics of financial regulation. Section staff work on conducting ex ante analysis of the costs and benefits of pending regulations as well as the ex post assessment of existing regulations. Section economists also engage in academic research on topics related to banking and financial regulation."

- Under what statutory authority did the Federal Reserve Board establish this unit? What is the unit's mandate and priorities?
- As of April 25, 2018, there were three individuals listed as working in the unit. How many staff does the Federal Reserve Board expect to hire for this unit? What is its budget? How will this unit interact with other divisions and units at the Federal Reserve Board?
- As you know, predicting the benefits from financial regulations preventing a future financial crisis are extremely difficult. How will this unit and the Federal Reserve Board include those considerations in any cost-benefit analysis of any regulation?
- There has been a wide range of studies that have attempted to analyze the cost of the 2008 financial crisis. Given its significance in any cost-benefit analysis the Federal Reserve Board may engage in, I would ask this unit conduct its own analysis of the cost of the financial crisis to the U.S. economy and its citizens, including taxpayers, consumers, investors and homeowners. Will you ask this unit to conduct such an analysis and provide that analysis to the Committee?

Racial Disparities in the Labor Market

- African-Americans in particular continue to suffer from overt employment discrimination. Indeed, the unemployment experience for better-educated African-Americans is on average worse than the unemployment rate for less educated whites.[20] To what extent can and should the Fed take such discrimination into account as it sets monetary policy? What policy recommendations can you offer for overcoming this persistent discrimination?

Wages

- Despite progress in reducing the overall level of unemployment, wage growth has largely remained low and stagnant for the vast majority of American families. What are the key

[20] http://financialservices.house.gov/uploadedfiles/hhrg-114-ba19-wstate-wspriggs-20160907.pdf

factors in your view that explain why a tighter labor-market has yet to translate into higher pay for most families? Do you believe that the general rule in economics that a tight U.S. labor market will produce higher wages for U.S. workers will hold, or are there other factors at play that will continue to depress the income earned by U.S. workers?

Normalization of the Fed's Balance Sheet

- Last October the Federal Reserve began the process gradually reducing its securities holdings in order to normalize the size of its balance sheet. Simultaneously policy makers at the Federal Reserve have outlined their intention to slowly lift the federal funds rate target. Can you discuss how these two normalization strategies are working in tandem? How is the Fed taking into effect the contractionary effects of balance sheet normalization in conjunction with its rate hikes?

Banks Hoarding Interest Income as the Fed Raises Rates

- Since the Fed began raising interest rates, banks have seen a significant jump in net interest income and charged consumers more for loans, all while keeping the interest rate paid on customer deposits relatively flat. Can you discuss why depositors seem to be getting short changed as the Fed raises the rate it pays banks on their reserves?

GOP Tax Plan

- Would you agree that the amount in compensation companies have provided their workers following the enactment of the GOP tax law, is only a small fraction of what corporations will return to shareholders and pay corporate executives in under the new law? Would you agree that the stimulative economic effects of the GOP tax law will be much smaller than had the tax law provided a larger share to lower and middle income families?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 12, 2018

The Honorable Nydia M. Velázquez
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed is my response to the written question that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

1. Chairman Quarles, I appreciated your commitment during our recent hearing that you will ensure the continuation of robust capital requirements for large, systemically-important banks. I believe these capital reforms were some of the most important components of the Dodd-Frank Act and the actions of the Obama Administration. Ensuring that larger banks hold significant capital buffers is critical to protecting consumers and ensuring financial stability. Similarly, I was heartened to hear you explain your views on the need for a rigorous stress testing program, predicated on risk- based measures, to guarantee that global banks have capital sufficient to withstand shocks. To that end, I am closely reviewing the capital reform and stress testing proposal the Fed recently published.

You correctly pointed out in your testimony that leverage capital standards should be a strong backstop, but not the binding, capital constraint. As you know, this is because binding leverage standards penalize low-risk banking activities such as accepting deposits and processing transactions, and create incentives to pursue higher-risk activities. I am concerned that having firms primarily engaged in custody and asset servicing operations bound by leverage-based standards could have the perverse effect of increasing, rather decreasing systemic risk.

As you finalize the new stress testing program will you commit that the Fed will not create a new binding leverage standard through the imposition of a stressed leverage buffer?

I believe that, as a general matter, leverage capital requirements should serve as a backstop to risk-based capital requirements in order to reduce incentives for firms to increase their exposure to riskier assets. The Federal Reserve Board (Board) has recently taken two important steps to help ensure that leverage-based capital requirements generally serve as a backstop to risk-based capital requirements. First, the Board, in conjunction with the Office of the Comptroller of the Currency, issued a proposal that would recalibrate the enhanced supplementary leverage ratio standards for certain large domestic firms in a manner that is expected to help ensure that these firms' risk-based capital requirements remain their binding regulatory capital constraint. Second, the Board's stress buffer proposal, which would integrate the quantitative assessment of the Comprehensive Capital Analysis and Review program with the capital rule's requirements, was designed with the goal of simplifying capital requirements while helping to ensure that leverage-based capital requirements generally continue to serve as a backstop to risk-based capital requirements. The Board is currently seeking public comment on these proposals. In addition to these two proposals, the Board, in collaboration with the other federal banking agencies, will revise the capital rule to address the recent legislative exclusion of central bank reserves from the total leverage exposure amount of certain banking organizations.

From: Congresswoman Nydia M. Velázquez (NY-7)

To: The Honorable Randal Quarles, Member of the Board of Governors of the Federal Reserve and Vice Chairman for Supervision

Date: April 17, 2018,

Re: Full Committee Hearing titled "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System"

Chairman Quarles, I appreciated your commitment during our recent hearing that you will ensure the continuation of robust capital requirements for large, systemically-important banks. I believe these capital reforms were some of the most important components of the Dodd-Frank Act and the actions of the Obama Administration. Ensuring that larger banks hold significant capital buffers is critical to protecting consumers and ensuring financial stability. Similarly, I was heartened to hear you explain your views on the need for a rigorous stress testing program, predicated on risk-based measures, to guarantee that global banks have capital sufficient to withstand shocks. To that end, I am closely reviewing the capital reform and stress testing proposal the Fed recently published.

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As you finalize the new stress testing program will you commit that the Fed will not create a new binding leverage standard through the imposition of a stressed leverage buffer?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 11, 2018

The Honorable Randy Hultgren
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

1. During your testimony before the Committee, I asked you about making changes to the Current Exposure Method (CEM) to acknowledge the concept of delta-weighting for certain derivatives. As Chairman Powell noted last year, the CEM "ignores whether a derivative is margined and undervalues netting benefits." The CEM is insensitive to risk so its mandatory use artificially caps market liquidity, particularly in large-cap index options, which are crucial hedging vehicles. You responded that rulemaking, presumably to implement the Standardized Approach for Counterparty Credit Risk (SACCR), would be the appropriate course to address the issue that you acknowledged is damaging liquidity in our derivatives markets. As I mentioned during your testimony, the Treasury Department's October 2018 Report on Capital Markets calls for a "near-term" solution.

1. **Does the Federal Reserve Board have authority to address this issue through Exemptive Relief, Interpretive Relief, or an Interim Final Rule?**
2. **If so, why hasn't the Federal Reserve Board taken action to address this pressing issue? The implementation timeframe for SACCR is unclear; some observers estimate that it could be three of four years until it is finalized in the United States given the myriad of topics it proposes to address.**
3. **Can we expect the Federal Reserve Board to pursue Exemptive Relief, Interpretive Relief, or an Interim Final Rule to address the issue? If so, please provide a reasonable deadline for advising the public of your intention to take such action.**

The Federal Reserve Board (Board) has reviewed the capital rule in order to determine whether there are opportunities for interpretive relief or other near-term solutions to address the concerns raised in your question and by market participants. The primary means of near-term relief identified by the Board would be to exercise its reservation of authority under the rule to provide an alternative risk-weighted asset amount for particular types of exposures, such as listed options. However, the Board can exercise the reservation of authority only on a case-by-case basis for an individual banking organization that requests such a treatment. Addressing the treatment of only a subset of derivative products such as large-cap index options through the reservation of authority would result in disparate treatment under the rule among derivative products that present similar risks and, potentially, among banking organizations.

Due to these concerns, the Board's preferred approach to address the concerns raised regarding the current exposure method (CEM) is to revise the capital rule to incorporate Standardized Approach for Counterparty Credit Risk (SA-CCR). SA-CCR, as compared to CEM, would allow for increased recognition of netting and margin and results in a more risk-sensitive exposure amount for listed option contracts. The rule making process would allow a wide variety of market participants to consider the potential impact of SA-CCR and would open the way for its potential benefits to apply to a wide range of derivative products. Accordingly, the Board is working expeditiously to implement SA-CCR in the United States. Our aim is to issue a SA-CCR proposal for public comment, jointly with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), as soon as feasible.

2. Custodial banks, which provide safekeeping and related services to pension funds, mutual funds, endowments, and other institutional investors, have engaged in substantial dialogue with the Federal Reserve in recent years to develop a new standardized capital methodology for agency securities lending services provided to clients. These discussions have led to the inclusion of technical changes to these capital rules in the finalization of the Basel Committee's post-crisis capital reforms agreed to by the Federal Reserve in December, 2017.

1. **When does the Federal Reserve plan to adopt these technical changes to the capital rules for securities financing transactions?**
2. **Is there an opportunity for the Federal Reserve to propose rules to implement these technical changes, and perhaps others, separately and ahead of its longer range plan to solicit public input on the broader and more substantive capital changes later this year through the Advanced Notice of Proposed Rulemaking (ANPR) process?**

As noted, Board staff, in coordination with the other federal banking agencies, is evaluating this new standard as well as other standards adopted by the Basel Committee. The revised treatment of securities financing transactions adopted by the Basel Committee in December 2017 is meaningfully different from the current treatment in the Board's capital rules. Accordingly, it is unlikely that these changes could be addressed through a technical rulemaking.

3. As you know, one of the perennial problems in bank supervision is how policymakers in Washington, like yourself, ensure that their decisions are faithfully executed in the field – in this case, by your examiners. As you know, a lot can be "lost in translation" as we've learned over the years. It seems to me that this is a key management challenge for you in your current position.

1. **Is there any evidence to suggest that examiners are not faithfully executing the policies established by the Federal Reserve?**

It is very important that we communicate consistent messages to our examiners and to the banks we supervise. Our examiners, who are on the front lines of delivering supervisory messages to the firms we supervise, are committed to public service, and are faced with making tough calls every day. We at the Board have a responsibility to ensure that we provide them enough guidance that they can make those calls without micromanaging a bank's business decisions.

When we implement new regulations, guidance or supervisory practices, we conduct training though webinars or teleconferences to explain the new policies and practices to examiners. Board staff, who have drafted the regulation, guidance, or practices, will typically lead the training to ensure consistent messaging. We also incorporate these new policies and practices into our examiner commissioning training programs for bank examiners. As examiners implement new policies through the examination process, exam findings are carefully vetted to make sure they are consistent with the new policies. We also communicate regularly with senior leaders at the Reserve Banks to provide clear messages from the Board and to understand challenges they may be facing on the ground as they implement the policies and practices that are set here in Washington.

I do not currently have evidence that would suggest examiners are not diligent in executing Federal Reserve policies, but I fully agree with you that preventing gaps from developing between the policy of the Board, on the one hand, and supervisory practice in the field, on the other, will be a continuing challenge and one on which I am very focused. As mentioned above, the Board uses various communication mechanisms, including written guidance, System calls, and portfolio management group meetings, to clarify expectations for policy implementation and execution. The Board also has a formal process for overseeing the supervision activities of the twelve Federal Reserve Banks (Reserve Bank). Through ongoing monitoring and Reserve Bank- or topic-specific reviews, the Board is able to identify situations where a Reserve Bank may not be effectively executing policies established by the Board and would recommend corrective action.

2. **If so, what steps do you plan to make to oversee examiners to ensure they are following the policies established by the Federal Reserve?**

By statute, the Board is responsible for overseeing the supervision activities of the twelve Reserve Banks, including assessing how well Reserve Banks execute the supervisory authority delegated to them by the Board under 12 U.S.C. §248.

The Board has several oversight mechanisms designed to ensure that examiners are effectively applying supervisory policies, rules and guidance.

At least annually, in accordance with the Federal Reserve Act and U.S. Banking Code, the Board provides an assessment of each Reserve Bank's performance. The assessment incorporates results from ongoing monitoring of the Reserve Banks, horizontal reviews, and triennial operations reviews. The Reserve Banks are evaluated on the effectiveness and efficiency of their supervisory programs, their applications processes (e.g. mergers and acquisitions), as well as their support programs (e.g. information technology, training).

Apart from the Reserve Bank oversight process, Board staff also ensure adherence to our guidance, rules and regulations, through regular and ongoing consultation with Reserve Bank staff. Board staff regularly review Reserve Bank work products and provide program direction with the objective of promoting consistency in our supervisory approach around the Federal Reserve System.

To further promote consistency, the Board provides examiner training and commissioning programs along with continuing professional development opportunities on a variety of topics including emerging issues.

4. You have noted that the metrics to identify internationally active banks – such as $250 billion in total assets or $10 billion in on-balance sheet foreign exposures – were formulated well over a decade ago and have not been refined since then. Yet the $10 billion on balance sheet foreign exposure threshold triggers the application of the "advanced approaches" methodology for calculating a Bank Holding Company's capital requirement in addition to the standardized approach, more stringent single party credit limit requirements, and higher Liquidity Coverage Ratio (LCR) requirements.

1. **When will the Fed revisit the Basel Committee's "advanced approaches" thresholds that identify internationally active banks?**
2. **Will the Fed bring these criteria into better alignment with your objectives to tailor supervision and regulation to the size, systemic footprint, risk profile, and business model of banking firms?**

The advanced approaches threshold was established on an interagency basis with the FDIC and OCC, and is relevant for multiple elements of the Board's regulatory framework, including capital requirements, the liquidity coverage ratio rule, and related reporting requirements. The Board believes that capital and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle credit availability and economic growth. At the same time, the Board recognizes that prudential requirements should be tailored to the size, risk, and complexity of the firms subject to those requirements and is considering ways to adjust its regulations that will simplify rules and reduce unnecessary regulatory burdens without compromising safety and soundness. We are currently considering ways to better align the advanced approaches threshold with this objective, which could include changing both the total asset and foreign exposure thresholds, and would take into account the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act as part of this evaluation. Any proposed changes to the thresholds would be issued for public notice and comment after consultation in coordination with the FDIC and OCC.

House Committee on Financial Services hearing entitled, "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System"

4.17.18

Questions for the Record from Congressman Randy Hultgren (R-IL)

<u>The Honorable Randal Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System</u>

Question 1 –

During your testimony before the Committee, I asked you about making changes to the Current Exposure Method (CEM) to acknowledge the concept of delta-weighting for certain derivatives. As Chairman Powell noted last year, the CEM "ignores whether a derivative is margined and undervalues netting benefits." The CEM is insensitive to risk so its mandatory use artificially caps market liquidity, particularly in large-cap index options, which are crucial hedging vehicles. You responded that rulemaking, presumably to implement the Standardized Approach for Counterparty Credit Risk (SACCR), would be the appropriate course to address the issue that you acknowledged is damaging liquidity in our derivatives markets. As I mentioned during your testimony, the Treasury Department's October 2018 Report on Capital Markets calls for a "near-term" solution.

1. Does the Federal Reserve Board have authority to address this issue through Exemptive Relief, Interpretive Relief, or an Interim Final Rule?
2. If so, why hasn't the Federal Reserve Board taken action to address this pressing issue? The implementation timeframe for SACCR is unclear; some observers estimate that it could be three of four years until it is finalized in the United States given the myriad of topics it proposes to address.
3. Can we expect the Federal Reserve Board to pursue Exemptive Relief, Interpretive Relief, or an Interim Final Rule to address the issue? If so, please provide a reasonable deadline for advising the public of your intention to take such action.

Question 2 –

Custodial banks, which provide safekeeping and related services to pension funds, mutual funds, endowments, and other institutional investors, have engaged in substantial dialogue with the Federal Reserve in recent years to develop a new standardized capital methodology for agency securities lending services provided to clients. These discussions have led to the inclusion of technical changes to these capital rules in the finalization of the Basel Committee's post-crisis capital reforms agreed to by the Federal Reserve in December, 2017.

1. When does the Federal Reserve plan to adopt these technical changes to the capital rules for securities financing transactions?
2. Is there an opportunity for the Federal Reserve to propose rules to implement these technical changes, and perhaps others, separately and ahead of its longer range plan to solicit public input on the broader and more substantive capital changes later this year through the Advanced Notice of Proposed Rulemaking (ANPR) process?

Question 3 –

As you know, one of the perennial problems in bank supervision is how policymakers in Washington, like yourself, ensure that their decisions are faithfully executed in the field – in this case, by your examiners. As you know, a lot can be "lost in translation" as we've learned over the years. It seems to me that this is a key management challenge for you in your current position.

1. Is there any evidence to suggest that examiners are not faithfully executing the policies established by the Federal Reserve?
2. If so, what steps do you plan to make to oversee examiners to ensure they are following the policies established by the Federal Reserve?

Question 4 –

You have noted that the metrics to identify internationally active banks – such as $250 billion in total assets or $10 billion in on-balance sheet foreign exposures – were formulated well over a decade ago and have not been refined since then. Yet the $10 billion on balance sheet foreign exposure threshold triggers the application of the "advanced approaches" methodology for calculating a Bank Holding Company's capital requirement in addition to the standardized approach, more stringent single party credit limit requirements, and higher Liquidity Coverage Ratio (LCR) requirements.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 11, 2018

The Honorable Scott Tipton
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

1. <u>Market Structure</u>

<u>Background</u>: On October 15, 2014, the market for U.S. Treasury Securities, one of the deepest, most liquid, and critical markets in the world, experienced price volatility of historical magnitude with no obvious explanation. The 2015 Joint Staff Report developed and issued by staff from Treasury, the Fed, the SEC, and the CFTC could point to no clear culprit for the extreme volatility that day. They did identify several potential issues with the market structure, however, including wash trading (i.e., self-trading) and a lack of clearing by principal trading firms through a centralized counterparty. Since the release of Joint Staff Report in 2015, FINRA has mandated that its member firms report secondary-market transactions in Treasury securities to the Treasury and their supervisors. The reporting is not available to the public.

<u>Question</u>: There have been recent media reports suggesting that the Treasury Department is considering ways to bring even more transparency to the marketplace for Treasuries, as recommended in the department's Capital Markets Report from last year. Do you support this recommendation, and do you agree that bringing principal trading firms into clearing would also increase the safety, soundness, and stability to the U.S. Treasury securities market?

Regarding the first part of your question on bringing further transparency to the marketplace for Treasury securities, as was discussed in the 2015 Joint Staff Report (JSR) following the high level of volatility in the Treasury market on October 15, 2014, the structure of the Treasury market has evolved considerably over time. As highlighted in the JSR, the Treasury market has changed in ways not easily understood by either the official sector or the public due to a lack of readily available data on Treasury secondary market transactions. Through the JSR, we learned a great deal about how the Treasury market has evolved and the analysis conducted in the report made clear that gaining further insights into the Treasury market would be appropriate.

In July 2017, the Financial Industry Regulatory Authority (FINRA) began collecting from its members, Treasury secondary market transaction data through its Trade Reporting and Compliance Engine (TRACE). The collection of this data has been a useful contribution to the official sector's ability to monitor and understand the structure of, and activity in, the deepest and most liquid government securities market in the world. The recommendations in the Treasury Department's Capital Markets Report to require trading platforms operated by FINRA members to identify customers in their reports of Treasury security transactions to TRACE, as well as inter-agency efforts to collect Treasury transactions data from depository institutions, would likely further this understanding.

The Treasury TRACE data collection effort is still in its early stages, and a number of issues regarding the data collection are currently being worked out among FINRA and the members of the Inter-Agency Working Group on Treasury Market Surveillance (IAWG). Therefore, before taking a position on what data should be made available to the public, if any, further assessment is needed of the available data and of the potential impact on market functioning or other.

potential costs of public dissemination of the Treasury TRACE data. Note that the issue of public dissemination was raised in the Treasury Department's Request for Information in January 2016 and this received mixed feedback from market participants. As a general matter, my view is that increased transparency in the Treasury market would be desirable and can further bolster investor confidence in this market. However, any policy regarding public dissemination of Treasury market data would need to be consistent with the principle of not harming market functioning or adversely affecting liquidity.

Regarding your question on bringing principal trading firms (PTFs) into clearing, the implementation of more comprehensive clearing arrangements for Treasury securities, including appropriate risk management, would likely increase the stability of the Treasury market. However, what the potential solutions are for achieving this objective remains an open question, and significant study would be required. For example, the Treasury Department's Capital Markets Report notes that the fees and other standards imposed by the Fixed Income Clearing Corporation (FICC) on its members are not widely understood, and that these arrangements could pose an economic barrier for entry to PTFs. While FICC has recently altered its fee structure, the effect of this change is still unclear. Implementing more comprehensive clearing arrangements should take into consideration the potential risks and costs of any significant disruption to the structure and functioning of the Treasury market.

Question for the Record for Vice Chairman Randy Quarles

Hearing date: April 17, 2018, 10:00am
Request of: Congressman Scott R. Tipton, 3rd District of Colorado
Request for: Federal Reserve Board of Governors Vice Chairman Randal Quarles

Question seeking response:

Market Structure

Background: On October 15, 2014, the market for U.S. Treasury Securities, one of the deepest, most liquid, and critical markets in the world, experienced price volatility of historical magnitude with no obvious explanation. The 2015 Joint Staff Report developed and issued by staff from Treasury, the Fed, the SEC, and the CFTC could point to no clear culprit for the extreme volatility that day. They did identify several potential issues with the market structure, however, including wash trading (i.e., self-trading) and a lack of clearing by principal trading firms through a centralized counterparty. Since the release of Joint Staff Report in 2015, FINRA has mandated that its member firms report secondary-market transactions in Treasury securities to the Treasury and their supervisors. The reporting is not available to the public.

Question: There have been recent media reports suggesting that the Treasury Department is considering ways to bring even more transparency to the marketplace for Treasuries, as recommended in the department's Capital Markets Report from last year. Do you support this recommendation, and do you agree that bringing principal trading firms into clearing would also increase the safety, soundness, and stability to the U.S. Treasury securities market?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

July 16, 2018

The Honorable Ted Budd
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions that you submitted following the April 17, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on May 22, 2018.

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

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

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

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

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

Chairman Powell responded:

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

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

Provide a Level Playing Field

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

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

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

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

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

As a member of the International Association of Insurance Supervisors (IAIS), the Federal Reserve, in partnership with the National Association of Insurance Commissioners and the Federal Insurance Office, remains committed to pursuing an engaged dialogue to achieve outcomes on international standards that are appropriate for U.S. firms, U.S. consumers, and the U.S. market.

In the absence of appropriate international standards, non-U.S. firms may derive competitive advantages relative to U.S. firms based on local standards or may take advantage of such standards in accepting risk from U.S. counterparties. With regard to the Insurance Capital Standard (ICS) being developed through the IAIS, I completely agree with you that -- in order for it to be implementable -- it cannot be unsuited or inappropriate for the U.S., the world's largest insurance market.

Among other things, this motivates our advocacy of an aggregation alternative and the use of Generally Accepted Accounting Principles-plus in the ICS being developed through the IAIS. Through field testing and monitoring, we may be able to further advocate that an aggregation method, applied in accordance with U.S. law, provides comparable outcomes to the ICS that is emerging from the IAIS.

The Federal Reserve continues to consider the inclusion of an aggregation alternative to be important to an ICS that is acceptable and implementable in the U.S. It is also important to recall that the IAIS does not have the ability to impose requirements on any national jurisdiction, and any standards developed through these fora are not self-executing or binding on the U.S., unless adopted by the appropriate U.S. lawmakers or regulators in accordance with applicable domestic laws and rulemaking procedures.

2. <u>Limit Regulatory Arbitrage:</u>

Similarly, I am concerned about the assertion that the ICS is needed to combat regulatory arbitrage. I would greatly appreciate it if you could provide me with examples during (or since) the recent financial crisis where a large global insurance company chose to locate itself in a country based on the capital requirements of that country and then collapsed and spread financial contagion into the U.S. financial system based on this risk?

When you examine the largest insurance markets in the world --where the IAIGs are located-- and their insurance regulatory systems – specifically the U.S., EU, Japan, Switzerland, and Bermuda – do you see a major danger of regulatory arbitrage? If there is a problem with one of those jurisdictions, this seems to be an issue to be addressed in supervisory colleges, via the FSAP reviews of regulatory jurisdictions or other regulatory tools, not by a one-size-fits-all group capital standard.

During your testimony, you stated to me that you believed the U.S. state-based system of insurance regulation provided a solvent U.S. insurance system. Given that, could you please provide me a specific, hypothetical example of how an insurance entity could conduct "regulatory arbitrage" without an International Capital Standard and put U.S. taxpayers and consumers at risk?

If we do not need to "level the playing field" for U.S. insurers with an ICS for the reasons listed above AND if the argument to "limit regulatory arbitrage" is the red herring it appears to be AND if the current state-based solvency regime has ensured sound and solvent U.S. insurance companies; then please explain to me why we are working on an ICS in the first place? What specific problem are we trying to solve for? What specific benefits will U.S. insurers receive? Doesn't this whole process likely entail more harm than good for U.S. insurance policyholders and U.S. insurance industry?

As noted in the answer to question 1 above, we are not participating in the IAIS to level the playing field by imposing a European-style capital standard on U.S. firms, but rather to level the playing field by seeking to ensure that a U.S.-appropriate alternative is included in the capital recommendations being discussed there. If we ignore these discussions, they will proceed without us, and could result in global agreements being reached that disadvantage our companies (one possibility if we withdrew, for example, would be other jurisdictions requiring that US firms operating in those jurisdictions comply with capital standards that those U.S. firms would have had no say in developing, and with which they could not comply, potentially making it more costly for U.S. firms to compete abroad). The better alternative is to engage in these discussions to vigorously defend U.S. interests by seeking an alternative capital standard based on the aggregation method that would be suitable for U.S. firms. As also noted above, these discussions are not treaty negotiations and do not lead to any enforceable obligations on any country, including the United States.

3. <u>Kuala Lumpur</u>

One of the reasons there is so much concern regarding where the ICS is headed is because of the IAIS Kuala Lumpur Agreement in November of last year. In that agreement, "Team USA" agreed that the ICS (known as "the reference ICS") would (1) be a

prescribed capital requirement (PCR) and (2) use the European-centric accounting methodology of market-adjusted valuation (MAV).

US State Insurance Commissioners are now developing a group capital assessment tool (the Group Capital Calculation – GCC) that is directly at odds with the two key attributes agreed to in Kuala Lumpur. First, the GCC will be an assessment tool – that is, part of the toolkit a US regulator uses to evaluate groups. The GCC will not be a capital target or requirement. Second, the GCC will be based off US accounting principles – and not MAV.

The KL Agreement pays lip service to the possibility that the US GCC could be deemed "an outcome-equivalent approach for implementation of ICS as a PCR" – but given the very different approaches – that does not seem even theoretically possible. Moreover, your predecessor, Governor Daniel Tarullo, stated in a speech at the National Association of Insurance Commissioner's International Insurance Forum on May 20, 2016: "There are, as all of you know, a lot of ideas out there as to how we should construct the capital requirements we will apply to insurance companies. Some, such as variations on the Solvency II approach used in the European Union, strike us as unpromising. The valuation frameworks for insurance liabilities adopted in Solvency II differ starkly from U.S. GAAP and may introduce excessive volatility. Such an approach would also be inconsistent with our strong preference for building a predominantly standardized risk-based capital rule that enables comparisons across firms without excessive reliance on internal models. Finally, it appears that Solvency II could be quite pro-cyclical."

Do you share this assessment of your predecessor? If so, why did the Federal Reserve staff participating in the Kuala Lumpur negotiations agree to accede to the Europeans at the IAIS to mandate that the financial reporting for the reference ICS be done using a Solvency II MAV-type approach and not something more suitable for the U.S. insurance industry like GAAP or Statutory accounting? If you do agree with Governor Tarullo that a Solvency II accounting approach introduces excessive volatility into U.S. insurance markets, how do you plan on remedying this at the next IAIS negotiations on ICS?

Please explain how you will ensure the US approach (GCC) is deemed as satisfying the eventual ICS given that the only conceivable outcome that could work for the U.S. insurance industry is to have our system recognized as satisfying the eventual finished ICS.

As I continue to see the work product from the IAIS and the increasingly potential negative outcome it can have for the U.S. insurance industry, I am reminded of the quote, "Don't cling to a mistake just because you spent a lot of time making it." Seems like this advice might also be apt for the IAIS in regard to the ICS.

<u>Additional Questions:</u>

The cornerstone of the November Kuala Lumpur agreement by the IAIS, seeking an international capital standard, is the Market-Adjusted Valuation (MAV). The MAV is wholly inconsistent with GAAP and Statutory Accounting Principles (SAP) used by all 50 states in regulating the business of insurance. Given the likely de-designation of Prudential as the only remaining SIFI, how do you reconcile the inconsistencies of MAV with the Building Block Approach as applied to I-SLHCs—many of which only utilize SAP?

The Insurance Capital Standards Clarification Act of 2014 prohibits the Federal Reserve from requiring certain SAP-only I-SLHCS companies to use GAAP. How do you reconcile this statutory prohibition with the IAIS's demand for MAV? Do you believe the Fed can mandate I-SLHCs to use MAV, notwithstanding the GAAP prohibition?

The IAIS does not have any authority to impose enforceable obligations on U.S. insurance firms, and therefore no outcome of these discussions could result in an application of any capital standard to U.S. insurance firms that is inconsistent with U.S. statutory prohibitions.

House Committee on Financial Services

Hearing: "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System"

April 17, 2018

Questions for the Record from U.S. Representative Ted Budd (R-NC.)

Honorable Randal Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System

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

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

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Additional Questions:

1.) The cornerstone of the November Kuala Lumpur agreement by the IAIS, seeking an international capital standard, is the Market-Adjusted Valuation (MAV). The MAV is wholly inconsistent with GAAP and Statutory Accounting Principles (SAP) used by all 50 states in regulating the business of insurance. Given the likely de-designation of Prudential as the only remaining SIFI, how do you reconcile the inconsistencies of MAV with the Building Block Approach as applied to I-SLHCs—many of which only utilize SAP?

2.) The Insurance Capital Standards Clarification Act of 2014 prohibits the Federal Reserve from requiring certain SAP-only I-SLHCS companies to use GAAP. How do you reconcile this statutory prohibition with the IAIS's demand for MAV? Do you believe the Fed can mandate I-SLHCs to use MAV, notwithstanding the GAAP prohibition?

May 30, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 15, 2018[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michelle W. Bowman

Enclosure

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[1] Questions for the record related to this hearing were received on May 23, 2018.

<u>Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Cortez Masto:</u>

1. Community Reinvestment Act

- **Should CRA be expanded to all non-banks? Some assert that in today's financial landscape, CRA compliance should be expanded to all non-banks, including credit unions, fintechs, mortgage companies, investment, and others.**

If confirmed, I assure you that I would be committed to using the authorities available to the Federal Reserve to identify and take action against discriminatory lending practices. However, as the scope of the Community Reinvestment Act (CRA) is mandated by statute, any expansion of its coverage to non-depository institutions would require a statutory change.

- **Do you support a full scope review for CRA exams? Do you think geographical assessment areas should define CRA accountability both where the majority of branch lending and the majority of non-branch lending occurs?**

It is important that the agencies with rule writing authority for CRA (the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency) evaluate ways to provide a meaningful evaluation of a bank's CRA activities in all of the communities it serves.

My understanding is that the agencies are considering ways to make the area in which CRA performance is evaluated more reflective of current banking practices. I support that effort.

- **If a fair lending exam detects a violation after a bank has been graded for its CRA exam, do you think the bank should receive a retroactive downgrade?**

Discriminatory and other illegal credit practices hinder access to credit, which can limit opportunity in communities, and that is inconsistent with the spirit of the CRA.

I believe that regulators do take fair lending matters into consideration when assigning CRA ratings, as prescribed in the CRA regulations.

Given the importance of both the CRA and fair lending laws, I believe it is critical to ensure clarity in the rules and an understanding of compliance with those rules, and to ensure credit is flowing to consumers and businesses in all communities consistent with safe and sound lending, including in low- and moderate-income areas. Doing so, will help meet credit needs and further economic development and financial inclusion.

2. Many Democratic, Republican and Independent current and former regulatory officials raising concerns about the bank deregulation bill range from former Fed Chair Paul Volcker, former Fed governor and Deputy Treasury Secretary Sarah Bloom Raskin, former FDIC Chair Sheila Bair, former Counselor to the Treasury Secretary Antonio Weiss, and former Deputy Governor of the Bank of England Paul Tucker. These former banking regulators either state that a $250 billion bank threshold is too high to protect financial stability or that we should not weaken the leverage rules for the largest banks, or both.

- **Do you think anything in S. 2155 puts the financial system at risk? Do you share the concerns raised by your predecessors? If so, why? If not, why not?**

I believe that regulation and supervision should be tailored in a manner that allows the financial system to more efficiently support the real economy. The Federal Reserve has been working for many years to tailor regulation and supervision to the size, systemic footprint, and risk profile of individual institutions. Recognizing the levels and types of risk of the different institutions in the system improves the quality and efficiency of regulation, but I believe more tailoring can and should be done.

It is reasonable for Congress to raise the $50 billion asset threshold to limit the scope of the enhanced prudential standards to larger bank holding companies. My understanding is that the Economic Growth, Regulatory Relief, and Consumer Protection Act preserves the ability of the Federal Reserve to reach below the new $250 billion line, if warranted, to subject a firm to more stringent regulation. In general, the Act preserves the Federal Reserve's ability to adequately monitor and regulate systemic risk of banking firms as well as its ability to regulate banking firms for safety and soundness objectives.

I also support the Act's exemption for community banks from the Volcker rule. Such a move provides relief for thousands of small institutions that face ongoing compliance costs simply to confirm that their activities and investments are indeed exempt from the statute. An exemption at this level is not likely to increase risk to the financial system.

3. CRA regulations establish different CRA exams for banks with different asset levels. Small banks, those with less than $307 million in assets, have the most streamlined exam that consists of only a lending test. Intermediate small banks (ISB), those with assets of $307 million to $1.226 billion, have exams that consist of a lending test and a community development (CD) test. The CD test assesses the level of CD lending and investing for affordable housing, economic development, and community facilities. Large banks, those with assets above $1.2 billion, have the most complex exams which consist of a lending test, an investment test, and a service test.

- **It is my understanding that your bank qualified as a small bank, so it had a streamlined exam focused on lending only. In your response to my question on what it would take for your bank to earn an outstanding rating instead of a satisfactory rating, you stated you found the exam guidelines unclear. Please identify where you feel CRA guidelines for small banks are unclear.[1]**

In general, community bankers seek to serve their customers in ways that are safe and sound and within their institution's ability. I believe that community bankers, in spirit, would say they strive to be viewed as outstanding bankers by their customers and in their communities.

The CRA examination procedures describe a variety of factors that are taken into account, such as the economies and opportunities that may exist in the markets that the bank operates in.

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[1] CRA Examination Procedures Overview: Available at: https://www.ffiec.gov/cra/pdf/cra_exsmall.pdf.

Given that such conditions can vary between examinations, and that the regulations are not prescriptive, it can be difficult for banks to have certainty as to what factors may be viewed as more favorable and result in an "Outstanding" rating.

4. Chair Yellen was the first chair in Federal Reserve history to share data with this committee about racial economic disparities during her semi-annual testimony. When she presented that data, she touted significant progress, and indeed, black unemployment fell from 11.8% at the beginning of her term to the current historically low figure of 6.9%.

- **What do you attribute this trend to? Do you think the attention that Janet Yellen paid to this issue and the policies of the Federal Reserve deserve credit for the progress that has been made?**

With the aggregate unemployment rate near its lowest point since the 1970s, it is not surprising that the unemployment rate for African-Americans is also close to its lowest point since then. Both figures reflect the long economic expansion our country has been enjoying. Although our macroeconomic performance cannot be attributed to any single factor, the efforts of the Federal Open Market Committee (FOMC) to achieve its dual mandate have likely been a contributing factor. Moreover, while monetary policy is blunt tool, which works by lifting the economy as a whole rather than by targeting the well-being of any single group in our society, the efforts of the Federal Reserve to pay attention to the diversity of our economy contributes to a better understanding of how it works for all Americans, which should help to improve policy making.

5. At that same testimony where Janet Yellen presented information about racial economic disparities, she said, quote "it is troubling that unemployment rates for these minority groups remain higher than for the nation overall, and that the annual income of the median African-American household is still well below the median income of other U.S. households."

- **Though African American unemployment is lower today, Chair Yellen's point remains true. Do you think the recent progress is sufficient? What more can be done to ensure that unemployment among African Americans is equal to white unemployment? In addition to increasing employment rates for African Americans, what can the Fed do to increase wages and wealth for African Americans and Latinos?**

The economic disparities between African-American households relative to other U.S. households, with respect to both unemployment and incomes, are long-standing, and I would like to see the gap close further. By promoting a strong stable economy, the Federal Reserve can create widespread economic opportunities that both reduce unemployment and boost incomes among all households. African-Americans have also had problems accessing credit and other financial resources on an equal footing, and the Federal Reserve can use its regulatory and supervisory role to make sure that financial institutions meet their obligations in this regard. However, the tools available to the Federal Reserve cannot address many of the longstanding challenges facing African-American communities. These actions would require action by Congress and state and local governments.

6. Marvin Goodfriend, another nominee to the Federal Reserve Board of Governors has urged the Federal Reserve to incent spending by placing a tax on currency.[2]

- **Do you support Mr. Goodfriend's proposal to tax currency kept outside of circulation?**

The United States dollar enjoys a well-earned status as a store of value and a reliable means of exchange both domestically and across the world. Any new policy that could undermine the confidence the world places in the dollar should be thought through very carefully and undertaken only after a great deal of study. Fortunately, the United States does not find itself in such a situation presently, as the U.S. economy is strong and inflation is close to 2 percent, so there is no need to contemplate such a tax.

- **If Mr. Goodfriend's proposal were to be implemented, can you estimate what the impact would be on savers and low-income depositors?**

The effects of a currency tax on savers and low-income depositors are certainly part of the myriad of potential consequences that would have to be investigated if this policy were to be considered. As stated above, I believe that any new policy that could undermine the confidence the world places in the dollar should be thought through very carefully and undertaken only after a great deal of study. Moreover, the United States is not in a position of needing to consider such a policy at present.

7. The Consumer Financial Protection Bureau has endured new leadership that is hostile to its mission. A number of enforcement actions aimed at helping people receive redress from fraud or overcharges has been stopped.

- **If the Consumer Financial Protection Bureau's leadership refuses to ask for adequate funding or takes steps that you think are harmful to people or our economy, will you let Senate Banking Committee members know? If so, how? If not, why not?**

My understanding is that the Consumer Financial Protection Bureau (CFPB) consults with the Federal Reserve Board (Board) in its rulemakings and coordinates in the examinations as appropriate, but the Board does not have oversight of the CFPB organizational or structural design.

If confirmed to serve on the Board of Governors, I would fully support the Federal Reserve as it continues to carry out its supervisory and enforcement responsibilities to ensure that the banks it regulates are held accountable for compliance with all applicable federal consumer protection laws and regulations.

- **The Federal Reserve retains supervision and enforcement authority for financial institutions below $10 billion in assets. Please provide a list of public enforcement**

[2] Goodfriend, Marvin. "The Case for Unencumbering Interest Rate Policy at the Zero Bound." Carnegie Mellon University. September 15, 2015. Available at: https://www.kansascityfed.org/~/media/files/publicat/sympos/2016/econsymposium-goodfriend-paper.pdf.

actions taken towards any Fed-regulated institutions in the past three years. Please note any fines or penalties assessed. Please note if you agree or disagree with these enforcement actions.

Bank supervisors have a responsibility to ensure that the institutions subject to the Federal Reserve's supervision operate safely and soundly and that they comply with applicable statutes and regulations, and additionally, that the Federal Reserve should use its formal enforcement authority to achieve these objectives where appropriate. I cannot comment on the specific circumstances of actions the Federal Reserve has taken in the past. A list of public enforcement actions taken against institutions regulated by the Federal Reserve in the past three years, including any civil money penalties assessed against the institution, is provided in appendix A to this request.

8. Some current Federal Reserve leaders support reducing banks' capital requirements. This concerns me as capital requirements have been a key tool in restoring the safety of the financial system since the crisis. Ensuring modest leverage ratios prevents banks from lending out more than they can afford to, and especially keeps them away from riskier assets like the ones that fueled the crisis.

- **For this reason, Democrats and Republicans in the House and Senate, as well as FDIC Vice Chair (and former Kansas City Fed President) Thomas Hoenig all support higher capital requirements, not lower ones. Do you support any changes to the current capital requirements for financial institutions? If so, please describe.**

We need a resilient, well-capitalized financial system that is strong enough to withstand even severe shocks and support economic growth by lending through the economic cycle. To that end, the U.S. banking agencies have substantially strengthened regulatory capital requirements for U.S. banking firms, improving the quality and increasing the amount of capital in the banking system. At the same time, it is important to monitor the capital rules on an ongoing basis, to determine whether the framework is effectively measuring and addressing risk and working as intended, and to adjust the framework as needed.

9. In recent years, Federal Reserve policymakers have warned that we should raise interest rates to counter asset bubbles destabilizing the financial system. Board of Governor Nominee Marvin Goodfriend has suggested replacing liquidity coverage ratios and a host of other regulations with tighter monetary policy.[3]

- **Do you believe that the blunt tool of monetary policy can be a substitute for sound financial protections? What is your understanding of the historical evidence surrounding the relationship between monetary policy and asset bubbles?**

Monetary policy is the primary tool through which the Federal Reserve works to achieve the goals of price stability and full employment. To use that tool for other purposes could undermine its effectiveness for those goals, and thus monetary policy should not be considered a

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[3] Senate Committee on Banking, Housing, and Urban Affairs, June 7, 2016 Hearing. Available at: https://www.gpo.gov/fdsys/pkg/CHRG-114shrg21603/pdf/CHRG-114shrg21603.pdf.

substitute for prudent financial and supervisory standards. As we learned in the crisis, the lack of such standards had significant consequence. The build up of leverage and maturity transformation in the years leading up to the crisis left the U.S. and global economy vulnerable to shocks. When the housing market turned down, the effects of that shock were amplified as leverage was wound down and funding patterns shifted. The result was what we all painfully experienced as the financial crisis.

Post-crisis reforms have raised loss-absorbing capacity within the financial sector and reduced the susceptibility of the financial system to destabilizing runs. Of course, gaps exist in financial regulation, and therefore, changes in interest rates could at times be appropriate as a supplementary tool to address threats to full employment and price stability emanating from widespread imbalances or buildups of risk in areas where more-targeted tools are inadequate or nonexistent.

Understanding movements in asset prices is very difficult, and there are many factors that contribute to their short- and long-term movements. Monetary policy has not generally been a prime factor in historical episodes involving large increases in asset prices.

- **Besides monetary policy, what other tools are available to temper asset bubbles?**

Making a determination about the appropriate value of an asset is extremely difficult. Many factors come into play in the determination of both the short-term and long-term value. Instead of trying to determine every assets' appropriate value, it is important to monitor asset prices more broadly, along with the other crucial vulnerabilities that contribute to financial market difficulties, like leverage, maturity transformation, and interconnectedness. When shocks occur, it is those vulnerabilities that amplify the effects of the shocks and jeopardize the efficient functioning of the financial system, price stability, or full employment.

Because determination of the appropriate level of asset prices is difficult, we need to be prepared at all times by ensuring the safety and soundness of our financial institutions and our financial system through prudent regulations and supervisory standards. We never know when a negative shock can occur, including asset price reversals. As a result, the prudent capital, liquidity, and other regulations and policies adopted by the Federal Reserve are critical for the protection of our financial system going forward.

10. In the years since the financial meltdown, the Federal Reserve has played a key role in putting our economy back on stable footing and setting the conditions for more robust growth. Still, there have been bills introduced that would eliminate the Fed's full employment mandate on the basis that, according to the bill's findings "at best, the Federal Reserve may temporarily increase the level of employment through monetary policy."

- **Can you elaborate on how the Fed influences employment in the short-run, and discuss whether failure to use monetary policy effectively in the face of severe downturns could do permanent damage to the level of unemployment in the economy?**

In the short run, the Federal Reserve influences employment primarily through its effect on the financial conditions facing households and businesses. For example, lower interest rates promote household spending by reducing the cost of borrowing for big-ticket purchases such as houses and cars. Similarly, lower interest rates make it less costly for businesses to invest in new plants and equipment. This additional demand, in turn, leads to higher production, faster job growth, and rising household income and wealth. A failure to use monetary policy to effectively combat a severe downturn would risk persistently high unemployment and perhaps even risk falling into a harmful deflation where wages and prices actually fall.

11. Critics of quantitative easing have argued that it is incompatible with the Fed's price stability mandate; however in discussing quantitative easing the Fed has consistently noted that the program is designed to promote a stronger pace of economic growth and to ensure that inflation, over time, is at levels consistent with the Fed's mandate.

- **Can you comment on how the Fed's policies in recent years have actually supported the Fed's price stability mandate?**

Faced with the most severe financial crisis since the Great Depression, the FOMC cut short-term interest rates to zero by the end of 2008. The Federal Reserve also turned to nontraditional tools such as asset purchases and forward guidance, as means of providing the additional accommodation. These policies put downward pressure on longer-term interest rates and helped to make financial conditions more accommodative, encouraging and supporting the economic recovery. By providing a cushion for aggregate demand during the recession and supporting spending during the recovery, the Federal Reserve's monetary policy measures helped to keep inflation close to 2 percent. In particular, in part because aggregate demand was supported by monetary policy, the U.S. economy avoided the severe downward pressure on the price level that occurred during the Great Depression, which in turn prevented inflation expectations from falling sharply below 2 percent.

- **What does the latest research tell us about the effectiveness of the Fed's large scale asset purchases?**

It is difficult to say with certainty what the effects of large-scale asset purchases have been, but most studies find that the purchases put downward pressure on long-term interest rates, which in turn lowered borrowing rates for businesses and consumers, and boosted stock prices. These effects served to bolster spending on goods and services by households and businesses, supporting the recovery.

- **Is there any evidence that the Fed's asset-purchase program, which sought to support the economy by lowering long-term interest rates, has been a drag on U.S. productivity as some Republicans have suggested? Is there any evidence that the program has created a "false economy" as Trump has asserted?**

I find it unlikely that the Federal Reserve's policies have contributed to the sluggish pace of productivity growth observed over recent years. It is more likely that factors such as subdued spending on investment and research and development by businesses, as well as a reduction in the skills of the labor force resulting from the financial crisis and ensuing recession, have weighed on productivity.

- **How would the economy have likely fared in terms of unemployment, GDP, wage growth, etc. had the Fed chosen not to pursue its asset purchase program?**

The Federal Reserve conducts monetary policy to promote maximum employment and stable prices. Various research studies by academic and central bank economists suggest that the Federal Reserve's asset purchase programs helped to make financial conditions more accommodative, support economic recovery, strengthen labor market conditions, and foster price stability.[4]

- **Is there any evidence that the Fed's stimulus program has paved the way for the next global meltdown, as Trump claimed?**

While there are many sources of risk and uncertainty in the global economy, I believe the Federal Reserve's conduct of monetary policy has contributed to an improved global economic outlook by supporting the U.S. economic expansion and maintaining low and stable inflation.

- **How does the Fed's balance sheet as a percentage of GDP compare with the balance sheets of the next largest economies? Do these countries have a dual mandate similar to the Fed?**

The size of the Federal Reserve's balance sheet relative to nominal GDP currently stands at about 23 percent. Last October, the FOMC initiated its plan to normalize the size of the Federal Reserve's balance sheet. Under that plan, the size of the Federal Reserve's balance sheet will decline gradually over coming years. With nominal GDP expected to rise over that time, the size of the Federal Reserve's balance sheet relative to nominal GDP will likely decline appreciably.

The Federal Reserve's balance sheet as a percentage of GDP is smaller than those of most other major foreign central banks. The central bank balance sheets of the United Kingdom, the euro area, Japan, and Switzerland are about 28, 40, 100, and 120 percent of their nominal GDP, respectively. All of these central banks employed large-scale asset purchase programs to address the implications of the financial crisis in their countries.

All of these central banks operate with a single mandate to pursue price stability. However, in many cases, this mandate is treated as medium-term objective, and other goals, including output and employment stabilization and financial stability, are cited to justify deviations from price stability in the short run.

12. It is my understanding that major central banks around the world maintain and have drawn on their authority to purchase a wide range of assets including corporate bonds, commercial paper, real estate investment trusts, and equities among other assets.

- **Given the broad authorities available to other central banks, rather than shrink the Fed's tool kit, do you think Congress should consider expanding it?**

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[4] See, for example, Eric M. Engen, Thomas Laubach, and David Reifschneider (2015), "The Macroeconomic Effects of the Federal Reserve's Unconventional Monetary Policies," Finance and Economics Discussion Series 2015-005, Washington: Board of Governors of the Federal Reserve System, February, http://dx.doi.org/10.17016/FEDS.2015.005.

As mandated by Congress, the Federal Reserve conducts monetary policy to promote maximum employment and price stability. It is important that the Federal Reserve has the tools it needs to fulfill this mandate. The Federal Reserve's purchases of Treasury securities and agency securities in the wake of the financial crisis were designed to ease financial conditions and promote the recovery.

The Federal Reserve is quite limited in the kinds of assets it can purchase, and those limits seem appropriate to me. Expanding the Federal Reserve's authority to allow it to purchase a broad range of securities could expose the Federal Reserve to pressures to influence the allocation of credit to particular sectors. Such pressures could threaten the Federal Reserve's independence, which is essential to allow the Federal Reserve to make decisions in the best interest of the nation as a whole. Of course, it is up to Congress to determine the Federal Reserve's authorities.

- **For example, with an expanded authority, could the Fed play a useful role in supporting municipal finance, student loan financing or other types of consumer credit during periods where each of these sectors experienced heightened distress? Would you support or oppose such expansion of the Fed's authority?**

Please see response to question 12a.

- **As the Fed begins to shrink its balance sheet, what are some of the negative impacts that Senate Banking Committee members should monitor? What concerns – if any – do you have about shrinking the balance sheet? What will you do to monitor the process of maturing securities to avoid a negative impact on the economy?**

I believe that the gradual approach to removing policy accommodation that the FOMC has been pursuing has supported the economic recovery and helped the Committee make progress towards it 2 percent inflation objective. The program has proceeded smoothly thus far with no outsized financial market movements. If confirmed, I would support a continuation of clear communication about the FOMC's plans to shrink the Federal Reserve's balance sheet. My understanding is that, in the longer-run, the Federal Reserve intends to hold no more securities than it will need to implement monetary policy efficiently and effectively. I also understand that the
Federal Reserve expects its holdings will eventually consist primarily of Treasury securities. The FOMC has stressed and I believe it is appropriate that the shrinking of the balance sheet remains data dependent, and that it could change its plans if confronted with a substantial deterioration in the economic outlook.

13. Ms. Bowman, in your testimony, you stated, "the regulatory environment created in the aftermath of the crisis has disadvantaged community banks. If confirmed, I will bring this perspective to my work at the Board to ensure that rules preserve the resiliency of the financial system, but are appropriately tailored to the size, complexity, and risk of an institution."

As you know, the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) rules are tailored so larger banks have higher standards than smaller banks. Of the 14 "major" rules issued by banking regulators pursuant to the Dodd-Frank Act, 13 either include an exemption for small banks or are tailored to reduce the cost for small banks to comply. Supervision and enforcement are also structured to pose less of a burden on smaller banks than they do on larger banks, such as by requiring less frequent bank examinations for certain small banks.

- **Please explain which rules you think "have disadvantaged community banks?" Please explain which rules you think should be changed and how?**

In my experience, both as a community banker and as the Kansas State Bank Commissioner, two aspects of bank regulation can be particularly problematic for community banks: complexity and a one-size-fits-all approach that does not sufficiently differentiate between large and small banks. I believe it is worth exploring whether some regulations can be made simpler while still achieving their prudential aims (the regulatory capital framework for community banks, for example, could perhaps be simplified). Likewise, I would support exempting small banks from regulations that address large-bank issues, such as the Volcker rule.

- **Do you think community banks, those with less than $2 billion in assets, should follow federal consumer protection rules?**

Decisions about the application of federal consumer protection rules and compliance by particular institutions are for Congress to decide through law, and as implemented by the responsible rulewriting agency. In this case the rulewriting agency is the CFPB.

That being said, I believe that consumer protection is important regardless of where a consumer chooses to bank or to seek credit or other financial products. I also believe there is agreement across the industry that one-size-fits-all regulation does not always work. Exemptions to rules are sometimes warranted, and asset size of financial institutions can be a factor used to make that determination.

- **Do you think community banks should comply with the requirement that loans should be made to people who can repay them? This is called the "know before you owe" rule. Community banks are largely exempt from both mortgage origination and servicing rules because they are small creditors with less than $2 billion in assets or service fewer than 500 loans.**

I feel strongly that we should not allow the risky underwriting standards used by many originators prior to the housing crisis to return. It is also important, however, that laws and rules do not needlessly prevent creditworthy borrowers from getting a mortgage.

Decisions about which banks must comply with consumer financial service laws are up to Congress through statute or implementation of the statute by the CFPB, as the responsible rulewriting agency, through regulation.

As Congress and the CFPB consider which banks should comply with particular underwriting rules, it is important to consider the impact of any rule on a community bank's ability to provide credit to reliable borrowers but whose creditworthiness may be difficult to capture in a broad, universally applied rule.

- **Rules protecting people who send remittances apply to any financial institution that sends more than 100 remittances a year. Do you support changes to Regulation E/Electronic Fund Transfers? If so, how would you change this rule?**

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the CFPB has exclusive rule writing authority to implement most consumer laws, including the Electronic Fund Transfer Act provisions governing remittance transfers, which the Bureau implements through Regulation E.

The CFPB, however, generally is required to consult with prudential regulators or other federal agencies, including the Board, prior to proposing a rule and during the comment process regarding consistency with prudential, market, or systemic objectives administered by such agencies. (Sec. 1022(b) of the Dodd-Frank Act). If confirmed, I will work to ensure that the Board continues to fulfill its consultative role in Bureau rulemakings, including any rulemakings related to remittance transfers.

- **Dodd Frank limited compensation requirements for loan originators to prevent steering to high-cost loans. Only originators that make fewer than 10 loans in a 12-month period are exempt. Do you support changes to the Loan Originator Compensation Requirements (Regulation Z)?**

Under the Dodd-Frank Act, the CFPB has exclusive rule writing authority to implement most consumer laws, including the compensation rules for loan originators issued under the Truth in Lending Act. The Dodd-Frank Act also provides that the CFPB's rules are not subject to approval or review by the Board.

However, the Dodd-Frank Act also requires the CFPB to consult with prudential regulators, which includes the Board, before and during any rulemaking regarding the rules' consistency with prudential, market, or systemic objectives administered by the respective agency.

If confirmed, I will work to ensure that the Board continues to fulfill its consultative role in connection with the CFPB's rulemakings, including any rulemaking related to the loan originator compensation rules.

- **Mortgage Servicing Rules under Regulation X and Z are designed to protect homebuyers from high-cost loans. Servicers with fewer than 5,000 mortgage loans are exempted from some of these rules. What changes do your recommend to Regulations X and/or Z?**

The CFPB has exclusive rule writing authority to implement most consumer laws, including the mortgage servicing rules under Regulation X and Z. The Dodd-Frank Act also speaks to the autonomy of the CFPB's rulemaking authority by providing, for example, that no rule can be subject to approval or review by the Board. (Sec. 1012(c) of the Dodd-Frank Act). Therefore, changes to the mortgage servicing rules under Regulations X and/or Z are up to the CFPB to decide.

The Dodd-Frank Act requires that the CFPB engage in an interagency consultation process during the proposed and final rulemaking process with all the prudential regulators.

If the CFPB decided to amend the mortgage servicing rules, I would expect that Board staff would participate in the CFPB's process, and review rulemakings to identify principal areas of concern and potential effects with respect to credit availability, safety and soundness, regulatory burden, consumer protection and compliance supervision.

- **Do you think banks that make more than 25 mortgage loans should share the loan and borrower characteristics through the Home Mortgage Disclosure Act database?**

Decisions about what information banks should provide under the Home Mortgage Disclosure Act (HMDA) are up to Congress through statute or as implemented by the CFPB, as the responsible rulewriting agency, through its regulation.

HMDA is a valuable public disclosure law, with the data reported being instrumental in enhancing supervisory and research efforts for more than 30 years.

I am aware that an intent of the recently passed Economic Growth, Regulatory Relief, and Consumer Protection Act is to provide regulatory relief from the HMDA data collection and reporting requirements as expanded by the Dodd-Frank Act for certain banks that have a lower volume of loan origination. I am also aware that the CFPB plans to revisit its 2015 rulemaking under HMDA to re-evaluate institutional and transactional coverage, as well as what data should be collected and reported under HMDA.

As noted above, Congress requires the CFPB to engage in an interagency consultation process during the rulemaking process. If confirmed, I will work to ensure that the Board continues to fulfill its consultative role in connection with such rulemakings, including any rules under HMDA.

- **Banks with assets under $50 billion are not required to comply with the liquidity coverage ratio. Do you think they should be? Why or why not?**

Prudent liquidity management is important at all banks. Longstanding supervisory guidance emphasizes the importance of banks regularly monitoring their liquidity positions and maintaining sufficient levels of liquidity to meet anticipated and unexpected demands for funding. Supervisors monitor banks' liquidity levels using financial data provided by banks on quarterly Call Reports and review liquidity risk management practices in depth during bank examinations to ensure that banks are managing their liquidity in a safe and sound manner. In my experience, this supervisory approach has been effective for smaller banks. For larger, systemically important banks that have more complex funding profiles, the liquidity coverage ratio requirements are more important. In the case of these entities, the liquidity coverage ratio helps ensure that acceptable levels of liquidity are maintained in order to minimize the risk that a liquidity strain at one large bank causes broader disruptions to the financial system.

I understand that the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act provides additional discretion to the Federal Reserve to determine the appropriate supervisory tools to monitor liquidity in institutions with assets between $50 billion and $250 billion. If confirmed, I look forward to studying the liquidity coverage ratio and its effectiveness more closely and working with my Board colleagues to ensure that Federal Reserve supervision continues to promote effective liquidity risk management in all institutions under its supervision, regardless of their size or complexity.

- **Banks with assets under $250 billion are not required to comply with regulatory capital rules. Do you think they should be? Why or why not?**

Banks of all sizes must maintain adequate capital to ensure their safety and soundness. All banks are required to comply with regulatory capital rules. I believe it is appropriate that large banks are subject to more stringent capital requirements, reflecting their greater complexity and the greater risk they pose to the stability of the U.S. financial system.

- **The Volcker rule which prohibits proprietary trading applies to all banks but has streamlined policies and procedures for banks with less than $10 billion in assets. Do you think banks under a certain size should be allowed to invest in hedge funds and private equity funds on their own behalf? Do you think the Volcker Rule should not apply to banks under a certain size?**

Congress has recently spoken to this question by enacting legislation that excludes certain small banking organizations from the restrictions of the Volcker Rule. These firms do not have large trading operations in relation to their size. I believe that this reform will reduce regulatory burdens on community banks without causing harm to the financial system because these banks do not engage in the type of trading that the Volcker Rule was intended to restrict. Additionally, I believe that the regulatory regime that applies outside of the Volcker Rule is sufficient to protect the safety and soundness of community banks.

- **Collateralized debt obligations backed by Trust Preferred Securities are restricted. Do you think banks under a certain size that hold CDO-TruPs should not have to comply with restrictions?**

Interconnectedness in the banking system increases when banking organizations invest in other banking organization's capital securities, including through structured products. This interconnectedness heightens the likelihood that instability at one banking organization will spread to others, regardless of the size of the banking organizations involved.

- **Debit card interchange fees and routing requirements do not apply to banks that have fewer than $10 billion in assets. Do you think banks under this size should comply with interchange fees and routing requirements?**

I believe that it is a matter for Congress to decide what, if any, additional exemptions from these provisions should be provided.

14. Let me ask you about other regulations that apply to banks but were not enacted by the Dodd- Frank Wall Street Reform and Consumer Protection Act.

- **Do you think the "primary duty" of a bank's board of directors is "to ensure the bank operates in a safe and sound manner"?**

I believe that an effective board of directors is integral to the continuing safety and soundness of a banking firm, including its compliance with laws and regulations. I understand that the Federal Reserve has proposed guidance on board effectiveness in part, and in recognition that the supervisory expectations in existing guidance did not consistently focus on the core responsibilities of boards. The proposed guidance would eliminate unnecessary or outdated expectations and encourage boards to devote more time and attention to their core responsibilities, which when exercised effectively, promote the safety and soundness of the firm.

- **Do you have recommendations for changes to the Bank Secrecy or Anti-Money Laundering rules?**

Banks are required to comply with the Bank Secrecy Act and Anti-Money Laundering (BSA/AML) laws and regulations in order to safeguard the U.S. financial system from the risks of money laundering and terrorist financing. In my time as a banker at Farmers & Drovers Bank in Kansas, and as the Kansas State Bank Commissioner, I know that banks take this responsibility seriously, but this compliance incurs significant costs and resources, especially for smaller banks.

BSA/AML regulations are generally issued by the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) or on an interagency basis, which means that most BSA/AML requirements are handled on an interagency basis. Further, I understand that the Federal Reserve participates in several groups designed specifically for BSA/AML issues. Notably, the Federal Reserve participates, along with other federal banking agencies and the Conference of State Banking Supervisors, in the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Working Group, which meets regularly to discuss various BSA/AML supervisory and policy matters. The Federal Reserve also participates in the BSA Advisory Group (BSAAG), which brings together federal and state financial regulatory agencies, FinCEN, law enforcement and industry.

I do not have any recommendations for changes to the BSA/AML laws and regulations at this time; however, I support continuation of the Federal Reserve's interagency efforts to increase the efficiency, transparency, and effectiveness of the supervision and regulation of financial institutions, including those related to compliance with BSA/AML rules.

15. In 2017, when you served as the Banking Commissioner of Kansas, George and Agatha Enns conspired with Plains State Bank employees to launder money. The Enns were sentenced to three years of probation and forfeited nearly $2 million in ill-gotten gains.

- **What was the Enns' crimes? What was the role of the Kansas Banking Commission and your role personally in this investigation and lawsuit?**

The Office of the State Bank Commissioner (OSBC) shares regulatory authority with federal agencies in enforcing banking laws. The Department of Justice, in consultation with the FDIC, IRS and DEA, prosecuted George and Agatha Enns and certain employees of the Plains State Bank for crimes of conspiracy to commit money laundering, failing to file a Suspicious Activity Report, and money laundering that occurred from 2011 to 2014. The indictments were unsealed in April 2015. The Department of Justice did not consult with the OSBC in this matter, and no Kansas Bank Commissioner has played a role in this federal criminal action. The charges alleging that the Plains State Bank employees failed to file SAR reports for activity conducted 2011-2014 were dropped in this case.

- **Please describe other criminal and civil lawsuits that occurred during your tenure as Commissioner.**

The OSBC is currently involved in an ongoing case filed in 2008 resulting from the actions of a previous Bank Commissioner as described below.

Columbian Financial Corporation v. Bowman, in her official capacity as Bank Commissioner of Kansas, et al.

Columbian Bank and Trust Company was a state-chartered bank regulated by the OSBC. On August 22, 2008, the then-Kansas Bank Commissioner declared the bank insolvent and appointed the FDIC as receiver due to a liquidity failure. Shortly thereafter, Columbian Financial Corporation, as the sole shareholder of Columbian Bank and Trust Company, began litigating the Declaration of Insolvency and Tender of Receivership in state and federal courts. Most recently, Columbian Financial Corporation filed in the District Court of Kansas alleging violations of 42 U.S.C. § 1983 by the Bank Commissioner of Kansas in the Commissioner's official capacity. Due to being appointed as the Bank Commissioner of Kansas, I was substituted as a defendant in this official capacity on September 18, 2017.

In 2008, Columbian Financial Corporation alleged that the Bank Commissioner in his official capacity denied Columbian Bank and Trust Company and Columbian Financial Corporation due process by declaring the bank insolvent, seizing the bank's assets and not providing adequate constitutional protections and remedies before and after the declaration and seizure. The allegations contained in the suit arise from the actions of the former Bank Commissioner who made the decision to close the bank. On November 21, 2017, I, in my capacity as Bank Commissioner, filed a motion for summary judgement and alterative motion for judgment on the pleadings based on the doctrinal bars of res judicata and collateral estoppel alleging Columbian Financial Corporation had a full and fair opportunity to litigate these allegations in an administrative hearing and judicial review in the Kansas court system. On May 17, 2018, the

District Court of Kansas granted the Commissioner's motion for summary judgement and dismissed the case finding the previous state proceedings did not fall below the minimum procedural requirements of the Due Process Clause. As of this writing, Columbian Financial Corporation has not filed an appeal.

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Affinity Financial Corp., Newport Beach, California, and Waterfield Financial Services, Inc., Indianapolis, Indiana	C&D Order	Safety and Soundness	6/13/2016
Agricultural Bank of China, Beijing, Peoples Republic of China, and Agricultural Bank of China New York Branch, New York, New York	C&D Order	BSA/AML	9/28/2016
Allied Bank, Mulberry, Arkansas	PCA	Safety and Soundness	8/15/2016
Banco Bilbao Vizcaya Argentaria S.A., Bilbao, Spain, and BBVA Securities, Inc., New York, New York	$27,000,000 CMP	Safety and Soundness	12/21/2016
Bank & Trust, S.S.B., Del Rio, Texas	C&D Order	BSA/AML	8/18/2017
Bank of America Corp., Charlotte, North Carolina	C&D Order & $205,000,000 CMP	FX	5/20/2015
Bank of Fayette County, Piperton, Tennessee	$12,000 CMP	Flood Insurance	4/26/2018
Bank of Gueydan, Gueydan, Louisiana	$7,000 CMP	Flood Insurance	10/6/2017
Bank of Monroe, Union, West Virginia	$28,640 CMP	Flood Insurance	11/23/2015
Bank of New York Mellon Corp., New York, New York	$3,000,000 CMP	Safety and Soundness	6/27/2017
Bank of Nova Scotia, Toronto, Canada, and Bank of Nova Scotia New York Agency, New York, New York	Written Agreement	BSA/AML	11/5/2015
Bank of Star City, Star City, Arkansas	$11,000 CMP	Flood Insurance	3/27/2017
Bank of the Orient, San Francisco, California	C&D Order	BSA/AML	6/17/2015
Barclays Bank plc, London, England, and Barclays Bank plc New York Branch, New York, New York	C&D Order & $342,000,000 CMP	FX	5/20/2015
BB&T Corp., Winston-Salem, North Carolina	C&D Order	BSA/AML	1/25/2017
BCBank, Inc., Philippi, West Virginia	$5,000 CMP	Flood Insurance	6/1/2015
BNP Paribas S.A., Paris, France, and BNP Paribas USA, Inc., New York, New York, and BNP Paribas Securities Corp., New York, New York	C&D Order & $246,375,000 CMP	FX	7/17/2017

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Calumet County Bank, Brillion, Wisconsin	Written Agreement	Safety and Soundness	12/17/2015
Cecil Bank, Elkton, Maryland	PCA	Safety and Soundness	8/7/2015
Chicago Shore Corp., Chicago, Illinois, and Security Chicago Corp., Chicago, Illinois	Written Agreement	Safety and Soundness	10/28/2016
China Construction Bank Corp., Beijing, People's Republic of China, and China Construction Bank New York Branch, New York, New York	Written Agreement	BSA/AML	7/16/2015
CIT Group, Inc., Livingston, New Jersey	$5,200,000 CMP	Mortgage Servicing	1/12/2018
Citigroup Inc., New York, New York	C&D Order & $342,000,000 CMP	FX	5/20/2015
Clear Mountain Bank, Bruceton Mills, West Virginia	$14,000 CMP	Flood Insurance	2/12/2018
CommerceWest Bank, Irvine, California	C&D Order	BSA/AML	4/12/2016
Commerzbank AG, Frankfurt am Main, Germany	C&D Order & $200,000,000 CMP	BSA/AML and OFAC	3/12/2015
Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A., Utrecht, Netherlands, and Rabobank Nederland New York Branch, New York, New York	Written Agreement	BSA/AML	6/30/2015
Covenant Bancgroup, Inc., Leeds, Alabama	Written Agreement	Safety and Soundness	12/28/2015
Credit Agricole S.A., Paris, France	C&D Order & $90,300,000 CMP	OFAC	10/19/2015
Customers Bank, Phoenixville, Pennsylvania	C&D Order & $960,000 CMP	FTC Act	12/2/2016
Deutsche Bank AG, Frankfurt am Main, Germany	C&D Order & $19,710,000 CMP	Volcker	4/20/2017
Deutsche Bank AG, Frankfurt am Main, Germany	C&D Order & $58,000,000 CMP	OFAC	11/4/2015
Deutsche Bank AG, Frankfurt am Main, Germany, and DB USA Corp., New York, New York, and Deutsche Bank AG New York Branch, New York, New York	C&D Order & $136,950,000 CMP	FX	4/20/2017

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Deutsche Bank AG, Frankfurt am Main, Germany, and DB USA Corp., New York, New York, and Deutsche Bank AG New York Branch, New York, New York, and Deutsche Bank Trust Company Americas, New York, New York	C&D Order & $41,000,000 CMP	BSA/AML	5/26/2017
Discover Financial Services, Riverwoods, Illinois	Written Agreement	BSA/AML	5/26/2015
East West Bank, Pasadena, California	Written Agreement	BSA/AML	11/9/2015
Everbank Financial Corp, Jacksonville, Florida	$1,800,000 CMP	Mortgage Servicing	6/8/2017
Farmers & Merchants Bank of Ashland, Ashland, Nebraska	$6,200 CMP	Flood Insurance	4/26/2016
Farmers State Bank, Victor, Montana	$12,000 CMP	Flood Insurance	10/6/2017
Fayette County Bank, St. Elmo, Illinois	Written Agreement	Safety and Soundness	6/22/2015
Fayette County Bank, St. Elmo, Illinois	PCA	Safety and Soundness	10/31/2016
Federal One Holdings, LLC, Milton, Massachusetts, and Admirals Bancorp, Inc., Boston, Massachusetts	Written Agreement	Safety and Soundness	7/28/2017
First Bankshares, Inc., Barboursville, West Virginia	Written Agreement	Safety and Soundness	8/8/2016
First Community Bank, Glasgow, Montana	$27,285 CMP	Flood Insurance	5/11/2016
First Iowa State Bank, Keosauqua, Iowa	$7,500 CMP	Flood Insurance	6/1/2015
First Nebraska Bank, Valley, Nebraska	$55,500 CMP	Flood Insurance	9/13/2017
First State Bank of Colorado, Hotchkiss, Colorado	$9,285 CMP	Flood Insurance	9/18/2015
Four Oaks Bank & Trust Company, Four Oaks, North Carolina	Written Agreement	Safety and Soundness	7/30/2015
Freedom Bank of Virginia, Fairfax, Virginia	$2,100 CMP	Flood Insurance	5/11/2015
Goldman Sachs Bank USA, New York, New York	$90,000 CMP	Flood Insurance	1/12/2018
Goldman Sachs Group, Inc., New York, New York, and Goldman Sachs Bank USA, New York, New York	$14,000,000 CMP	Mortgage Servicing	1/12/2018

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Goldman Sachs Group, Inc., New York, New York, and Goldman, Sachs & Co. New York, New York	C&D Order & $36,300,000 CMP	Safety and Soundness	8/2/2016
Goldman Sachs Group, Inc., New York, New York	C&D Order & $54,750,000 CMP	FX	5/1/2018
Habib Bank Limited, Karachi, Pakistan, and Habib Bank Limited New York Branch, New York, New York	C&D Order	BSA/AML	12/11/2015
Hazard Bancorp, Hazard, Kentucky, and Peoples Bank and Trust Company of Hazard, Hazard, Kentucky	Written Agreement	Safety and Soundness	3/3/2016
Heartland Bank, Little Rock, Arkansas	PCA	Safety and Soundness	8/15/2017
Higher One, Inc., New Haven, Connecticut	C&D Order & $2,231,250 CMP & $24,000,000 Restitution	FTC Act	12/23/2015
HSBC Holdings plc, London, England, and HSBC North America Holdings Inc., New York, New York	C&D Order & $175,296,000 CMP	FX	9/29/2017
HSBC North America Holdings, Inc., New York, New York, and HSBC Finance Corp., Mettawa, Illinois	$131,000,000 CMP	Mortgage Servicing	2/5/2016
Hua Nan Commercial Bank Ltd., Taipei City, Taiwan, and Hua Nan Commercial Bank Ltd., New York Agency, New York, New York	C&D Order	BSA/AML	4/19/2018
Independent Bank, Grand Rapids, Michigan	$56,205 CMP	Flood Insurance	8/27/2015
Industrial and Commercial Bank of China Ltd., Beijing, People's Republic of China, Industrial, and Commercial Bank of China Ltd. New York Branch, New York, New York	C&D Order	BSA/AML	3/12/2018
Industrial Bank of Korea, Seoul, South Korea, and Industrial Bank of Korea New York Branch, New York, New York	Written Agreement	BSA/AML and OFAC	2/24/2016
JPMorgan Chase & Co., New York, New York	C&D Order & $342,000,000 CMP	FX	5/20/2015
JPMorgan Chase & Co., New York, New York	C&D Order & $61,932,500 CMP	Safety and Soundness	11/17/2016
Liberty Bank, South San Francisco, California	Written Agreement	BSA/AML	8/5/2016
Markesan State Bank, Markesan, Wisconsin	Written Agreement	Safety and Soundness	9/8/2017
Mega International Commercial Bank Co., Ltd., Taipei, Taiwan	C&D Order & $29,000,000 CMP	BSA/AML	1/17/2018

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Mesquite Financial Services, Inc., Alice, Texas	Written Agreement	Safety and Soundness	7/6/2017
Mid America Bank and Trust Company, Dixon, Missouri	C&D & $5,000,000 Restitution	FTC Act	10/26/2017
Morgan Stanley, New York, New York	$8,000,000 CMP	Mortgage Servicing	1/12/2018
National Bank of Pakistan, Karachi, Pakistan, and National Bank of Pakistan, New York Branch, New York, New York	Written Agreement	BSA/AML	3/14/2016
NongHyup Bank, Seoul, South Korea, and NongHyup Bank, New York Branch, New York, New York	Written Agreement	BSA/AML	1/17/2017
OSB Community Bank, Brooklyn, Michigan	Written Agreement	Safety and Soundness	7/30/2015
Peoples Bank, Lawrence, Kansas	C&D & $2,800,000 Restitution	FTC Act	11/28/2017
Platte Valley Bank, Scottsbluff, Nebraska	$33,785 CMP	Flood Insurance	3/6/2017
PNC Financial Services Group, Inc., Pittsburgh, Pennsylvania	$3,500,000 CMP	Mortgage Servicing	1/12/2018
Raton Capital Corp., Raton, New Mexico	Written Agreement	Safety and Soundness	7/10/2015
Rock Bancshares, Inc., Little Rock, Arkansas, and Heartland Bank, Little Rock, Arkansas	Written Agreement	Safety and Soundness	12/13/2016
Royal Bank of Scotland, Edinburgh, Scotland, and RBS Securities Inc., Stamford, Connecticut	C&D Order & $274,000,000 CMP	FX	5/20/2015
Santander Holdings USA, Inc. Boston, Massachusetts, and Santander Consumer USA, Inc., Dallas, Texas	Written Agreement	Safety and Soundness	3/21/2017
Santander Holdings USA, Inc. Boston, Massachusetts	Written Agreement	Safety and Soundness	7/2/2015
Seaway Bancshares, Inc., Chicago, Illinois	Written Agreement	Safety and Soundness	6/24/2015
ServiceLink Holdings, LLC, Jacksonville, Florida	$65,000,000 CMP	Mortgage Servicing	1/23/2017
Société Générale S.A., Paris, France, and Société Générale New York Branch, New York, New York	C&D Order	BSA/AML	12/14/2017

Appendix A Federal Reserve Enforcement Actions
Jan. 2015 - May 2018

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
State Street Corp., Boston, Massachusetts, and State Street Bank and Trust Company, Boston, Massachusetts	Written Agreement	BSA/AML	5/28/2015
SunTrust Bank, Atlanta, Georgia	$1,501,000 CMP	Flood Insurance	5/24/2017
Tri-County Bank, Brown City, Michigan	$5,000 CMP	Flood Insurance	11/18/2015
Truxton Trust Company, Nashville, Tennessee	$11,285 CMP	Flood Insurance	4/29/2015
U.S. Bancorp, Minneapolis, Minnesota	$4,400,000 CMP	Mortgage Servicing	1/12/2018
U.S. Bancorp, Minneapolis, Minnesota and USB Americas Holding Co., Minneapolis, Minnesota	C&D Order & $15,000,000 CMP	BSA/AML and OFAC	2/14/2018
UBS AG, Zurich, Switzerland, and UBS AG Stamford Branch, Stamford, Connecticut	C&D Order & $342,000,000 CMP	FX	5/20/2015
Wayne Bank and Trust Company, Cambridge City, Indiana	$23,000 CMP	Flood Insurance	10/31/2017
Wells Fargo, San Francisco, California	C&D Order	Safety and Soundness	2/2/2018

Committee on Banking, Housing, and Urban Affairs
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May 15, 2018

Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Cortez Masto:

Community Reinvestment Act

- Should CRA be expanded to all non-banks? Some assert that in today's financial landscape, CRA compliance should be expanded to all non-banks, including credit unions, fintechs, mortgage companies, investment, and others.

- Do you support a full scope review for CRA exams? Do you think geographical assessment areas should define CRA accountability both where the majority of branch lending and the majority of non-branch lending occurs?

- If a fair lending exam detects a violation after a bank has been graded for its CRA exam, do you think the bank should receive a retroactive downgrade?

Many Democratic, Republican and Independent current and former regulatory officials raising concerns about the bank deregulation bill range from former Fed Chair Paul Volcker, former Fed governor and Deputy Treasury Secretary Sarah Bloom Raskin, former FDIC Chair Sheila Bair, former Counselor to the Treasury Secretary Antonio Weiss, and former Deputy Governor of the Bank of England Paul Tucker. These former banking regulators either state that a $250 billion bank threshold is too high to protect financial stability or that we should not weaken the leverage rules for the largest banks, or both.

Do you think anything in S. 2155 puts the financial system at risk? Do you share the concerns raised by your predecessors? If so, why? If not, why not?

CRA regulations establish different CRA exams for banks with different asset levels. Small banks, those with less than $307 million in assets, have the most streamlined exam that consists of only a lending test. Intermediate small banks (ISB), those with assets of $307 million to $1.226 billion, have exams that consist of a lending test and a community development (CD) test. The CD test assesses the level of CD lending and investing for affordable housing, economic development, and community facilities. Large banks, those with assets above $1.2 billion, have the most complex exams which consist of a lending test, an investment test, and a service test.

- It is my understanding that your bank qualified as a small bank, so it had a streamlined exam focused on lending only. In your response to my question on what it would take for your bank to earn an outstanding rating instead of a satisfactory rating, you stated you found the exam guidelines unclear. Please identify where you feel CRA guidelines for small banks are unclear.[3]

[3] CRA Examination Procedures Overview: Available at: https://www.ffiec.gov/cra/pdf/cra_exsmall.pdf

Chair Yellen was the first chair in Federal Reserve history to share data with this committee about racial economic disparities during her semi-annual testimony. When she presented that data, she touted significant progress, and indeed, black unemployment fell from 11.8% at the beginning of her term to the current historically low figure of 6.9%.

- What do you attribute this trend to? Do you think the attention that Janet Yellen paid to this issue and the policies of the Federal Reserve deserve credit for the progress that has been made?

At that same testimony where Janet Yellen presented information about racial economic disparities, she said, quote "it is troubling that unemployment rates for these minority groups remain higher than for the nation overall, and that the annual income of the median African-American household is still well below the median income of other U.S. households."

- Though African American unemployment is lower today, Chair Yellen's point remains true. Do you think the recent progress is sufficient? What more can be done to ensure that unemployment among African Americans is equal to white unemployment? In addition to increasing employment rates for African Americans, what can the Fed do to increase wages and wealth for African Americans and Latinos?

Marvin Goodfriend, another nominee to the Federal Reserve Board of Governors has urged the Federal Reserve to incent spending by placing a tax on currency.[4]

- Do you support Mr. Goodfriend's proposal to tax currency kept outside of circulation?

- If Mr. Goodfriend's proposal were to be implemented, can you estimate what the impact would be on savers and low-income depositors?

The Consumer Financial Protection Bureau has endured new leadership that is hostile to its mission. A number of enforcement actions aimed at helping people receive redress from fraud or overcharges has been stopped.

- If the Consumer Financial Protection Bureau's leadership refuses to ask for adequate funding or takes steps that you think are harmful to people or our economy, will you let Senate Banking Committee members know? If so, how? If not, why not?

- The Federal Reserve retains supervision and enforcement authority for financial institutions below $10 billion in assets. Please provide a list of public enforcement actions taken towards any Fed-regulated institutions in the past three years. Please note any fines or penalties assessed. Please note if you agree or disagree with these enforcement actions.

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[4] Goodfriend, Marvin. "The Case for Unencumbering Interest Rate Policy at the Zero Bound." Carnegie Mellon University. September 15, 2015. Available at: https://www.kansascityfed.org/~/media/files/publicat/sympos/2016/econsymposium-goodfriend-paper.pdf

Some current Federal Reserve leaders support reducing banks' capital requirements. This concerns me as capital requirements have been a key tool in restoring the safety of the financial system since the crisis. Ensuring modest leverage ratios prevents banks from lending out more than they can afford to, and especially keeps them away from riskier assets like the ones that fueled the crisis.

- For this reason, Democrats and Republicans in the House and Senate, as well as FDIC Vice Chair (and former Kansas City Fed President) Thomas Hoenig all support higher capital requirements, not lower ones. Do you support any changes to the current capital requirements for financial institutions? If so, please describe.

In recent years, Federal Reserve policymakers have warned that we should raise interest rates to counter asset bubbles destabilizing the financial system. Board of Governor Nominee Marvin Goodfriend has suggested replacing liquidity coverage ratios and a host of other regulations with tighter monetary policy.[5]

- Do you believe that the blunt tool of monetary policy can be a substitute for sound financial protections? What is your understanding of the historical evidence surrounding the relationship between monetary policy and asset bubbles?

- Besides monetary policy, what other tools are available to temper asset bubbles?

In the years since the financial meltdown, the Federal Reserve has played a key role in putting our economy back on stable footing and setting the conditions for more robust growth. Still, there have been bills introduced that would eliminate the Fed's full employment mandate on the basis that, according to the bill's findings "at best, the Federal Reserve may temporarily increase the level of employment through monetary policy."

- Can you elaborate on how the Fed influences employment in the short-run, and discuss whether failure to use monetary policy effectively in the face of severe downturns could do permanent damage to the level of unemployment in the economy?

Critics of quantitative easing have argued that it is incompatible with the Fed's price stability mandate; however in discussing quantitative easing the Fed has consistently noted that the program is designed to promote a stronger pace of economic growth and to ensure that inflation, over time, is at levels consistent with the Fed's mandate.

- Can you comment on how the Fed's policies in recent years have actually supported the Fed's price stability mandate?

- What does the latest research tell us about the effectiveness of the Fed's large scale asset purchases?

[5] Senate Committee on Banking, Housing and Urban Affairs, June 7, 2016 Hearing. Available at: https://www.gpo.gov/fdsys/pkg/CHRG-114shrg21603/pdf/CHRG-114shrg21603.pdf

- Is there any evidence that the Fed's asset-purchase program, which sought to support the economy by lowering long-term interest rates, has been a drag on U.S. productivity as some Republicans have suggested? Is there any evidence that the program has created a "false economy" as Trump has asserted?

- How would the economy have likely fared in terms of unemployment, GDP, wage growth, etc. had the Fed chosen not to pursue its asset purchase program?

- Is there any evidence that the Fed's stimulus program has paved the way for the next global meltdown, as Trump claimed?

- How does the Fed's balance sheet as a percentage of GDP compare with the balance sheets of the next largest economies? Do these countries have a dual mandate similar to the Fed?

It is my understanding that major central banks around the world maintain and have drawn on their authority to purchase a wide range of assets including corporate bonds, commercial paper, real estate investment trusts, and equities among other assets.

- Given the broad authorities available to other central banks, rather than shrink the Fed's tool kit, do you think Congress should consider expanding it?

- For example, with an expanded authority, could the Fed play a useful role in supporting municipal finance, student loan financing or other types of consumer credit during periods where each of these sectors experienced heightened distress? Would you support or oppose such expansion of the Fed's authority?

- As the Fed begins to shrink its balance sheet, what are some of the negative impacts that Senate Banking Committee members should monitor? What concerns – if any – do you have about shrinking the balance sheet? What will you do to monitor the process of maturing securities to avoid a negative impact on the economy?

Ms. Bowman, in your testimony, you stated, "the regulatory environment created in the aftermath of the crisis has disadvantaged community banks. If confirmed, I will bring this perspective to my work at the Board to ensure that rules preserve the resiliency of the financial system, but are appropriately tailored to the size, complexity, and risk of an institution."

As you know, the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) rules are tailored so larger banks have higher standards than smaller banks. Of the 14 "major" rules issued by banking regulators pursuant to the Dodd-Frank Act, 13 either include an exemption for small banks or are tailored to reduce the cost for small banks to comply. Supervision and enforcement are also structured to pose less of a burden on smaller banks than they do on larger banks, such as by requiring less frequent bank examinations for certain small banks.

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- Please explain which rules you think "have disadvantaged community banks?" Please explain which rules you think should be changed and how?

- Do you think community banks, those with less than $2 billion in assets, should follow federal consumer protection rules?

- Do you think community banks should comply with the requirement that loans should be made to people who can repay them? This is called the "know before you owe" rule. Community banks are largely exempt from both mortgage origination and servicing rules because they are small creditors with less than $2 billion in assets or service fewer than 500 loans.

- Rules protecting people who send remittances apply to any financial institution that sends more than 100 remittances a year. Do you support changes to Regulation E/Electronic Fund Transfers? If so, how would you change this rule?

- Dodd Frank limited compensation requirements for loan originators to prevent steering to high-cost loans. Only originators that make fewer than 10 loans in a 12-month period are exempt. Do you support changes to the Loan Originator Compensation Requirements (Regulation Z)?

- Mortgage Servicing Rules under Regulation X and Z are designed to protect homebuyers from high-cost loans. Servicers with fewer than 5,000 mortgage loans are exempted from some of these rules. What changes do your recommend to Regulations X and/or Z?

- Do you think banks that make more than 25 mortgage loans should share the loan and borrower characteristics through the Home Mortgage Disclosure Act database?

- Banks with assets under $50 billion are not required to comply with the liquidity coverage ratio. Do you think they should be? Why or why not?

- Banks with assets under $250 billion are not required to comply with regulatory capital rules. Do you think they should be? Why or why not?

- The Volcker rule which prohibits proprietary trading applies to all banks but has streamlined policies and procedures for banks with less than $10 billion in assets. Do you think banks under a certain size should be allowed to invest in hedge funds and private equity funds on their own behalf? Do you think the Volcker Rule should not apply to banks under a certain size?

- Collateralized debt obligations backed by Trust Preferred Securities are restricted. Do you think banks under a certain size that hold CDO-TruPs should not have to comply with restrictions?

- Debit card interchange fees and routing requirements do not apply to banks that have fewer than $10 billion in assets. Do you think banks under this size should comply with interchange fees and routing requirements?

Let me ask you about other regulations that apply to banks but were not enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

- Do you think the "primary duty" of a bank's board of directors is "to ensure the bank operates in a safe and sound manner"?

- Do you have recommendations for changes to the Bank Secrecy or Anti-Money Laundering rules?

In 2017, when you served as the Banking Commissioner of Kansas, George and Agatha Enns conspired with Plains State Bank employees to launder money. The Enns were sentenced to three years of probation and forfeited nearly $2 million in ill-gotten gains.

- What was the Enns' crimes? What was the role of the Kansas Banking Commission and your role personally in this investigation and lawsuit?

- Please describe other criminal and civil lawsuits that occurred during your tenure as Commissioner.

May 30, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 15, 2018[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Rich Cordray

Enclosure

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[1] Questions for the record related to this hearing were received on May 23, 2018.

<u>Questions for Mr. Richard Clarida, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Cortez Masto:</u>

1. Community Reinvestment Act

- **Should CRA be expanded to all non-banks? Some assert that in today's financial landscape, CRA compliance should be expanded to all non-banks, including credit unions, fintechs, mortgage companies, investment, and others.**

The Community Reinvestment Act (CRA) has been a part of banking regulation for 40 years. It would be a very high priority of mine, if confirmed, to make sure that it is enforced.

I support the CRA's goal of encouraging banks to meet their affirmative obligation to serve their entire community, and in particular, the credit needs of low-and moderate-income communities. Doing so benefits low-and moderate-income communities and helps them to thrive by providing opportunities for community members, for example, to buy and improve their homes and to start and expand small businesses.

If confirmed, I would be open-minded to discussions for improving or bringing the CRA up to date, but the essential mission of the act needs to be respected.

- **Do you support a full scope review for CRA exams? Do you think geographical assessment areas should define CRA accountability both where the majority of branch lending and the majority of non-branch lending occurs?**

It is important that the agencies with rule writing authority for CRA (the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency) evaluate ways to provide a meaningful evaluation of a bank's CRA activities in all of the communities it serves. I understand that the agencies are considering ways to make the area in which CRA performance is evaluated more reflective of current banking practices, and I support that effort.

- **If a fair lending exam detects a violation after a bank has been graded for its CRA exam, do you think the bank should receive a retroactive downgrade?**

Discriminatory and other illegal credit practices are inconsistent with helping to meet community credit needs. I can understand why regulators would want to take into account banks' records in fair lending when evaluating their performance in the spirit of community reinvestment. What would seem to be important is that there is clarity in the application and the implications of the ratings on a bank's supervisory record, particularly if the timing of the examinations are different.

2. Many Democratic, Republican and Independent current and former regulatory officials raising concerns about the bank deregulation bill range from former Fed Chair Paul Volcker, former Fed governor and Deputy Treasury Secretary Sarah Bloom Raskin, former FDIC Chair Sheila Bair, former Counselor to the Treasury Secretary Antonio Weiss, and former Deputy Governor of the Bank of England Paul Tucker. These former banking regulators either state that a $250 billion bank threshold is too high to protect

financial stability or that we should not weaken the leverage rules for the largest banks, or both.

- **Do you think anything in S. 2155 puts the financial system at risk? Do you share the concerns raised by your predecessors? If so, why? If not, why not?**

Regulation and supervision should continue to be tailored to firms' size, systemic footprint, and risk profiles. I believe that it was prudent for the Congress to raise the $50 billion asset threshold for larger bank holding companies in order to limit the scope of enhanced prudential standards. As I understand the Economic Growth, Regulatory Relief, and Consumer Protection Act, it adjusts thresholds but still allows the Federal Reserve to subject a firm with a higher risk profile to more rigorous regulation.

3. There are a number of places in S. 2155 that would require the Federal Reserve to conduct additional cost-benefit analysis in order to regulate big banks.

- **Mr. Clarida, you have said that the Federal Reserve underestimated the human costs of the financial crisis prior to 2008? What have you learned from your previous analytic mistakes? How will you ensure you will not repeat those previous errors?**

The financial crisis and its effect on the economy clearly harmed millions of Americans who lost their jobs, their homes, their savings, access to credit, etc. The crisis served as a cautionary tale about the critical importance of a resilient financial system that supports economic growth and meets the credit needs of businesses and consumers. I believe this experience underpinned much of the post-crisis regulatory agenda, and if I were to be confirmed, I would certainly keep the importance of financial stability firmly in mind as a policymaker.

4. Chair Yellen was the first chair in Federal Reserve history to share data with this committee about racial economic disparities during her semi-annual testimony. When she presented that data, she touted significant progress, and indeed, black unemployment fell from 11.8% at the beginning of her term to the current historically low figure of 6.9%.

- **What do you attribute this trend to? Do you think the attention that Janet Yellen paid to this issue and the policies of the Federal Reserve deserve credit for the progress that has been made?**

The unemployment rate of African-Americans has historically been more cyclical than the unemployment rate for the economy as a whole. It deteriorates more when the economy goes into a recession and improves more during expansions. Thus, the current historically low level of the African-American unemployment rate is a function of the long economic expansion our country is currently experiencing. The efforts of the Federal Open Market Committee (FOMC) to achieve its dual mandate have likely contributed to the strong overall macroeconomic performance, although many other factors have also contributed. With respect to the attention paid by former Chair Janet Yellen and the FOMC in recent years to racial economic disparities, I would say that understanding the heterogeneity in how different groups in the economy fare can help to improve our understanding of the economy as a whole. That said, the tools available to monetary policymakers are not designed to ameliorate long-standing economic disparities.

5. At that same testimony where Janet Yellen presented information about racial economic disparities, she said, quote "it is troubling that unemployment rates for these minority groups remain higher than for the nation overall, and that the annual income of the median African-American household is still well below the median income of other U.S. households."

- **Though African American unemployment is lower today, Chair Yellen's point remains true. Do you think the recent progress is sufficient? What more can be done to ensure that unemployment among African Americans is equal to white unemployment? In addition to increasing employment rates for African Americans, what can the Fed do to increase wages and wealth for African Americans and Latinos?**

I have been heartened to see that, as you note, the steady macroeconomic performance of recent years has measurably improved employment and income among African-American households. That said, I believe more progress could be made. However, the tools that the Federal Reserve has at its disposal are not designed for ameliorating long-standing economic disparities. The main way in which the Federal Reserve can contribute is by promoting a healthy and stable economy, which will provide economic opportunity for a broad range of households. Moreover, to the extent allowed by law, the Federal Reserve can also use its regulatory and supervisory role to ensure that African-Americans have equal access to credit and the financial system so as to promote their economic well-being. In addition, the Federal Reserve produces a variety of datasets and research that can help inform our understanding of the economy and policies that could be undertaken by those outside of the Federal Reserve System to help close the gap between African-Americans and other U.S. households.

6. Marvin Goodfriend, another nominee to the Federal Reserve Board of Governors has urged the Federal Reserve to incent spending by placing a tax on currency.[1]

- **Do you support Mr. Goodfriend's proposal to tax currency kept outside of circulation?**

I am very skeptical that a tax on currency could be justified as a tool of monetary policy.

- **If Mr. Goodfriend's proposal were to be implemented, can you estimate what the impact would be on savers and low-income depositors?**

I do not have such an estimate, as I have not undertaken research on this topic.

7. The Consumer Financial Protection Bureau has endured new leadership that is hostile to its mission. A number of enforcement actions aimed at helping people receive redress from fraud or overcharges has been stopped.

- **If the Consumer Financial Protection Bureau's leadership refuses to ask for adequate funding or takes steps that you think are harmful to people or our**

[1] Goodfriend, Marvin. "The Case for Unencumbering Interest Rate Policy at the Zero Bound." Carnegie Mellon University. September 15, 2015. Available at: https://www.kansascityfed.org/~/media/files/publicat/sympos/2016/econsymposium-goodfriend-paper.pdf.

economy, will you let Senate Banking Committee members know? If so, how? If not, why not?

I understand that the Federal Reserve Board (Board) plays a consultative role in Consumer Financial Protection Bureau (CFPB) rulemakings and coordinates in the examinations as appropriate, but does not have any oversight of the CFPB organizational or structural design, nor of CFPB enforcement priorities.

If confirmed, I would support efforts to collaborate with the CFPB, while supporting the Federal Reserve's efforts to continue to carry out supervisory and enforcement responsibilities for the financial institutions, and for the laws and regulations under its authority to comply with all applicable federal consumer protection laws and regulations.

- **The Federal Reserve retains supervision and enforcement authority for financial institutions below $10 billion in assets. Please provide a list of public enforcement actions taken towards any Fed-regulated institutions in the past three years. Please note any fines or penalties assessed. Please note if you agree or disagree with these enforcement actions.**

Although I cannot comment on the specific circumstances of actions the Federal Reserve has taken in the past, I believe bank supervisors have a responsibility to ensure that the institutions subject to supervision operate safely and soundly and that they comply with applicable statutes and regulations, and furthermore, that the Federal Reserve should use its formal enforcement authority to achieve these objectives where appropriate. A list of public enforcement actions taken against institutions regulated by the Federal Reserve in the past three years, including any civil money penalties assessed against the institution, is provided in appendix A to this request.

8. Some current Federal Reserve leaders support reducing banks' capital requirements. This concerns me as capital requirements have been a key tool in restoring the safety of the financial system since the crisis. Ensuring modest leverage ratios prevents banks from lending out more than they can afford to, and especially keeps them away from riskier assets like the ones that fueled the crisis.

- **For this reason, Democrats and Republicans in the House and Senate, as well as FDIC Vice Chair (and former Kansas City Fed President) Thomas Hoenig all support higher capital requirements, not lower ones. Do you support any changes to the current capital requirements for financial institutions? If so, please describe.**

The financial crisis demonstrated the importance of a financial system that has sufficient capital to absorb losses and allow banks to continue lending in an economic downturn. Since the crisis, the U.S. banking agencies have strengthened and improved the quality of the regulatory capital requirements for U.S. banking firms. However, I believe the banking agencies should continue to examine whether the requirements remain effective over time and adjust the framework as appropriate while preserving the essential gains in resiliency and stability of our financial system that have resulted from the reforms put in place since the financial crisis.

9. In recent years, Federal Reserve policymakers have warned that we should raise interest rates to counter asset bubbles destabilizing the financial system. Board of Governor Nominee Marvin Goodfriend has suggested replacing liquidity coverage ratios and a host of other regulations with tighter monetary policy.[2]

- **Do you believe that the blunt tool of monetary policy can be a substitute for sound financial protections? What is your understanding of the historical evidence surrounding the relationship between monetary policy and asset bubbles?**

Monetary policy, which is already tasked with the goals of price stability and full employment, should not be considered a substitute for strong financial and supervisory standards. Such standards are critical for ensuring stability of the U.S. financial system. The excessive leverage and maturity transformation in place in 2007 left the economy vulnerable to a deterioration in the housing market and an increase in investor concerns regarding the solvency and liquidity of large, interconnected financial institutions.

Reforms since that time, enacted by Congress and implemented by the appropriate agencies, have raised loss-absorbing capacity within the financial sector and reduced the susceptibility of the financial system to destabilizing runs.

Of course, gaps exist in financial regulation, and some institutions, like hedge funds and many finance companies, largely fall outside of the prudential regulatory perimeter. Therefore, changes in interest rates could at times be appropriate as a supplementary tool to address threats to full employment and price stability emanating from widespread imbalances or buildups of risk in areas where more-targeted tools are inadequate or nonexistent.

Asset-price swings owe to many factors, and monetary policy has not generally been a prime factor in historical episodes involving large increases in asset prices. Run-ups in asset prices that are not supported by economic fundamentals usually involve an increased tolerance for risk or a decreased perception of risk.

- **Besides monetary policy, what other tools are available to temper asset bubbles?**

It is always difficult to judge whether the price of an asset has reached an unsustainable level, particularly in real time. That said, it is important for the appropriate authorities, including the Federal Reserve, to monitor asset price developments and to consider whether, for example, unusually rapid increases in asset prices are leading to vulnerabilities that could jeopardize the efficient functioning of the financial system, price stability, or full employment.

The difficulties associated with detecting asset bubbles as they emerge highlight the need for strong and appropriately tailored regulatory and supervisory standards at all times. Negative shocks, including asset price declines, the sudden failure of a major financial institution and so forth are always possible. The core capital and liquidity regulations and supervisory policies

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[2] Senate Committee on Banking, Housing, and Urban Affairs, June 7, 2016 Hearing. Available at: https://www.gpo.gov/fdsys/pkg/CHRG-114shrg21603/pdf/CHRG-114shrg21603.pdf.

adopted by the Federal Reserve, including stricter standards for the most systemic firms, are, in my view, consistent with a view that the system should be resilient to such shocks.

10. In the years since the financial meltdown, the Federal Reserve has played a key role in putting our economy back on stable footing and setting the conditions for more robust growth. Still, there have been bills introduced that would eliminate the Fed's full employment mandate on the basis that, according to the bill's findings "at best, the Federal Reserve may temporarily increase the level of employment through monetary policy."

- **Can you elaborate on how the Fed influences employment in the short-run, and discuss whether failure to use monetary policy effectively in the face of severe downturns could do permanent damage to the level of unemployment in the economy?**

In the short run, the Federal Reserve influences employment by adjusting its target range for the federal funds rate and by influencing the expected future path of short-term interest rates through its forward guidance. These monetary policy actions affect the interest rates that many households confront when deciding whether to borrow and spend, and that businesses face when making their investment plans. Additional spending by households and businesses will, in turn, cause businesses to hire more workers to meet the higher demand for their products and services. In this way, monetary policy can be used to combat recessions and reduce the associated rise in unemployment.

11. Critics of quantitative easing have argued that it is incompatible with the Fed's price stability mandate; however in discussing quantitative easing the Fed has consistently noted that the program is designed to promote a stronger pace of economic growth and to ensure that inflation, over time, is at levels consistent with the Fed's mandate.

- **Can you comment on how the Fed's policies in recent years have actually supported the Fed's price stability mandate?**

Faced with the most severe financial crisis since the Great Depression, the FOMC cut short-term interest rates to zero by the end of 2008. In order to address the economic downturn and stem disinflationary pressures, the Federal Reserve also turned to nontraditional tools such as asset purchases and forward guidance, as means of providing the additional accommodation. These policies put downward pressure on longer-term interest rates and helped to make financial conditions more accommodative, encouraging and supporting the economic recovery. By providing a cushion for aggregate demand during the recession and supporting spending during the recovery, the Federal Reserve's monetary policy measures helped to keep inflation close to 2 percent. In particular, in part because aggregate demand was supported by monetary policy, the U.S. economy avoided the severe downward pressure on the price level that occurred during the Great Depression, which in turn prevented inflation expectations from falling sharply below 2 percent.

- **What does the latest research tell us about the effectiveness of the Fed's large scale asset purchases?**

Estimates of the effects of large-scale asset purchases vary across studies, but most suggest that asset purchases put downward pressure on term premiums and resulted in lower longer-term interest rates than would otherwise have been the case. Lower long-term interest rates, in turn, helped to support asset prices more broadly and to bolster spending on goods and services by households and businesses. That said, there are costs as well as benefits to large-scale asset purchases and certainly today I support the Federal Reserve's program to shrink its balance sheet.

- **Is there any evidence that the Fed's asset-purchase program, which sought to support the economy by lowering long-term interest rates, has been a drag on U.S. productivity as some Republicans have suggested? Is there any evidence that the program has created a "false economy" as Trump has asserted?**

I am not aware of research suggesting that the Federal Reserve's policies have contributed to the sluggish pace of productivity growth observed over recent years. Studies focusing on the slowdown in U.S. productivity growth point to various developments such as weak capital spending in the wake of the financial crisis, a slower pace of technological advance, a decline business dynamism, and a deterioration in workforce skills as factors contributing to recent productivity trends.

- **How would the economy have likely fared in terms of unemployment, GDP, wage growth, etc. had the Fed chosen not to pursue its asset purchase program?**

The Federal Reserve conducts monetary policy to promote maximum employment and stable prices. Various research studies by academic and central bank economists suggest that the Federal Reserve's asset purchase programs helped to make financial conditions more accommodative, support economic recovery, strengthen labor market conditions, and foster price stability.[3]

- **Is there any evidence that the Fed's stimulus program has paved the way for the next global meltdown, as Trump claimed?**

While there are many sources of risk and uncertainty in the global economy, the Federal Reserve's conduct of monetary policy has contributed to an improved global economic outlook by supporting the U.S. economic expansion and maintaining low and stable inflation.

- **How does the Fed's balance sheet as a percentage of GDP compare with the balance sheets of the next largest economies? Do these countries have a dual mandate similar to the Fed?**

The size of the Federal Reserve's balance sheet relative to nominal GDP currently stands at about 23 percent. Last October, the FOMC initiated its plan to normalize the size of the Federal Reserve's balance sheet. Under that plan, the size of the Federal Reserve's balance sheet will decline gradually over coming years. With nominal GDP expected to rise over that time, the size of the Federal Reserve's balance sheet relative to nominal GDP will likely decline appreciably.

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[3] See, for example, Eric M. Engen, Thomas Laubach, and David Reifschneider (2015), "The Macroeconomic Effects of the Federal Reserve's Unconventional Monetary Policies," Finance and Economics Discussion Series 2015–005, Washington: Board of Governors of the Federal Reserve System, February, http://dx.doi.org/10.17016/FEDS.2015.005.

The size of the Federal Reserve's balance sheet as a percent of GDP is smaller than those of many other major foreign central banks. The size of the central bank balance sheets relative to nominal GDP for the United Kingdom, the euro area, Japan, and Switzerland are, very roughly, about 28, 40, 100, and 120 percent, respectively. All of these central banks employed large-scale asset purchase programs to address the implications of the financial crisis in their countries.

All of these central banks operate with a single mandate to pursue price stability. However, in many cases, this mandate is treated as medium-term objective, and other goals, including output and employment stabilization and financial stability, are cited to justify deviations from price stability in the short run.

12. It is my understanding that major central banks around the world maintain and have drawn on their authority to purchase a wide range of assets including corporate bonds, commercial paper, real estate investment trusts, and equities among other assets.

- **Given the broad authorities available to other central banks, rather than shrink the Fed's tool kit, do you think Congress should consider expanding it?**

As I indicated above, I believe the FOMC's existing monetary policy toolkit--notably including forward guidance and balance sheet policies--has served the nation well and has supported the U.S. economy in the wake of the financial crisis. Currently, I do not see compelling reasons why the toolkit needs to be expanded, but I do believe that the experience of the past decade suggests the value of preserving the existing toolkit.

- **For example, with an expanded authority, could the Fed play a useful role in supporting municipal finance, student loan financing or other types of consumer credit during periods where each of these sectors experienced heightened distress? Would you support or oppose such expansion of the Fed's authority?**

The Federal Reserve conducts monetary policy to promote its statutory goals of maximum employment and stable prices. The Congress has granted the Federal Reserve authority to purchase and sell certain types of assets in pursuit of these goals. In general, the range of assets the Federal Reserve is authorized to purchase is limited to very high quality assets with minimal credit risk such as Treasury and agency securities.

The Federal Reserve's purchases of Treasury and agency securities during the crisis were effective in making financial conditions more accommodative and helping to support economic recovery and stem disinflationary pressures.

Limiting the Federal Reserve's authorities to a narrow range of very high-quality assets helps to insulate the Federal Reserve from political pressures that could undercut the effective conduct of monetary policy and result in poor macroeconomic outcomes. That theme was highlighted in the joint statement issued by the Treasury and the Federal Reserve in 2009 on "The Federal Reserve's Role in Preserving Financial and Monetary Stability."

That document noted that, "Actions taken by the Federal Reserve should also aim to improve financial or credit conditions broadly, not to allocate credit to narrowly-defined sectors or classes of borrowers. Government decisions to influence the allocation of credit are the province of the fiscal authorities."

Other central banks have the authority to purchase a broad range of assets, and have utilized these authorities in responding to the financial crisis. The Congress could consider expanding the Federal Reserve's asset purchase authorities if it wished. In doing so, the Congress would need to weigh the possible benefits of expanded purchase authorities for the Federal Reserve as a tool for addressing economic weakness versus the possible costs associated with exposing the Federal Reserve to heightened political pressures and involving the Federal Reserve in decisions involving significant credit allocation.

My own view is that the Federal Reserve's current authorities for purchasing assets have served the country well, and I do not see a compelling reason to expand those authorities.

- **As the Fed begins to shrink its balance sheet, what are some of the negative impacts that Senate Banking Committee members should monitor? What concerns – if any – do you have about shrinking the balance sheet? What will you do to monitor the process of maturing securities to avoid a negative impact on the economy?**

I believe that the FOMC's gradual approach regarding the removal of policy accommodation has supported the economy's continued expansion, the ongoing strengthening of the labor market, and a likely return to 2 percent inflation on a sustained basis.

As part of this gradual approach, the FOMC initiated its balance sheet program last October. This program will reduce the Federal Reserve's securities holdings in a gradual and predictable manner. The program has gone smoothly so far and has not given rise to any unduly large reaction of financial markets.

The FOMC has indicated that, consistent with the data dependence of monetary policy, it could change the details of its plans in light of economic and financial developments. If confirmed, I will be monitoring developments very carefully along with Board and FOMC colleagues for any signs that the normalization of the Federal Reserve's balance sheet is contributing to strains in the financial system.

In addition, if confirmed, I will advocate continued clear communication by the FOMC about its longer-term plans regarding the Federal Reserve's balance sheet.

With regard to the liabilities side of its balance sheet, the FOMC has stated that it anticipates a reduction in the quantity of reserve balances, over time, to a level appreciably below that seen in recent years but larger than that prevailing before the financial crisis. Federal Reserve officials have indicated the aggregate level of Federal Reserve liabilities will reflect the public's demand for currency, the banking system's demand for reserve balances, and the Committee's decisions about how to implement monetary policy most efficiently and effectively in the future. These statements by the FOMC and the Federal Reserve about the ultimate policymaking framework strike me as appropriate and correct.

I support the FOMC's position that, in the longer-run, it intends to hold no more securities than it will need to implement monetary policy efficiently and effectively. I believe that the Committee's expectation that the Federal Reserve's balance sheet will consist primarily of Treasury securities is appropriate and is consistent with effective and efficient monetary policy implementation.

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Affinity Financial Corp., Newport Beach, California, and Waterfield Financial Services, Inc., Indianapolis, Indiana	C&D Order	Safety and Soundness	6/13/2016
Agricultural Bank of China, Beijing, Peoples Republic of China, and Agricultural Bank of China New York Branch, New York, New York	C&D Order	BSA/AML	9/28/2016
Allied Bank, Mulberry, Arkansas	PCA	Safety and Soundness	8/15/2016
Banco Bilbao Vizcaya Argentaria S.A., Bilbao, Spain, and BBVA Securities, Inc., New York, New York	$27,000,000 CMP	Safety and Soundness	12/21/2016
Bank & Trust, S.S.B., Del Rio, Texas	C&D Order	BSA/AML	8/18/2017
Bank of America Corp., Charlotte, North Carolina	C&D Order & $205,000,000 CMP	FX	5/20/2015
Bank of Fayette County, Piperton, Tennessee	$12,000 CMP	Flood Insurance	4/26/2018
Bank of Gueydan, Gueydan, Louisiana	$7,000 CMP	Flood Insurance	10/6/2017
Bank of Monroe, Union, West Virginia	$28,640 CMP	Flood Insurance	11/23/2015
Bank of New York Mellon Corp., New York, New York	$3,000,000 CMP	Safety and Soundness	6/27/2017
Bank of Nova Scotia, Toronto, Canada, and Bank of Nova Scotia New York Agency, New York, New York	Written Agreement	BSA/AML	11/5/2015
Bank of Star City, Star City, Arkansas	$11,000 CMP	Flood Insurance	3/27/2017
Bank of the Orient, San Francisco, California	C&D Order	BSA/AML	6/17/2015
Barclays Bank plc, London, England, and Barclays Bank plc New York Branch, New York, New York	C&D Order & $342,000,000 CMP	FX	5/20/2015
BB&T Corp., Winston-Salem, North Carolina	C&D Order	BSA/AML	1/25/2017
BCBank, Inc., Philippi, West Virginia	$5,000 CMP	Flood Insurance	6/1/2015
BNP Paribas S.A., Paris, France, and BNP Paribas USA, Inc., New York, New York, and BNP Paribas Securities Corp., New York, New York	C&D Order & $246,375,000 CMP	FX	7/17/2017

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Calumet County Bank, Brillion, Wisconsin	Written Agreement	Safety and Soundness	12/17/2015
Cecil Bank, Elkton, Maryland	PCA	Safety and Soundness	8/7/2015
Chicago Shore Corp., Chicago, Illinois, and Security Chicago Corp., Chicago, Illinois	Written Agreement	Safety and Soundness	10/28/2016
China Construction Bank Corp., Beijing, People's Republic of China, and China Construction Bank New York Branch, New York, New York	Written Agreement	BSA/AML	7/16/2015
CIT Group, Inc., Livingston, New Jersey	$5,200,000 CMP	Mortgage Servicing	1/12/2018
Citigroup Inc., New York, New York	C&D Order & $342,000,000 CMP	FX	5/20/2015
Clear Mountain Bank, Bruceton Mills, West Virginia	$14,000 CMP	Flood Insurance	2/12/2018
CommerceWest Bank, Irvine, California	C&D Order	BSA/AML	4/12/2016
Commerzbank AG, Frankfurt am Main, Germany	C&D Order & $200,000,000 CMP	BSA/AML and OFAC	3/12/2015
Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A., Utrecht, Netherlands, and Rabobank Nederland New York Branch, New York, New York	Written Agreement	BSA/AML	6/30/2015
Covenant Bancgroup, Inc., Leeds, Alabama	Written Agreement	Safety and Soundness	12/28/2015
Credit Agricole S.A., Paris, France	C&D Order & $90,300,000 CMP	OFAC	10/19/2015
Customers Bank, Phoenixville, Pennsylvania	C&D Order & $960,000 CMP	FTC Act	12/2/2016
Deutsche Bank AG, Frankfurt am Main, Germany	C&D Order & $19,710,000 CMP	Volcker	4/20/2017
Deutsche Bank AG, Frankfurt am Main, Germany	C&D Order & $58,000,000 CMP	OFAC	11/4/2015
Deutsche Bank AG, Frankfurt am Main, Germany, and DB USA Corp., New York, New York, and Deutsche Bank AG New York Branch, New York, New York	C&D Order & $136,950,000 CMP	FX	4/20/2017

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Deutsche Bank AG, Frankfurt am Main, Germany, and DB USA Corp., New York, New York, and Deutsche Bank AG New York Branch, New York, New York, and Deutsche Bank Trust Company Americas, New York, New York	C&D Order & $41,000,000 CMP	BSA/AML	5/26/2017
Discover Financial Services, Riverwoods, Illinois	Written Agreement	BSA/AML	5/26/2015
East West Bank, Pasadena, California	Written Agreement	BSA/AML	11/9/2015
Everbank Financial Corp, Jacksonville, Florida	$1,800,000 CMP	Mortgage Servicing	6/8/2017
Farmers & Merchants Bank of Ashland, Ashland, Nebraska	$6,200 CMP	Flood Insurance	4/26/2016
Farmers State Bank, Victor, Montana	$12,000 CMP	Flood Insurance	10/6/2017
Fayette County Bank, St. Elmo, Illinois	Written Agreement	Safety and Soundness	6/22/2015
Fayette County Bank, St. Elmo, Illinois	PCA	Safety and Soundness	10/31/2016
Federal One Holdings, LLC, Milton, Massachusetts, and Admirals Bancorp, Inc., Boston, Massachusetts	Written Agreement	Safety and Soundness	7/28/2017
First Bankshares, Inc., Barboursville, West Virginia	Written Agreement	Safety and Soundness	8/8/2016
First Community Bank, Glasgow, Montana	$27,285 CMP	Flood Insurance	5/11/2016
First Iowa State Bank, Keosauqua, Iowa	$7,500 CMP	Flood Insurance	6/1/2015
First Nebraska Bank, Valley, Nebraska	$55,500 CMP	Flood Insurance	9/13/2017
First State Bank of Colorado, Hotchkiss, Colorado	$9,285 CMP	Flood Insurance	9/18/2015
Four Oaks Bank & Trust Company, Four Oaks, North Carolina	Written Agreement	Safety and Soundness	7/30/2015
Freedom Bank of Virginia, Fairfax, Virginia	$2,100 CMP	Flood Insurance	5/11/2015
Goldman Sachs Bank USA, New York, New York	$90,000 CMP	Flood Insurance	1/12/2018
Goldman Sachs Group, Inc., New York, New York, and Goldman Sachs Bank USA, New York, New York	$14,000,000 CMP	Mortgage Servicing	1/12/2018

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Goldman Sachs Group, Inc., New York, New York, and Goldman, Sachs & Co. New York, New York	C&D Order & $36,300,000 CMP	Safety and Soundness	8/2/2016
Goldman Sachs Group, Inc., New York, New York	C&D Order & $54,750,000 CMP	FX	5/1/2018
Habib Bank Limited, Karachi, Pakistan, and Habib Bank Limited New York Branch, New York, New York	C&D Order	BSA/AML	12/11/2015
Hazard Bancorp, Hazard, Kentucky, and Peoples Bank and Trust Company of Hazard, Hazard, Kentucky	Written Agreement	Safety and Soundness	3/3/2016
Heartland Bank, Little Rock, Arkansas	PCA	Safety and Soundness	8/15/2017
Higher One, Inc., New Haven, Connecticut	C&D Order & $2,231,250 CMP & $24,000,000 Restitution	FTC Act	12/23/2015
HSBC Holdings plc, London, England, and HSBC North America Holdings Inc., New York, New York	C&D Order & $175,296,000 CMP	FX	9/29/2017
HSBC North America Holdings, Inc., New York, New York, and HSBC Finance Corp., Mettawa, Illinois	$131,000,000 CMP	Mortgage Servicing	2/5/2016
Hua Nan Commercial Bank Ltd., Taipei City, Taiwan, and Hua Nan Commercial Bank Ltd., New York Agency, New York, New York	C&D Order	BSA/AML	4/19/2018
Independent Bank, Grand Rapids, Michigan	$56,205 CMP	Flood Insurance	8/27/2015
Industrial and Commercial Bank of China Ltd., Beijing, People's Republic of China, Industrial, and Commercial Bank of China Ltd. New York Branch, New York, New York	C&D Order	BSA/AML	3/12/2018
Industrial Bank of Korea, Seoul, South Korea, and Industrial Bank of Korea New York Branch, New York, New York	Written Agreement	BSA/AML and OFAC	2/24/2016
JPMorgan Chase & Co., New York, New York	C&D Order & $342,000,000 CMP	FX	5/20/2015
JPMorgan Chase & Co., New York, New York	C&D Order & $61,932,500 CMP	Safety and Soundness	11/17/2016
Liberty Bank, South San Francisco, California	Written Agreement	BSA/AML	8/5/2016
Markesan State Bank, Markesan, Wisconsin	Written Agreement	Safety and Soundness	9/8/2017
Mega International Commercial Bank Co., Ltd., Taipei, Taiwan	C&D Order & $29,000,000 CMP	BSA/AML	1/17/2018

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
Mesquite Financial Services, Inc., Alice, Texas	Written Agreement	Safety and Soundness	7/6/2017
Mid America Bank and Trust Company, Dixon, Missouri	C&D & $5,000,000 Restitution	FTC Act	10/26/2017
Morgan Stanley, New York, New York	$8,000,000 CMP	Mortgage Servicing	1/12/2018
National Bank of Pakistan, Karachi, Pakistan, and National Bank of Pakistan, New York Branch, New York, New York	Written Agreement	BSA/AML	3/14/2016
NongHyup Bank, Seoul, South Korea, and NongHyup Bank, New York Branch, New York, New York	Written Agreement	BSA/AML	1/17/2017
OSB Community Bank, Brooklyn, Michigan	Written Agreement	Safety and Soundness	7/30/2015
Peoples Bank, Lawrence, Kansas	C&D & $2,800,000 Restitution	FTC Act	11/28/2017
Platte Valley Bank, Scottsbluff, Nebraska	$33,785 CMP	Flood Insurance	3/6/2017
PNC Financial Services Group, Inc., Pittsburgh, Pennsylvania	$3,500,000 CMP	Mortgage Servicing	1/12/2018
Raton Capital Corp., Raton, New Mexico	Written Agreement	Safety and Soundness	7/10/2015
Rock Bancshares, Inc., Little Rock, Arkansas, and Heartland Bank, Little Rock, Arkansas	Written Agreement	Safety and Soundness	12/13/2016
Royal Bank of Scotland, Edinburgh, Scotland, and RBS Securities Inc., Stamford, Connecticut	C&D Order & $274,000,000 CMP	FX	5/20/2015
Santander Holdings USA, Inc. Boston, Massachusetts, and Santander Consumer USA, Inc., Dallas, Texas	Written Agreement	Safety and Soundness	3/21/2017
Santander Holdings USA, Inc. Boston, Massachusetts	Written Agreement	Safety and Soundness	7/2/2015
Seaway Bancshares, Inc., Chicago, Illinois	Written Agreement	Safety and Soundness	6/24/2015
ServiceLink Holdings, LLC, Jacksonville, Florida	$65,000,000 CMP	Mortgage Servicing	1/23/2017
Société Générale S.A., Paris, France, and Société Générale New York Branch, New York, New York	C&D Order	BSA/AML	12/14/2017

Appendix A Federal Reserve Enforcement Actions
Jan. 2015 - May 2018

Name of Entity	Type of Enforcement Action	Issue Type (e.g. Safety and Soundness, BSA/AML, etc.)	Effective/Issued Date
State Street Corp., Boston, Massachusetts, and State Street Bank and Trust Company, Boston, Massachusetts	Written Agreement	BSA/AML	5/28/2015
SunTrust Bank, Atlanta, Georgia	$1,501,000 CMP	Flood Insurance	5/24/2017
Tri-County Bank, Brown City, Michigan	$5,000 CMP	Flood Insurance	11/18/2015
Truxton Trust Company, Nashville, Tennessee	$11,285 CMP	Flood Insurance	4/29/2015
U.S. Bancorp, Minneapolis, Minnesota	$4,400,000 CMP	Mortgage Servicing	1/12/2018
U.S. Bancorp, Minneapolis, Minnesota and USB Americas Holding Co., Minneapolis, Minnesota	C&D Order & $15,000,000 CMP	BSA/AML and OFAC	2/14/2018
UBS AG, Zurich, Switzerland, and UBS AG Stamford Branch, Stamford, Connecticut	C&D Order & $342,000,000 CMP	FX	5/20/2015
Wayne Bank and Trust Company, Cambridge City, Indiana	$23,000 CMP	Flood Insurance	10/31/2017
Wells Fargo, San Francisco, California	C&D Order	Safety and Soundness	2/2/2018

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

Questions for Mr. Richard Clarida, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Cortez Masto:

Community Reinvestment Act

- Should CRA be expanded to all non-banks? Some assert that in today's financial landscape, CRA compliance should be expanded to all non-banks, including credit unions, fintechs, mortgage companies, investment, and others.

- Do you support a full scope review for CRA exams? Do you think geographical assessment areas should define CRA accountability both where the majority of branch lending and the majority of non-branch lending occurs?

- If a fair lending exam detects a violation after a bank has been graded for its CRA exam, do you think the bank should receive a retroactive downgrade?

Many Democratic, Republican and Independent current and former regulatory officials raising concerns about the bank deregulation bill range from former Fed Chair Paul Volcker, former Fed governor and Deputy Treasury Secretary Sarah Bloom Raskin, former FDIC Chair Sheila Bair, former Counselor to the Treasury Secretary Antonio Weiss, and former Deputy Governor of the Bank of England Paul Tucker. These former banking regulators either state that a $250 billion bank threshold is too high to protect financial stability or that we should not weaken the leverage rules for the largest banks, or both.

- Do you think anything in S. 2155 puts the financial system at risk? Do you share the concerns raised by your predecessors? If so, why? If not, why not?

There are a number of places in S. 2155 that would require the Federal Reserve to conduct additional cost-benefit analysis in order to regulate big banks.

- Mr. Clarida, you have said that the Federal Reserve underestimated the human costs of the financial crisis prior to 2008? What have you learned from your previous analytic mistakes? How will you ensure you will not repeat those previous errors?

Chair Yellen was the first chair in Federal Reserve history to share data with this committee about racial economic disparities during her semi-annual testimony. When she presented that data, she touted significant progress, and indeed, black unemployment fell from 11.8% at the beginning of her term to the current historically low figure of 6.9%.

- What do you attribute this trend to? Do you think the attention that Janet Yellen paid to this issue and the policies of the Federal Reserve deserve credit for the progress that has been made?

At that same testimony where Janet Yellen presented information about racial economic disparities, she said, quote "it is troubling that unemployment rates for these minority groups remain higher than for the nation overall, and that the annual income of the median African-American household is still well below the median income of other U.S. households."

- Though African American unemployment is lower today, Chair Yellen's point remains true. Do you think the recent progress is sufficient? What more can be done to ensure that unemployment among African Americans is equal to white unemployment? In addition to increasing employment rates for African Americans, what can the Fed do to increase wages and wealth for African Americans and Latinos?

Marvin Goodfriend, another nominee to the Federal Reserve Board of Governors has urged the Federal Reserve to incent spending by placing a tax on currency.[3]

- Do you support Mr. Goodfriend's proposal to tax currency kept outside of circulation?

- If Mr. Goodfriend's proposal were to be implemented, can you estimate what the impact would be on savers and low-income depositors?

The Consumer Financial Protection Bureau has endured new leadership that is hostile to its mission. A number of enforcement actions aimed at helping people receive redress from fraud or overcharges has been stopped.

- If the Consumer Financial Protection Bureau's leadership refuses to ask for adequate funding or takes steps that you think are harmful to people or our economy, will you let Senate Banking Committee members know? If so, how? If not, why not?

- The Federal Reserve retains supervision and enforcement authority for financial institutions below $10 billion in assets. Please provide a list of public enforcement actions taken towards any Fed-regulated institutions in the past three years. Please note any fines or penalties assessed. Please note if you agree or disagree with these enforcement actions.

Some current Federal Reserve leaders support reducing banks' capital requirements. This concerns me as capital requirements have been a key tool in restoring the safety of the financial system since the crisis. Ensuring modest leverage ratios prevents banks from lending out more than they can afford to, and especially keeps them away from riskier assets like the ones that fueled the crisis.

- For this reason, Democrats and Republicans in the House and Senate, as well as FDIC Vice Chair (and former Kansas City Fed President) Thomas Hoenig all support higher capital requirements, not lower ones. Do you support any changes to the current capital requirements for financial institutions? If so, please describe.

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[3] Goodfriend, Marvin. "The Case for Unencumbering Interest Rate Policy at the Zero Bound." Carnegie Mellon University. September 15, 2015. Available at: https://www.kansascityfed.org/~/media/files/publicat/sympos/2016/econsymposium-goodfriend-paper.pdf

In recent years, Federal Reserve policymakers have warned that we should raise interest rates to counter asset bubbles destabilizing the financial system. Board of Governor Nominee Marvin Goodfriend has suggested replacing liquidity coverage ratios and a host of other regulations with tighter monetary policy.[4]

- Do you believe that the blunt tool of monetary policy can be a substitute for sound financial protections? What is your understanding of the historical evidence surrounding the relationship between monetary policy and asset bubbles?

- Besides monetary policy, what other tools are available to temper asset bubbles?

In the years since the financial meltdown, the Federal Reserve has played a key role in putting our economy back on stable footing and setting the conditions for more robust growth. Still, there have been bills introduced that would eliminate the Fed's full employment mandate on the basis that, according to the bill's findings "at best, the Federal Reserve may temporarily increase the level of employment through monetary policy."

- Can you elaborate on how the Fed influences employment in the short-run, and discuss whether failure to use monetary policy effectively in the face of severe downturns could do permanent damage to the level of unemployment in the economy?

Critics of quantitative easing have argued that it is incompatible with the Fed's price stability mandate; however in discussing quantitative easing the Fed has consistently noted that the program is designed to promote a stronger pace of economic growth and to ensure that inflation, over time, is at levels consistent with the Fed's mandate.

- Can you comment on how the Fed's policies in recent years have actually supported the Fed's price stability mandate?

- What does the latest research tell us about the effectiveness of the Fed's large scale asset purchases?

- Is there any evidence that the Fed's asset-purchase program, which sought to support the economy by lowering long-term interest rates, has been a drag on U.S. productivity as some Republicans have suggested? Is there any evidence that the program has created a "false economy" as Trump has asserted?

- How would the economy have likely fared in terms of unemployment, GDP, wage growth, etc. had the Fed chosen not to pursue its asset purchase program?

- Is there any evidence that the Fed's stimulus program has paved the way for the next global meltdown, as Trump claimed?

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[4] Senate Committee on Banking, Housing and Urban Affairs, June 7, 2016 Hearing. Available at: https://www.gpo.gov/fdsys/pkg/CHRG-114shrg21603/pdf/CHRG-114shrg21603.pdf

- How does the Fed's balance sheet as a percentage of GDP compare with the balance sheets of the next largest economies? Do these countries have a dual mandate similar to the Fed?

It is my understanding that major central banks around the world maintain and have drawn on their authority to purchase a wide range of assets including corporate bonds, commercial paper, real estate investment trusts, and equities among other assets.

- Given the broad authorities available to other central banks, rather than shrink the Fed's tool kit, do you think Congress should consider expanding it?

- For example, with an expanded authority, could the Fed play a useful role in supporting municipal finance, student loan financing or other types of consumer credit during periods where each of these sectors experienced heightened distress? Would you support or oppose such expansion of the Fed's authority?

- As the Fed begins to shrink its balance sheet, what are some of the negative impacts that Senate Banking Committee members should monitor? What concerns – if any – do you have about shrinking the balance sheet? What will you do to monitor the process of maturing securities to avoid a negative impact on the economy?

May 30, 2018

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 15, 2018[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on May 23, 2018.

<u>Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Warren:</u>

1. Do you believe that any US banks are Too Big to Fail?

- **If so, what can and should the Fed do to address this problem?**
- **If not, what evidence supports your conclusion?**

I believe substantial progress has been made in making the financial system more resilient, particularly as a result of stronger capital, liquidity, stress testing, and resolution planning requirements that were introduced in the wake of the financial crisis. Activities and risks in the financial sector evolve quickly, however, especially at the largest firms, so I also believe that regulators need to closely monitor risks to the financial system over time and act accordingly.

2. Section 402 of S.2155, which recently passed the Senate and allows banks "predominantly engaged in custody, safekeeping, and asset servicing activities" to have less capital.

- **Do you believe that language applies to JPMorgan Chase and Citigroup?**

Section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act allows depository institution holding companies that qualify as "custodial banks" to exclude reserves at certain central banks for purposes of leverage capital requirements. This section defines a custodial bank as any depository institution holding company that is predominantly engaged in custody, safekeeping and asset servicing activities (and any subsidiary depository institution of such a holding company) and the banking agencies could issue regulations to implement these provisions. Diversified bank holding companies, such as JPMorgan Chase and Citigroup, have significant custodial operations but these operations are relatively small compared to the companies' overall operations. Therefore, these organizations would not appear to qualify as "custodial banks."

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

The Federal Reserve Board's (Board) regulatory capital rules are based on financial consolidation. Consolidation combines the assets and activities of the top-tier company and its subsidiaries so that they can be viewed holistically. In my current understating, if a depository institution holding company reorganized all of its custodial services under an intermediate holding company but made no other changes, the assets and activities of the top-tier, consolidated depository institution holding company would not be affected. Housing the custody services under an intermediate holding company therefore would not affect whether a company received capital relief under section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act.

3. Banks today reported record profits – up 27.5% from the first quarter of last year. The economy is nearly a decade into a long expansionary period.

- **Why is a reduction in capital requirements necessary or appropriate at this time?**

It is clear that a resilient, well-capitalized financial system that is strong enough to withstand even severe shocks and support economic growth by lending through the economic cycle is needed. To that end, the U.S. banking agencies have acted to substantially strengthen regulatory capital requirements for U.S. banking firms, resulting in improved quality and an increase in our amount of capital in our banking system. At the same time, it is important to monitor the capital rules on an ongoing basis, to determine whether the framework is effectively measuring and addressing risk and working as intended, and to adjust the framework as needed.

Reforms proposed by the Federal Reserve suggest that the enhanced supplementary leverage ratio standards may be currently calibrated too high, creating potential incentives for firms to disengage from certain low-risk, low-return financial activities that are beneficial for the economy. Modest recalibration may reduce these negative incentives while not materially changing overall large bank capital requirements.

4. Fed Chair Powell recently announced that the Fed's Board of Governors would vote on whether to relieve Wells Fargo from the growth restriction the Fed imposed on it pursuant to its February 2018 consent order.

- **What kind of changes at Wells Fargo would you need to see before voting to lift the growth restriction?**

As specified in the Consent Order, the firm must adopt and implement the remediation plans the Consent Order requires to improve Wells Fargo's governance and risk management, including internal controls and testing of those controls, particularly for compliance and operational risk.

I understand that the firm must also engage a third party to review the implementation of the plans and required improvements.

And furthermore, that a number of improvements must be made to the firms' governance and risk management practices to be fully compliant with the terms of the Consent Order. If confirmed, with regard to lifting the asset cap imposed, I would only vote to do so if the required improvements are implemented to the satisfaction of the Board.

- **Do you believe the Fed should place more emphasis on finding diverse leaders for the regional banks? If so, how do you recommend changing the current hiring process so that it produces more diverse leaders?**

My impression is that the Federal Reserve System and its leadership has placed considerable emphasis on increasing the diversity of senior leadership, and with some significant successes. However, I think all also agree that more must still be done. If confirmed, I will join the Board with the intent to devote time and attention to understanding the full range of challenges in this space, and think creatively about how the Board in particular can engage more effectively in support of the shared goal of a more diverse senior leadership.

In reviewing recent searches, I have observed that search committees have used a variety of new channels to solicit input on important attributes for the districts' presidents, as well as suggestions of specific individuals for consideration. They have also worked to make the process as transparent as possible. Outreach has occurred through social media--for example, webinars and YouTube videos--and also through more traditional efforts, such as meetings with key constituencies, including non-profit and advocacy groups as well as the business community. All of this seems promising and important, and represents a foundation on which I hope we can continue to build.

I believe the Federal Reserve is committed to making further progress and to better understanding the challenges to promoting and improving diversity of ideas and backgrounds. It has described this as an ongoing objective, and I assure you that diversity will remain a high-priority objective for the Federal Reserve, if I am confirmed.

- **The Fed is apparently participating in an interagency effort to reform regulations implementing the Community Reinvestment Act. In April, the Treasury Department sent a memo to the Fed, the OCC, and the FDIC recommending several rule changes. Do you disagree with any of the Treasury recommendations?**

I understand that the Treasury's recommendations were based on a broad outreach effort and the summary sent to the agencies includes helpful insights.

As with any process, I believe that it is likely that some recommendations may be difficult to implement as a practical matter, such as the recommendation to standardize the examination schedules across the regulatory agencies.

If confirmed, I would want to review the recommendations to see which would result in improving the effectiveness of the Community Reinvestment Act (CRA), while focusing on potential ways to relieve regulatory burden for community banks.

I would like to see the agencies work together to find ways to accomplish both goals.

- **What are your priorities for CRA reform?**

There is a great deal of consensus among banks, community development organizations, and others regarding the need to make CRA evaluations more consistent and transparent.

I also agree that CRA should be revised in a way that encourages more lending and investment in underserved areas.

I believe these are good goals for the agencies to pursue and that any revisions to the CRA regulations need to balance the interests of both community and industry stakeholders.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Elizabeth Warren:

- Do you believe that any US banks are Too Big to Fail?
- If so, what can and should the Fed do to address this problem?
- If not, what evidence supports your conclusion?

Section 402 of S.2155, which recently passed the Senate and allows banks "predominantly engaged in custody, safekeeping, and asset servicing activities" to have less capital.

- Do you believe that language applies to JPMorgan Chase and Citigroup?
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- What are your priorities for CRA reform?

May 30, 2018

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

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Please let me know if I can be of further assistance.

Sincerely,

Rich Clarida

Enclosure

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<u>Questions for Mr. Richard Clarida, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Warren:</u>

1. Now that you have had more time to examine the Fed's recent proposal on changes to capital standards, do you support the proposal as currently written? If so, why do you think it is appropriate to reduce capital requirements for the country's largest banks at this time? If not, what changes would you need to see to the proposal before supporting it?

We need a resilient, well-capitalized financial system that is strong enough to withstand even severe shocks and support economic growth by lending through the economic cycle. Since the crisis, the U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system. It would be important to me not to give up any of the gains in resiliency and stability that have been achieved since the crisis.

Risk-based and leverage capital requirements work best together when leverage capital requirements generally serve as a backstop to risk-based capital requirements. In cases where the leverage ratio becomes a binding constraint, it can create incentives for banking organizations to reduce their participation in lower-risk, lower-return business activity, such as repo financing, central clearing services for market participants, and taking custody deposits, notwithstanding client demand for those services.

I understand that the Federal Reserve's enhanced supplementary leverage ratio (eSLR) proposal is designed to maintain the eSLR standards as a meaningful constraint on leverage while ensuring a more appropriate complementary relationship between global systemically important banks' (GSIBs) risk-based and leverage-based capital requirements, and to help ensure that the leverage-based capital requirements generally serve as a backstop to risk-based capital requirements. If confirmed, I would look forward to reviewing the comments that the Federal Reserve receives on the proposal.

2. Do you believe that any US banks are Too Big to Fail?

- **If so, what can and should the Fed do to address this problem?**
- **If not, what evidence supports your conclusion?**

I believe that the post-crisis regulatory reforms and stronger supervision have resulted in a great deal of progress being made in strengthening the financial system and making large firms better able to absorb losses. Having said that, it is important for financial supervisors to remain vigilant to ensure that the financial system continues to remain resilient as economic conditions and market practices evolve.

3. Section 402 of S.2155, which recently passed the Senate and allows banks "predominantly engaged in custody, safekeeping, and asset servicing activities" to have less capital.

- **Do you believe that language applies to JPMorgan Chase and Citigroup? Would that analysis hold if those two banks created intermediate holding companies to house their custody services?**

Section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act provides leverage ratio relief to firms that qualify as "custodial banks" with respect to reserves held at certain central banks. The bill defines a custodial bank as any depository institution holding company that is predominantly engaged in custody, safekeeping and asset servicing activities (and any subsidiary depository institution of such a holding company). The Federal Reserve Board (Board) and the other federal banking agencies have authority to issue regulations implementing this section. By its terms, the bill does not appear to apply to diversified holding companies, such as JPMorgan Chase or Citigroup, because their custodial operations constitute a relatively small percentage of their overall businesses.

The Board applies regulatory capital requirements to bank holding companies on a consolidated basis. Under this approach, the top-tier bank holding company is required to aggregate all its activities and the assets of its subsidiaries. As a result, simply inserting an intermediate holding company would not affect the activities or assets of the consolidated banking organization or the analysis of whether the consolidated organization was considered to be predominantly engaged in custody, safekeeping, and asset servicing activities. This result would apply to an intermediate holding company that controlled the custody services of the banking organization as well as to any other intermediate holding company in the structure. An intermediate holding company therefore would not affect the capital requirements of the consolidated banking organization.

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We need a resilient, well-capitalized financial system that is strong enough to withstand even severe shocks and support economic growth by lending through the economic cycle. To that end, the U.S. banking agencies have substantially strengthened regulatory capital requirements for U.S. banking firms, improving the quality and increasing the amount of capital in the banking system. At the same time, it is important to monitor the capital rules on an ongoing basis, to determine whether the framework is effectively measuring and addressing risk and working as intended, and to adjust the framework as needed.

Reforms proposed by the Federal Reserve suggest that the enhanced supplementary leverage ratio standards may be currently calibrated too high, creating potential incentives for firms to disengage from certain low-risk, low-return financial activities that are beneficial for the economy. Modest recalibration may reduce these negative incentives while not materially changing overall large bank capital requirements. As mentioned previously, if confirmed, I look forward to reviewing the comments received on reform proposals.

4. Fed Chair Powell recently announced that the Fed's Board of Governors would vote on whether to relieve Wells Fargo from the growth restriction the Fed imposed on it pursuant to its February 2018 consent order.

- **What kind of changes at Wells Fargo would you need to see before voting to lift the growth restriction?**

First, let me say that just based upon the news accounts, the activities of Wells Fargo in this domain are egregious and unacceptable, and I was as shocked as anyone to read about it in the newspaper. If I am confirmed and this matter came before me, I would certainly individually want to be absolutely convinced that appropriate steps had been taken and could be verified.

My understanding is that the firm must fully comply with the terms of the Consent Order, which requires a number of improvements to be made to the firm's governance and risk management practices. If confirmed, I would only vote to lift the asset cap if the required improvements are implemented to the satisfaction of the Federal Reserve.

- **Do you believe the Fed should place more emphasis on finding diverse leaders for the regional banks?**

Like many others, I was excited to see the appointment of Raphael Bostic in 2017 as the first African-American Reserve Bank president and, more recently, the appointment of Andre Anderson as the first African-American First Vice President. Andre's appointment to this senor leadership role was particularly satisfying as I understand that he rose through the ranks at the Federal Reserve, beginning at the Birmingham Branch where he was hired to process municipal bonds.

Despite these recent appointments, I know that the senior leadership of the Board, and indeed the System, agree that there is a lot more work to be done to move the System toward its objective of benefiting fully from a diverse workforce and leadership. I and I know my potential future colleagues on the Board as well, view this as critical first and foremost because it allows the best possible job to be done in meeting the responsibilities enumerated for the System in the Federal Reserve Act.

If I am confirmed, I will arrive on the job eager to engage with my colleagues across the System on this important issue. I fully understand that the Federal Reserve Act assigns primary responsibility for selecting senior leadership at the Reserve Banks to their Class B and Class C directors. But the Act also gives the Board of Governors the responsibility to approve such appointments, and I intend to take that role seriously, including by doing everything that I can to use my position to help attract more diverse leaders to the System like Raphael and Andre.

- **If so, how do you recommend changing the current hiring process so that it produces more diverse leaders?**

Diversity is a critical aspect of all successful organizations. In my experience, and in agreement with Chairman Powell's sentiments, we make better decisions when we have a wide range of backgrounds and voices around the table.

There is value in having a diverse workforce at all levels of an organization. I am committed to achieving further progress, and to better understanding the challenges to improving and promoting diversity of ideas and backgrounds.

My understanding is that while different Reserve Banks tried different approaches, diversity has been a point of emphasis in all recent searches. Specific efforts of which I am aware include advance engagement with community groups and hiring of national search firms with specific expertise in diversity. If confirmed I look forward to encouraging the continuation of these efforts and I also commit to look for additional proven approaches to further expand the Federal Reserve's efforts.

5. The Fed is apparently participating in an interagency effort to reform regulations implementing the Community Reinvestment Act. In April, the Treasury Department sent a memo to the Fed, the OCC, and the FDIC recommending several rule changes.

- **Do you disagree with any of the Treasury recommendations?**

I understand that Treasury's recommendations were based on the Department's outreach effort and the summary sent to the agencies includes helpful insights. If confirmed, I look forward to reviewing the recommendations in more detail and supporting efforts to ensure that the agencies work together to find ways to improve both effectiveness and transparency in Community Reinvestment Act (CRA) supervision.

- **What are your priorities for CRA reform?**

If confirmed, I would work to better understand the calls from banks, community development organizations and others for making CRA evaluations more consistent and transparent. As well as for calls to revise the CRA in a way that encourages more lending and investment in underserved areas.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

Questions for Mr. Richard Clarida, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Elizabeth Warren:

- Now that you have had more time to examine the Fed's recent proposal on changes to capital standards, do you support the proposal as currently written? If so, why do you think it is appropriate to reduce capital requirements for the country's largest banks at this time? If not, what changes would you need to see to the proposal before supporting it?

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- Do you disagree with any of the Treasury recommendations?

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

- What are your priorities for CRA reform?

May 30, 2018

The Honorahle Jack Reed
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 15, 2018[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also heen forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

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<u>Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Reed:</u>

1. The Federal Reserve is one of the agencies authorized to enforce the Military Lending Act (MLA), which is a bipartisan law enacted in 2006 that sets a hard cap of 36% interest for most loans to servicemembers and their families. On July 22, 2015, the Department of Defense finalized MLA rules that closed prior loopholes that allowed unscrupulous lenders to prey upon servicemembers and their families.

- **Do you support these stronger MLA rules? If confirmed, will you ensure that the MLA is vigorously enforced?**

The Military Lending Act (MLA) provides special consumer protections for service members and their dependents. In enacting the MLA, the Congress directed the Department of Defense to issue implementing regulations after consulting with the Federal Reserve and other agencies.

I understand that Federal Reserve staff has worked with Department of Defense staff to carry out that mandate and, if confirmed, I will support that effort as well as the Federal Reserve's full enforcement of the MLA at the institutions it supervises.

- **If changes are made to the Community Reinvestment Act that lead to financial institutions, including those that have an online presence, to take deposits from communities but actually make less of an effort to reinvest in these same communities, would you consider that to be a good or bad outcome?**

The Community Reinvestment Act (CRA) was enacted to ensure that banks help meet the credit needs of the communities where they are chartered to do business.

As a community banker and bank commissioner, it is my interest to see credit flowing to consumers and businesses in all communities consistent with safe and sound lending--including in low-and moderate-income areas--to further economic development and financial inclusion.

I believe that any revisions to CRA that expand the area within which a bank's CRA performance is evaluated should ensure that the new areas are consistent with the original intent of the law, and that changes would include clear guidance to banks so that they are able to comply.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Jack Reed:

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May 30, 2018

The Honorable Jack Reed
United States Senate
Washington, D.C. 20510

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Sincerely,

Rich Clarida

Enclosure

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In enacting the Military Lending Act (MLA), Congress directed the Department of Defense to issue implementing regulations after consulting with the Federal Reserve and other agencies. I understand that Federal Reserve staff has worked with Defense Department staff to carry out that mandate and, if confirmed, I will support that effort and the Federal Reserve's full enforcement of the MLA at the institutions it supervises.

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The Community Reinvestment Act (CRA) was enacted to ensure that banks help meet the credit needs of the communities where they are chartered to do business. It is important that credit flow to consumers and businesses in all communities, including in low-and moderate-income areas, consistent with safe and sound lending to meet their credit needs and further economic development and financial inclusion. Any revisions to CRA that expand the area within which a bank's CRA performance is evaluated should ensure that the new areas are consistent with the original intent of the law.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

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- Do you support these stronger MLA rules? If confirmed, will you ensure that the MLA is vigorously enforced?

- If changes are made to the Community Reinvestment Act that lead to financial institutions, including those that have an online presence, to take deposits from communities but actually make less of an effort to reinvest in these same communities, would you consider that to be a good or bad outcome?

May 30, 2018

The Honorable Mark Warner
United States Senate
Washington, D.C. 20510

Dear Senator:

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Please let me know if I can be of further assistance.

Sincerely,

Michelle Bowman

Enclosure

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Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Warner:

1. I believe strongly in the importance of the Fed's independence. Recent comments from another Fed candidate (and former Fed Governor)—Kevin Warsh—suggest that President Trump has been anything but shy in revealing his preference for a low interest rate environment.

- **Has the President—or anyone in the Administration—impressed upon you their beliefs on how you should vote on matters of monetary policy?**

I have had no communication with the President or members of the Administration seeking to influence my position or future vote, if confirmed, on monetary policy issues.

- **Do you commit to safeguarding the independence of our central bank?**

I believe that Congress wisely chose to insulate monetary policy decisions from short-term political influences. Insulation from short-term political pressures is crucially important for the effective conduct of monetary policy, the Federal Reserve is and must also remain accountable to the public. If confirmed, I will be committed to building on the Federal Reserve's tradition of transparency, openness, and accountability while maintaining the independence of the Federal Reserve in the conduct of monetary policy.

- **What do believe is the biggest threat to financial stability at the moment?**

We have enjoyed many years of economic growth since the recession that followed the financial crisis. The financial system has been relatively stable during that period. As a result, there is a tendency to forget the lessons that we have learned. When we forget, however, we make ourselves vulnerable again.

A crucial lesson from the financial crisis is that we always need to be prepared. The reforms that have been implemented since the crisis have helped us to build a more resilient financial system. However, we cannot rest. We must be vigilant in monitoring the financial system, both the vulnerabilities that were important contributors to the financial crisis – like asset valuations, leverage, maturity transformation, and complexity – as well as new vulnerabilities that could emerge. Only with vigilance can we avoid the natural slide toward complacency that overtakes us as the distance between us and the crisis grows.

- **Do you believe that Title II's Orderly Liquidation Authority is an important tool available at the Fed's disposal during a crisis? Would you vote to use the Authority if bankruptcy was not an appropriate method for resolving a systemic financial institution?**

Bankruptcy should be the preferred resolution framework for a failing systemic financial firm, in the same way that it is the resolution framework for the holding companies of our nation's community banks. However, as the Treasury noted in their report on Orderly Liquidation

Authority and Bankruptcy Reform, it is important to have an emergency tool for use in extraordinary circumstances.

I would need to know all of the facts and circumstances before deciding whether it was appropriate to vote in favor of recommending that the Treasury Secretary use Title II's Orderly Liquidation Authority in connection with a specific failure. One aspect of Title II that I would weigh is that it does not allow for government capital injections and requires that taxpayers suffer no losses from the resolution.

- **Do you think current bank risk-based capital levels are too high, too low, or about right? How about the leverage ratio?**

Maintaining the safety and soundness of the largest U.S. banks is fundamental to maintaining the stability of the U.S. financial system and the broader economy. To be safe and sound financial institutions, these firms must be well-capitalized. The U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system. Indeed, large U.S. banking firms have roughly doubled their capital positions from before the crisis to today, making them significantly more resilient, as well as able to support lending and financial intermediation in times of financial stress.

It is my understanding that reforms proposed by the Federal Reserve suggest that the enhanced supplementary leverage ratio standards may be currently calibrated too high, creating potential incentives for firms to disengage from certain low-risk, low-return financial activities that are beneficial for the economy. Additionally, I understand that modest recalibration may reduce these negative incentives while not materially changing overall large bank capital requirements.

2. As you may know in S. 2155, we contemplate raising the enhanced prudential standards from $50 billion to $250 billion, with an 18 month-delayed effectiveness to give the Fed time to do a rulemaking and decide whether it should apply any of the enhanced prudential standards to banks between $100 billion and $250 billion.

- **What do you see as the most important enhanced prudential standards for these midsized banks?**

I believe the bank regulatory framework should continue to protect the core tenets of regulatory reform--capital, stress testing, liquidity, resolution planning, and orderly liquidation authority. However, not all standards are appropriate for all banking organizations, and it is appropriate to tailor regulation and supervision to the size, systemic footprint, and risk profile of individual institutions. Recognizing the levels and types of risk of the different institutions in the system improves the quality and efficiency of regulation.

Periodic supervisory stress testing is an important post-crisis reform maintained for banks with assets between $100 billion and $250 billion by the Economic Growth, Regulatory Relief, and Consumer Protection Act, and will help the Federal Reserve Board ensure that these firms are engaged in less burdensome but still robust, forward-looking capital assessments.

3. The urban-rural economic divide is an area of particular interest for me and an area where I've done a lot of work. I believe that someone shouldn't be forced to leave their community to find a good paying job. As we've seen in the Great Recession and the recovery that's followed, the impacts of these macroeconomic trends are not universal and, in this case, have often been felt more harshly in rural areas.

- **What do you believe to be the driving forces behind the decline of rural America? Is this trend the result of globalization and technological change?**
- **Do you believe these trends are irreversible?**

I agree that the relatively poor labor market outcomes in rural areas in recent years is a big concern. Globalization and technological change may be playing a role, but determining the causes of these adverse trends is difficult. What's clearer to me is that these trends are reversible. Public policy can ameliorate, if not fully reverse, these trends by, for example, increasing infrastructure investment and promoting greater educational and job-training opportunities. Moreover, some current or future changes in technology can prove favorable to workers in rural areas by increasing their ability to work remotely, or by making it easier for production to be located in rural areas but still be connected to supply chains.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Mark Warner:

I believe strongly in the importance of the Fed's independence. Recent comments from another Fed candidate (and former Fed Governor)—Kevin Warsh—suggest that President Trump has been anything but shy in revealing his preference for a low interest rate environment.

- Has the President—or anyone in the Administration—impressed upon you their beliefs on how you should vote on matters of monetary policy?

- Do you commit to safeguarding the independence of our central bank?

- What do believe is the biggest threat to financial stability at the moment?

- Do you believe that Title II's Orderly Liquidation Authority is an important tool available at the Fed's disposal during a crisis? Would you vote to use the Authority if bankruptcy was not an appropriate method for resolving a systemic financial institution?

- Do you think current bank risk-based capital levels are too high, too low, or about right? How about the leverage ratio?

As you may know in S. 2155, we contemplate raising the enhanced prudential standards from $50 billion to $250 billion, with an 18 month-delayed effectiveness to give the Fed time to do a rulemaking and decide whether it should apply any of the enhanced prudential standards to banks between $100 billion and $250 billion.

- What do you see as the most important enhanced prudential standards for these midsized banks?

The urban-rural economic divide is an area of particular interest for me and an area where I've done a lot of work. I believe that someone shouldn't be forced to leave their community to find a good paying job. As we've seen in the Great Recession and the recovery that's followed, the impacts of these macroeconomic trends are not universal and, in this case, have often been felt more harshly in rural areas.

- What do you believe to be the driving forces behind the decline of rural America? Is this trend the result of globalization and technological change?

- Do you believe these trends are irreversible?

May 30, 2018

The Honorable Mark Warner
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 15, 2018[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

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Enclosure

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<u>Questions for Mr. Richard Clarida, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Warner:</u>

1. I believe strongly in the importance of the Fed's independence. Recent comments from another Fed candidate (and former Fed Governor)—Kevin Warsh—suggest that President Trump has been anything but shy in revealing his preference for a low interest rate environment.

- **Has the President—or anyone in the Administration—impressed upon you their beliefs on how you should vote on matters of monetary policy?**

No. I had a number of meetings over several months with a number of officials in the Administration including the President. In no meeting and at no time did anyone impress upon me their belief on how I should vote on matters of monetary policy.

- **Do you commit to safeguarding the independence of our central bank?**

Yes. I have no reason to expect any political pressure or interference that would challenge the independence of our central bank, but I fully commit that if confirmed I would completely ignore any political pressure or interference, whether it be direct or indirect from any member of the Administration.

- **What do believe is the biggest threat to financial stability at the moment?**

An important lesson of the global financial crisis was the need for greater vigilance in monitoring the financial system. This includes looking at asset valuations, leverage, liquidity and maturity transformation, and the complexity of the financial system. Understanding the key vulnerabilities in the system is a necessary step in order to pursue effective policies to ensure the health of our financial system should vulnerabilities increase.

Given that we have enjoyed many years of solid growth amid a stable financial system, in my view complacency is a particular threat. Failure to remain vigilant even as the financial system evolves and grows risks the possibility that the reforms put in place since the crisis will lose their effectiveness.

- **Do you believe that Title II's Orderly Liquidation Authority is an important tool available at the Fed's disposal during a crisis? Would you vote to use the Authority if bankruptcy was not an appropriate method for resolving a systemic financial institution?**

Bankruptcy should be the preferred resolution framework for a failing financial firm. Companies, counterparties, the markets, and investors understand the rules and procedures under the Bankruptcy Code. Nevertheless, Title II's Orderly Liquidation Authority provides an important backstop resolution framework for extraordinary situations.

Every failure of a systemic financial firm is different, and I would consider the facts and circumstances on a case-by-case basis in deciding whether to vote in favor of recommending that the Treasury Secretary use Title II's Orderly Liquidation Authority. One aspect of Title II that would factor into my analysis is that Title II does not allow for government capital injections and requires that taxpayers suffer no losses from the resolution.

- **Do you think current bank risk-based capital levels are too high, too low, or about right? How about the leverage ratio?**

Maintaining the safety and soundness of the largest U.S. banks is fundamental to maintaining the stability of the U.S. financial system and the broader economy. To be safe and sound financial institutions, these firms must be well capitalized. The U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system.

High-quality common equity tier 1 capital (CET1) is important because it is available under all circumstances to absorb losses. Since the financial crisis, U.S. banks have been required to meet new higher minimum requirements for CET1 to ensure a solid base of protection against losses. U.S. banks also have been required to meet a new capital conservation buffer on top of the minimum to preserve flexibility to make capital distributions. For the U.S. global systemically important banks (G-SIBs), the Federal Reserve has imposed an additional capital surcharge designed to reduce the threat that a failure of any of these firms would pose to financial stability. (Commonly referred to as the GSIB surcharge.) Large U.S. banking firms have roughly doubled their capital positions from before the crisis to today.

If confirmed, I look forward to examining this question more closely and consulting with my colleagues. Absent critical supervisory information, it would be premature for me to judge the precise appropriate capital levels. However, given its importance, I am very encouraged by the steps that I have observed the Federal Reserve has taken.

2. As you may know in S. 2155, we contemplate raising the enhanced prudential standards from $50 billion to $250 billion, with an 18 month-delayed effectiveness to give the Fed time to do a rulemaking and decide whether it should apply any of the enhanced prudential standards to banks between $100 billion and $250 billion.

- **What do you see as the most important enhanced prudential standards for these midsized banks?**

Throughout out banking regulatory system, we should continue to protect the core tenets of regulatory reform--capital, stress testing, liquidity, resolution planning, and orderly liquidation authority. One important post-crisis reform maintained for banks of that size by S. 2155 is periodic stress testing.

The Federal Reserve further helps ensure the capital adequacy of our largest banking firms through the annual stress testing and Comprehensive Capital Analysis Review (CCAR) exercises, which consider the losses these firms would suffer under adverse economic scenarios on a forward-looking basis. In doing so, these programs help determine firms' capital needs when they will be needed most--in a serious economic downturn.

As we move away from the crisis and as banks continue to add risk to their balance sheets, the stress testing and CCAR programs will be critical to ensuring that banks are doing so in a manner that does not jeopardize their safety and soundness or the stability of the U.S. financial system.

3. The urban-rural economic divide is an area of particular interest for me and an area where I've done a lot of work. I believe that someone shouldn't be forced to leave their community to find a good paying job. As we've seen in the Great Recession and the recovery that's followed, the impacts of these macroeconomic trends are not universal and, in this case, have often been felt more harshly in rural areas.

- **What do you believe to be the driving forces behind the decline of rural America? Is this trend the result of globalization and technological change?**
- **Do you believe these trends are irreversible?**

Research has shown that employment growth relative to population has been slower in rural areas in recent years than in large cities, and several important measures of well-being in rural areas have declined dramatically over recent decades. While important research is being done to better understand these disturbing trends, no firm conclusions regarding the underlying causes have yet emerged. Research does suggest that globalization and technological change have adversely affected the wages and employment of lower-educated workers, many of whom reside in rural areas. There is also some research that suggests that the increased availability of opioid drugs has also adversely affected employment and welfare in rural areas.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

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- Has the President—or anyone in the Administration—impressed upon you their beliefs on how you should vote on matters of monetary policy?
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As you may know in S. 2155, we contemplate raising the enhanced prudential standards from $50 billion to $250 billion, with an 18 month-delayed effectiveness to give the Fed time to do a rulemaking and decide whether it should apply any of the enhanced prudential standards to banks between $100 billion and $250 billion.

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- What do you believe to be the driving forces behind the decline of rural America? Is this trend the result of globalization and technological change?
- Do you believe these trends are irreversible?

May 30, 2018

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 15, 2018[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michelle W Bowman

Enclosure

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<u>Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Menendez:</u>

1. Will you commit that if confirmed, you will ignore any political pressure or interference, whether it be direct or indirect from the President or any other member of the Administration?

Yes.

2. Do you agree that the achievement of full employment should be associated with strong and broad-based wage growth for average workers, not just senior executives and managers?

The labor market remains strong. Job gains have been solid, on average, in recent months, and the unemployment rate has fallen to 3.9 percent, the lowest level in many years. However, wage growth is also a very important issue, and while it is encouraging that wages seem to be rising a little faster than a few years ago, I would like to see stronger wage growth. In addition, I think that, as the economy improves, it is important that a wide range of individuals and communities benefit from a strong labor market. The Federal Reserve can best help a broad range of workers by focusing on achieving its dual mandate of full employment and stable inflation.

3. Why isn't this tight labor market forcing employers to offer higher and more competitive wages?

Even though wage growth has been slow relative to previous decades, most measures of aggregate wages have increased gradually over the past few years as the labor market has tightened. Moreover, we have seen some indications that workers are benefiting from a tighter labor market in ways other than higher wages. Firms appear to be searching out workers whom they might have previously passed over and seem to be more willing to offer training to workers whose skills need to be improved. I expect these trends to continue and expect workers to reap greater benefits from the strong labor market.

4. To what extent has workers' decreased leverage to negotiate with their employers impacted their ability to demand higher wages?

Over much of the recovery, many workers had very little negotiating leverage with employers because labor was abundant, but jobs were not. This has changed in recent years, and there are signs that negotiating leverage for at least some workers has increased. Some firms are exerting considerably greater effort to find and sign workers, which gives sought-after employees some negotiating leverage. Looking back over a longer time period, it could be that changes in technology, or other factors, may have decreased worker negotiating leverage by, for example, increasing employers' ability to monitor workers, automate tasks or shift production to different locations. But it is difficult to know how much such longer-term developments have affected negotiating leverage and wages.

5. Do you agree with Federal Reserve Governor Brainard that it is important to retain a focus on place as the Federal Reserve contemplates changes to the Community Reinvestment Act? Do you agree that in some low-income and hard to reach communities, physical branches are sometimes the only way to meet local credit needs?

In Governor Brainard's recent remarks on Community Reinvestment Act (CRA) modernization, she stated that the time is "ripe for a refresh to make it even more relevant to today's challenges." In particular, she focused on finding a way to expand the area in which a bank's CRA activities are evaluated, in addition to the importance of retaining a core focus on location.

In her statement, she cited research that demonstrates that branches are an important vehicle for reaching small business customers and low-income consumers.

I agree with her assessment that the agencies should focus on how to make the area where CRA activity is evaluated more meaningful to both banks and low-and moderate-income communities.

6. Do you agree that robust enforcement against discriminatory or unfair and deceptive lending practices must work hand-in-hand with any revisions to the Community Reinvestment Act?

Discrimination and other illegal credit practices are barriers to helping to meet community credit needs and, as such, are inconsistent with the CRA.

I understand why the regulators take evidence of discrimination into account when assigning CRA ratings as prescribed in the CRA regulations.

I believe that there is a connection between CRA, fair lending, and laws protecting against other illegal credit practices, and this connection should be clear to bankers trying to comply with laws designed to ensure that consumers and communities have fair access to credit.

7. A Treasury Department report issued in April recommends that the Federal Reserve adopt the OCC's new policy allowing banks with failing CRA ratings to merge or expand so long as they can demonstrate a potential benefit.

- **Do you think the Federal Reserve should adopt this policy?**

One means of enforcing CRA is the bank applications process. An institution's most recent CRA record is a particularly important consideration in the applications process. In addition to wanting to serve their communities, banks know that CRA ratings are also important to their ability to grow and expand.

I understand that the Office of the Comptroller of the Currency's (OCC) guidance on how it will assess CRA ratings in the context of its review of a banking application has recently changed and varies from the Federal Reserve's guidance. If confirmed to the Federal Reserve Board (Board), I would want to understand how the Federal Reserve guidance is applied and the nature of the differences between its guidance and the OCC's approach.

Fundamentally, I believe that it is important to maintain the Congress' intent to use the CRA as a measure in evaluating banking applications, while ensuring that there is clarity and transparency for banks to understand how the guidance is applied.

8. Prior to the financial crisis, regulators treated assets like subprime mortgage-backed securities as "low risk," which allowed big banks to load up on risky assets without the necessary capital backing. When the crisis hit, the nation's biggest banks didn't have the capital to withstand the losses.

- **Do you agree that regulators and banks misperceived risks before the last crisis, and assigned low ratings to assets that were actually toxic?**

The financial crisis highlighted deficiencies in both the quantity and quality of capital required by the banking agencies' regulatory capital rules. Since the crisis, U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms. Maintaining the safety and soundness of the largest U.S. banks is fundamental to maintaining the stability of the U.S. financial system and the broader economy.

9. Last month, the Fed and the OCC proposed a rule that would weaken the enhanced supplementary leverage ratio, a requirement that the nation's biggest banks hold enough capital to support lending and absorb losses in a downturn. Those banks are required to meet leverage ratios at the holding company level and at the depository institution level—where the deposits are backed by taxpayers. According to the FDIC, this proposal would result in the departure of more than $120 billion in capital—capital that our regulators unanimously deemed necessary after the financial crisis to ensure our nation's largest banks can withstand losses. Federal Reserve Governor Brainard voted against this proposal – the first dissent in the history of Board votes it keeps on it's website (315 votes total) – and the FDIC declined to join the proposal, a significant departure from other post-crisis rulemaking, even though the Fed and FDIC jointly established this rule after the crisis.

- **Are you at all concerned that without the backstop of an adequate leverage ratio for the nation's eight biggest banks, banks will once again load up on so-called "low risk" assets, and place taxpayers at risk of future bailouts?**

The supplementary leverage ratio is an important component of the regulatory capital framework. The enhanced supplementary leverage ratio standards applicable to U.S. global systemically important banks were intended to serve as an appropriate complement and strong backstop to these firms' risk-based capital requirements. It is important to get the relative calibration of the leverage and risk-based requirements right.

Experience suggests that the enhanced supplementary leverage ratio standards are currently calibrated too high, creating potential incentives for firms to disengage from certain low-risk, low-return financial activities that are beneficial for the economy. Similarly, they potentially incent high-risk, high-return activities. Modest recalibration can reduce these negative incentives while not materially changing overall large bank holding companies' capital requirements.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Bob Menendez:

- Will you commit that if confirmed, you will ignore any political pressure or interference, whether it be direct or indirect from the President or any other member of the Administration?

- Do you agree that the achievement of full employment should be associated with strong and broad-based wage growth for average workers, not just senior executives and managers?

- Why isn't this tight labor market forcing employers to offer higher and more competitive wages?

- To what extent has workers' decreased leverage to negotiate with their employers impacted their ability to demand higher wages?

- Do you agree with Federal Reserve Governor Brainard that it is important to retain a focus on place as the Federal Reserve contemplates changes to the Community Reinvestment Act? Do you agree that in some low-income and hard to reach communities, physical branches are sometimes the only way to meet local credit needs?

- Do you agree that robust enforcement against discriminatory or unfair and deceptive lending practices must work hand-in-hand with any revisions to the Community Reinvestment Act?

A Treasury Department report issued in April recommends that the Federal Reserve adopt the OCC's new policy allowing banks with failing CRA ratings to merge or expand so long as they can demonstrate a potential benefit.

- Do you think the Federal Reserve should adopt this policy?

Prior to the financial crisis, regulators treated assets like subprime mortgage-backed securities as "low risk," which allowed big banks to load up on risky assets without the necessary capital backing. When the crisis hit, the nation's biggest banks didn't have the capital to withstand the losses.

- Do you agree that regulators and banks misperceived risks before the last crisis, and assigned low ratings to assets that were actually toxic?

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<u>Questions for Mr. Richard Clarida, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Senator Menendez:</u>

1. How many times did you meet with President Trump prior to being selected as a nominee to the Federal Reserve?

I met with President Trump one time.

2. In that/those meeting(s), did President Trump ask how you would vote on proposed increases to the federal funds rate?

The President did not ask how I would vote on proposed increases to the federal funds rate.

3. Did the President indicate a preference, one way or the other, for how you should approach decisions on whether to increase the federal funds rate?

The President did not indicate a preference for how I should approach decisions on whether to increase the federal funds rate.

4. After meeting with the President, do you believe he understands the value of an independent central bank? If yes, what did he say to give you that indication?

In addition to my meeting with the President, I had a number of meetings over several months with a number of officials in the Administration. In no meeting and at no time did I ever have any cause for concern that anyone I met with questioned the independence of the Federal Reserve to conduct monetary policy that would best achieve the mandates assigned to it by the Congress.

5. Will you commit that if confirmed, you will ignore any political pressure or interference, whether it be direct or indirect from the President or any other member of the Administration?

I have no reason to expect any political pressure or interference, but I fully commit that if confirmed I would completely ignore any political pressure or interference, whether it be direct or indirect from any member of the Administration.

6. Do you agree that the achievement of full employment should be associated with strong and broad-based wage growth for average workers, not just senior executives and managers?

Absolutely, that is something that we would like to see associated with full employment. It is the case in recent decades that there has been more dispersion between workers in different categories and that some workers have fallen behind. There is no consensus on the primary reason for this divergence, but economists tend to attribute this to a number of factors, including globalization, technological change, and a need to better equip workers with the skills needed in today's labor market.

I think the Federal Reserve can best promote faster wage growth by focusing on its full employment mandate--that is, by getting the unemployment rate to a level that is, on average, consistent with a healthy labor market, but acknowledging that there are factors at work that are impacting different workers in different ways and encouraging policymakers to address those inequities.

7. Why isn't this tight labor market forcing employers to offer higher and more competitive wages?

It is true that measures of nominal wage growth have been increasing more slowly recently than during the strong labor markets of the mid-2000s or late 1990s. While many factors may be contributing to the relatively slow growth in wages, the most important factor is likely the slowdown in productivity growth over the past decade or so. Indeed, over the past couple of years (and over the past decade), productivity growth averaged 1 percent per year, well below the average rate of 2-1/4 percent since 1950. When productivity growth is lower, employers cannot afford to increase wages by as much as otherwise. Price inflation has also been slower over the past two years than the tight labor market of 2006-2007. As a result, real wage growth, which is what matters for workers' welfare, has not slowed as much as nominal wages.

Even though current wage growth is lower than previously, most measures of aggregate wages have increased gradually as the labor market has tightened, suggesting that the tighter labor market is pushing up wages. If the labor market tightens further, I would expect wage growth to rise as well, all else held constant.

8. To what extent has workers' decreased leverage to negotiate with their employers impacted their ability to demand higher wages?

It is difficult to assess how much decreased negotiating leverage has affected workers' ability to demand higher wages. Workers' leverage has increased as the labor market has tightened, producing higher wages and greater employment and employer-provided training. Although wage growth is lower currently than in previous periods of strong labor demand--which would be consistent with decreased negotiating leverage--several other factors are also likely holding down wages. Productivity growth, which is ultimately responsible for the increase in real wages over time, has been quite slow in recent years, as has inflation which influences the rate of nominal wage growth. It's possible that changes in technology may have decreased worker negotiating leverage by, for example, increasing employers' ability to monitor workers and automate jobs, and by making it easier for employers to shift production to different locations. But it is difficult to distinguish the effect of any change in workers' negotiating leverage from the influence of other factors.

9. Do you agree with Federal Reserve Governor Brainard that it is important to retain a focus on place as the Federal Reserve contemplates changes to the Community Reinvestment Act? Do you agree that in some low-income and hard to reach communities, physical branches are sometimes the only way to meet local credit needs?

Governor Brainard has stated that the time is right to revise the Community Reinvestment Act (CRA) regulations and, in particular, expand the area in which a bank's CRA activities are evaluated. She also emphasized the importance of retaining a core focus on place. In her statement, she cited research that demonstrates that branches are an important vehicle for reaching small business customers and low-income consumers.

I agree with her assessment that the agencies should be thoughtful about how to make the area where CRA activity is evaluated more meaningful to both banks and low-and moderate-income communities.

10. Do you agree that robust enforcement against discriminatory or unfair and deceptive lending practices must work hand-in-hand with any revisions to the Community Reinvestment Act?

Discriminatory and other illegal credit practices are inconsistent with helping to meet community credit needs and, as such, have a negative effect on a bank's CRA performance. I understand that the Federal Reserve takes evidence of discrimination into account when assigning CRA ratings as prescribed in the CRA regulations. It is important to retain the connection between CRA, fair lending, and laws protecting against other illegal credit practices to ensure that consumers have fair access to credit. I would support examinations that are data-driven, as much as possible, to examine for compliance with fair lending laws and regulations.

11. A Treasury Department report issued in April recommends that the Federal Reserve adopt the OCC's new policy allowing banks with failing CRA ratings to merge or expand so long as they can demonstrate a potential benefit.

- **Do you think the Federal Reserve should adopt this policy?**

The applications process serves as a means of enforcing CRA, which requires that the appropriate federal supervisory agency consider a depository institution's record of helping to meet the credit needs of its local communities and to take that record and public comments into account in evaluating applications for deposit-taking facilities, such as for mergers, acquisitions, and branches.

I understand that the Office of the Comptroller of the Currency (OCC) issued guidance last November on how it will assess CRA ratings in the context of its review of a banking application, which varies from the Federal Reserve's guidance.[1] If confirmed, I would want to understand better how the agencies' respective guidance differ and ensure that there is clarity and transparency so that banks can comply, and applications can be evaluated in a manner that is consistent with the congressional intent of enforcing the CRA.

12. Prior to the financial crisis, regulators treated assets like subprime mortgage-backed securities as "low risk," which allowed big banks to load up on risky assets without the

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[1] OCC, Policy and Procedures Manual, "Impact of CRA Ratings on Licensing Applications", PPM 6300-2, November 8, 2017, www.occ.treas.gov/publications/publications-by-type/other-publications-reports/ppms/ppm-6300-2.pdf.

necessary capital backing. When the crisis hit, the nation's biggest banks didn't have the capital to withstand the losses.

- **Do you agree that regulators and banks misperceived risks before the last crisis, and assigned low ratings to assets that were actually toxic?**

The financial crisis demonstrated the importance of a financial system that has sufficient capital to absorb losses and allow banks to continue lending in an economic downturn. Since the crisis, the U.S. banking agencies have appropriately strengthened and improved the quality of the regulatory capital requirements for U.S. banking firms.

13. Last month, the Fed and the OCC proposed a rule that would weaken the enhanced supplementary leverage ratio, a requirement that the nation's biggest banks hold enough capital to support lending and absorb losses in a downturn. Those banks are required to meet leverage ratios at the holding company level and at the depository institution level—where the deposits are backed by taxpayers. According to the FDIC, this proposal would result in the departure of more than $120 billion in capital—capital that our regulators unanimously deemed necessary after the financial crisis to ensure our nation's largest banks can withstand losses. Federal Reserve Governor Brainard voted against this proposal – the first dissent in the history of Board votes it keeps on its website (315 votes total) – and the FDIC declined to join the proposal, a significant departure from other post-crisis rulemaking, even though the Fed and FDIC jointly established this rule after the crisis.

- **Are you at all concerned that without the backstop of an adequate leverage ratio for the nation's eight biggest banks, banks will once again load up on so-called "low risk" assets, and place taxpayers at risk of future bailouts?**

In setting capital requirements, there is a risk that leverage ratios may become too binding. When a leverage ratio becomes a binding constraint, it can create incentives for firms to increase their investments in higher-risk, higher-return assets and, conversely, reduce their participation in lower-risk activities. My understanding of the enhanced supplementary leverage ratio proposal is that it was aimed at striking an appropriate balance between leverage and risk-based capital requirements. If I was to be confirmed, I would look forward to better understanding the analysis underpinning the proposal and the public comments that were received in response.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

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- Did the President indicate a preference, one way or the other, for how you should approach decisions on whether to increase the federal funds rate?

- After meeting with the President, do you believe he understands the value of an independent central bank? If yes, what did he say to give you that indication?

- Will you commit that if confirmed, you will ignore any political pressure or interference, whether it be direct or indirect from the President or any other member of the Administration?

- Do you agree that the achievement of full employment should be associated with strong and broad-based wage growth for average workers, not just senior executives and managers?

- Why isn't this tight labor market forcing employers to offer higher and more competitive wages?

- To what extent has workers' decreased leverage to negotiate with their employers impacted their ability to demand higher wages?

- Do you agree with Federal Reserve Governor Brainard that it is important to retain a focus on place as the Federal Reserve contemplates changes to the Community Reinvestment Act? Do you agree that in some low-income and hard to reach communities, physical branches are sometimes the only way to meet local credit needs?

- Do you agree that robust enforcement against discriminatory or unfair and deceptive lending practices must work hand-in-hand with any revisions to the Community Reinvestment Act?

A Treasury Department report issued in April recommends that the Federal Reserve adopt the OCC's new policy allowing banks with failing CRA ratings to merge or expand so long as they can demonstrate a potential benefit.

- Do you think the Federal Reserve should adopt this policy?

Prior to the financial crisis, regulators treated assets like subprime mortgage-backed securities as "low risk," which allowed big banks to load up on risky assets without the necessary capital backing. When the crisis hit, the nation's biggest banks didn't have the capital to withstand the losses.

- Do you agree that regulators and banks misperceived risks before the last crisis, and assigned low ratings to assets that were actually toxic?

Last month, the Fed and the OCC proposed a rule that would weaken the enhanced supplementary leverage ratio, a requirement that the nation's biggest banks hold enough capital to support lending and absorb losses in a downturn. Those banks are required to meet leverage ratios at the holding company level and at the depository institution level—where the deposits are backed by taxpayers. According to the FDIC, this proposal would result in the departure of more than $120 billion in capital—capital that our regulators unanimously deemed necessary after the financial crisis to ensure our nation's largest banks can withstand losses. Federal Reserve Governor Brainard voted against this proposal – the first dissent in the history of Board votes it keeps on its website (315 votes total) – and the FDIC declined to join the proposal, a significant departure from other post-crisis rulemaking, even though the Fed and FDIC jointly established this rule after the crisis.

- Are you at all concerned that without the backstop of an adequate leverage ratio for the nation's eight biggest banks, banks will once again load up on so-called "low risk" assets, and place taxpayers at risk of future bailouts?

May 30, 2018

The Honorable Sherrod Brown
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 15, 2018[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michelle Bowman

Enclosure

[1] Questions for the record related to this hearing were received on May 23, 2018.

<u>Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Ranking Member Brown:</u>

1. What is your view on what caused the 2008 financial crisis? What responsibility does the Federal Reserve share in terms of failures in regulatory and supervisory policy?

A build-up of leverage and maturity transformation in the years leading up to the crisis left the U.S. and global economy vulnerable to shocks. When the housing market turned down, the effects of that shock were amplified as leverage was wound down and funding patterns shifted. The result was what we all painfully experienced as the financial crisis.

Since then, post-crisis reforms have been designed to reduce the likelihood and severity of future financial crises. These efforts have been aimed at shoring up issues in the private sector, in regulation, and in the mandates and tools of the various regulatory agencies, including the Federal Reserve.

The Federal Reserve's response to the crisis included boosting the resilience of the financial system through stronger capital, liquidity, and other prudential requirements for large banking firms. Capital is critical to ensuring resiliency, as are the availability of high-quality liquid assets, appropriate management of risks, and the presence of a plan for resolution in case it is needed. Progress has been made in all of these areas, and newer tools like the stress testing regime and the countercyclical capital buffer should also contribute to the resiliency of the financial system going forward. I believe these actions have, broadly speaking, increased the resilience of the financial system.

2. How did large bank and investment bank leverage contribute to the 2008 financial crisis?

The increase in leverage, along with the rise of other vulnerabilities, contributed to the negative effects that were felt when the housing market turned down sharply in the United States. As the crisis unfolded in the Spring of 2008, markets were focused on the firms that had the highest leverage ratios, and it was one of the factors that led to investors putting more pressure on some firms than others.

It would be a mistake, however, to focus only on leverage. Maturity transformation, for example, also played a critical role, as did other vulnerabilities. Many firms relied on short-term wholesale funding that they then used to purchase longer-term assets. When that funding dried up, firms had difficulty finding new financing for those assets. As a result, assets were sold, and the effects were felt throughout the financial system and in the real economy.

3. How would you characterize current risk-weighted and leverage capital levels for the largest U.S. banks – too low, too high, or the correct amount?

Maintaining the safety and soundness of the largest U.S. banks is fundamental to maintaining the stability of the U.S. financial system and the broader economy. To be safe and sound financial institutions, these firms must be well-capitalized. The U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system. Indeed, large U.S. banking firms have roughly doubled their capital positions from before the crisis to today, making them significantly more resilient, as well as able to support lending and financial intermediation in times of financial stress. If confirmed, I look forward to looking more closely at this question and consulting with my colleagues.

4. As you know, the Federal Reserve recently proposed reducing leverage requirements for the eight biggest U.S. global systemically important banks (GSIBs).[1] In discussing the impact of its proposal, the Federal Reserve noted that it would reduce the amount of tier 1 capital required across the lead insured depository institution (IDI) subsidiaries of the GSIBs by approximately $121 billion.

- **Could a reduction in IDI capital pose any risks to depositors, taxpayers, or financial stability? Why or why not?**

While capital is good for absorbing losses, the manner in which capital requirements are determined can have important consequences. If a leverage ratio becomes a binding constraint, it can create incentives for banking organizations to reduce their participation in lower-risk, lower-return business activity, such as repo financing, central clearing services for market participants, and taking custody deposits, notwithstanding client demand for those services. Similarly, it can create incentives for firms to increase their participation in higher-risk, higher-return activities.

- **What is your view on raising the enhanced prudential standards threshold pursuant to Dodd-Frank section 165 from $50 billion to $250 billion in total consolidated assets, as contemplated in S.2155?**

I agree that regulation and supervision should be tailored in a manner that allows the financial system to more efficiently support the real economy. The Federal Reserve has been working for many years to tailor regulation and supervision to the size, systemic footprint, and risk profile of individual institutions. Recognizing the levels and types of risk of the different institutions in the financial system improves the quality and efficiency of regulation, but I believe more tailoring can and should be done.

It is reasonable for Congress to raise the $50 billion asset threshold to limit the scope of the enhanced prudential standards to larger bank holding companies. My understanding is that the Economic Growth, Regulatory Relief, and Consumer Protection Act (Act) preserves the ability of the Federal Reserve to reach below the new $250 billion line, if warranted, to subject a firm to more stringent regulation. In general, the Act preserves the Federal Reserve's ability to adequately monitor and regulate systemic risk of banking firms as well as its ability to regulate banking firms for safety and soundness objectives.

- **Federal Reserve Vice Chair Quarles has said that the Volcker Rule "is an example of a complex regulation that is not working well."[2] Do you agree or disagree? Why?**

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[1] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm.

[2] https://www.reuters.com/article/us-usa-fed-quarles/u-s-considering-material-changes-to-volcker-rule-feds-quarles-idUSKBN1GH2U8.

While Congress recently enacted legislation excluding smaller firms from the Volcker Rule, there is still room for the Federal Reserve and the other responsible agencies to tailor and reduce regulatory requirements to more efficiently implement the policy objectives of the statute in a manner consistent with the safety and soundness of the banking system. It is worthwhile for the agencies to consider further tailoring the implementing rule as it applies to firms that do not engage in a large amount of trading activity, and to simplify the requirements for satisfying exemptions for permitted activities such as hedging, market making, and underwriting. These changes would provide clarity to banking organizations and help them more efficiently provide market liquidity and facilitate capital formation.

- **What is your view of the Community Reinvestment Act? Does it need to be altered or modernized by the Federal Reserve? If so, what changes do you support?**

The Community Reinvestment Act's (CRA) goal of encouraging banks to meet their obligation to serve their entire community, including in low-and moderate-income communities is critically important. All communities, particularly low-and moderate-income communities, thrive when they have access to credit on fair terms that increase opportunities for investing in homes, starting businesses, and education.

I believe that the current CRA supervisory and regulatory framework could be improved based on feedback from industry and community stakeholders, and that it is time to review the CRA regulations to ensure they are effective in achieving the important objectives set by Congress. In particular, the regulation's definition of "assessment area," should be revised to reflect significant changes in the banking landscape since CRA was enacted and the current CRA regulations were adopted.

Technology and other industry advancements have enabled banks to serve consumers in areas far from their physical branches. As such, it is sensible for the agencies to consider expanding the assessment area definition to reflect the local communities that banks serve through delivery systems other than branches.

I believe that additional input and analysis on this matter will be needed to determine how best to define such assessment areas and how to evaluate performance in those areas.

5. On May 23, the FDIC released their Quarterly Banking Profile. It shows that that bank profits increased 28 percent over the last year, and even more for community banks.

- **Do you think it is sound policy to reduce capital requirements for banks that have profit levels this high?**

We need a resilient, well-capitalized financial system that is strong enough to withstand even severe shocks and support economic growth by lending through the economic cycle. To that end, the U.S. banking agencies have substantially strengthened regulatory capital requirements for U.S. banking firms, improving the quality and increasing the amount of capital in the banking system. At the same time, it is important to monitor the capital rules on an ongoing basis, to determine whether the framework is effectively measuring and addressing risk and working as intended, and to adjust the framework as needed.

- **If confirmed, you will be a member of the Federal Open Market Committee. What experience will you bring to this role? Are there any changes in how monetary policy is currently conducted that you will advocate for?**

The Federal Reserve's mandate to promote maximum employment and stable prices is critically important to our economy, to businesses, families and communities, and if I am confirmed, I will be very focused on how we can do the best job possible to fulfill that mandate.

My views on employment and the labor market have certainly been shaped by the experience of the last 10 to 15 years. We've seen the nation go from high levels of employment and solid wage growth into a very deep recession. In the crisis, it was clear that many people who were able to work lost their jobs and could not find work, and businesses that had the capacity to produce and grow could not find a market for their goods and services. And when you have a huge gap between what the economy can do and what it is currently doing, I believe that is where policy makers like the Federal Reserve can take appropriate action, sometimes quite strong action, and help the economy get back to a more normal level of employment and output.

Of course, as I have seen in my career as a community banker and as a regulator, the labor market, in a large, diverse economy like ours, is quite complicated and there are many factors to consider in measuring its health. For example, who is available to work and what can they do? I have worked with businesses that have trouble hiring, because there may be a shortage of highly skilled workers. In some communities in my home state, there are demographic changes--an aging workforce, for example--that affects how much businesses can hire. My family's bank lends to many consumers, and often we have seen that a strong job market will bring people back into the workforce and that is a good thing. And, of course, when there is strong demand for workers and the economy is growing, we see wages begin to grow. A strong economy supports strong wage growth.

Given the complexity involved in looking at the labor market, common sense tells me to be careful in assuming there is a precisely right level of employment that we can be very confident in saying is the right level for all economic conditions. In general, my approach as a community banker and regulator has been to take a look at all the best evidence and analysis you can find, listen hard to many different views, and then make your best judgment. And that is how I will approach evaluating the health of the labor market, should I be confirmed.

Stable prices and the level of overall inflation is a critical part of the dual mandate and, should I be confirmed, I will be focused on achieving this important goal. When inflation gets too high or too low, or is too volatile, that hurts everyone--consumers, businesses, and communities--because making economic decisions and planning for the future becomes more and more difficult.

I think one of the most important things the Federal Reserve can do is make sure that the expectations that people have for where inflation is heading remain stable. As a banker, I never wanted people to be put in a position where they were coming into my bank and showing me a business plan where they were just unable to predict what price they would be paying for a very broad range of important goods and services a year or two from now. Of course, some prices will always be going up while others will be going down. That is just how markets work. What is important is that the general level of prices remains fairly predictable. When people borrow money or make plans, it is important that they feel confident that their future incomes will support that debt and those plans. I want people focusing on making good business decisions, not spending their time guessing about inflation. So keeping inflation and inflation expectations stable is very important to me.

I also think we have learned that inflation can be too low. If demand is weak for a prolonged period of time, businesses cannot sell goods, they lower prices further, lay people off, keep wages down. And we have seen that is a tough cycle to break free from. For the Federal Reserve, when you get interest rates very low, it is hard to create additional incentives for borrowing and investing. It is tough to go below zero. As a policy maker, I would want to make sure we keep inflation at an appropriate level, so we reduce our risk of getting back to the so-called Zero Lower Bound.

Finally, let me just say that there is a great deal of complexity that goes into understanding why the general level of prices change. For example, Kansas produces a lot of oil and natural gas, so I am well aware of how swings in the supply and demand for commodities can shape prices. But it is not always clear how businesses and consumers set their expectations for inflation. Productivity and technological change affect prices too. This is an important area for more research, and I look forward to learning more about these topics, if I am confirmed.

- **Since the crisis, do you think the Federal Open Market Committee has been on the right course by gradually increasing interest rates?**

I believe the Federal Open Market Committee's (FOMC) monetary policy decisions should be guided strictly by its responsibilities under current law to promote maximum employment and price stability. The FOMC has been raising its target for the federal funds rate since December 2015 and reducing the size of its holdings of Treasury securities and mortgage-backed securities since October of 2017. The FOMC's gradual approach to reducing monetary accommodation in this way has been instrumental in supporting the economic recovery and a return of inflation to the FOMC's 2 percent objective. The FOMC has also stressed and I also believe that it is appropriate that monetary policy is not on a preset course. Instead, it is data dependent and chosen to best achieve the objectives set forth by Congress. If confirmed, I would look forward to working with other members of the FOMC to further promote the attainment of the FOMC's statutory goals.

6. As you know, the Federal Reserve currently uses a variety of monetary policy rules, including the Taylor rule, in its analysis and monetary policy decisionmaking, but does not rely solely on rules to determine interest rate adjustments.

- **Do you agree with the Federal Reserve's current approach, or will you advocate that the Fed use a single rule?**

The economy is very complex, and monetary policy is determined in an environment in which a multitude of indicators and conditions must be taken into account. Simple rules, by definition, cannot accommodate such a wide variety of considerations. For example, simple rules generally do not accommodate variation in the expectations of investors and consumers, risks to the economic outlook, or deep economic conditions such as productivity growth that may be time-varying. All that said, simple monetary policy rules do have some appeal because they capture some key elements of appropriate policy, and I believe that it is useful for policy makers to routinely consult the recommendations from a variety of benchmark rules. I also believe it can be useful for the FOMC to explain to Congress and the public the differences between its policies and those prescribed by simple rules, and the reasons for those differences.

- **While the unemployment rate continues to fall, the labor force participation rate remains at about its lowest level in 40 years. What do you think is contributing to this?**

The labor market remains strong. Job gains have been solid, on average, in recent months, and the unemployment rate has fallen to 3.9 percent, the lowest level in many years. As you note, however, the labor force participation rate is still quite low by historical standards. To some extent, the downward trend in the overall participation rate reflects demographic forces, most prominently increased retirements among members of the large baby boom generation. However, the labor force participation rate for prime-age workers is also below its level prior to the financial crisis, although it has risen more recently in response to the tight labor market. Longer-term trends in globalization and automation have likely contributed to the decline in prime-age participation over time, but my hope and expectation is that a strong labor market will continue to pull many of these workers back into the labor force.

- **Do think the opioid addiction epidemic is related to the decline in labor force participation among prime-age workers?**

The opioid epidemic is a very serious crisis that has had severe consequences for the affected individuals and their families. In addition, the opioid epidemic undoubtedly has had adverse effects on the economy. For example, I think the evidence shows that opioid addiction adversely affects an individual's ability to participate effectively in the labor market and thus has contributed to the decline in labor force participation among prime-age workers. Of course, causality may go the other way as well, with a lack of job opportunities, particularly in rural areas, contributing to both withdrawal from the labor force and increased opioid abuse.

- **Over the past forty years the link between productivity and wage increases has eroded. More and more, productivity gains aren't shared with workers. Why do you think wage growth has not kept pace with productivity growth? Is there anything the Fed can do to increase wages? Can the Federal Reserve, through monetary policy or regulatory policy, do more for individuals and communities that have not experienced the benefits from the economic recovery?**

Wage growth is a very important issue, and while it is encouraging that wages seem to be rising a little faster than a few years ago, I would like to see stronger wage growth. In addition, I think that, as the economy improves, it is important that a wide range of individuals and communities benefit from a strong labor market. However, monetary policy is a blunt tool that is not well equipped to affect specific sectors of the economy. Rather, the Federal Reserve can best help individuals and communities by focusing on achieving its dual mandate of full employment and stable inflation.

- **If confirmed, how will you advocate for increased diversity in the Federal Reserve System?**

There is great value in having a diverse workforce at all levels of an organization. Diversity, including diversity of thought, perspective, and experience, is an important attribute of all successful organizations. Better decisions are made when we have a wide range of backgrounds and voices to draw from.

I am committed to achieving further progress, and to better understanding the challenges to improving and promoting diversity of ideas and backgrounds at the Federal Reserve Board (Board) and the Federal Reserve Banks (Reserve Banks), including in the senior leadership ranks. My position will provide opportunities to meet and speak with individuals and groups throughout the System, the financial community, and regional and community organizations. Those opportunities will enable me to express strong support for the System's initiatives to encourage individuals with diverse cultural, academic, and professional backgrounds to consider positions with the Federal Reserve. I will also welcome the opportunity to work with Board and System groups to enhance programs and initiatives to identify and recruit individuals with diverse backgrounds and perspectives for careers at the Board and the Reserve Banks, as well as to create an environment where all will be successful.

- **Federal Reserve Board of Governors nominee Marvin Goodfriend, has recommended that the "central bank put in place systems to raise the cost of storing money by imposing a carry tax on its monetary liabilities." Do you believe that there should be a currency tax, or that there are financial conditions that would call for a currency tax?**

The United States dollar enjoys a well-earned status as a store of value and a reliable means of exchange both domestically and across the world. Any new policy that could undermine the confidence that is placed in the dollar should be thought through very carefully and undertaken only after a great deal of study. Fortunately, the United States economy is strong and inflation is close to 2 percent, so there is no need to consider such a policy. Moreover, the Federal Reserve's main monetary policy tools have helped to meet the goals set forth for the Federal Reserve by statute.

- **Please provide a complete list of The Bowman Group's clients.**

The Bowman Group provided consulting services to the following entities in the United Kingdom and European Union between 2004 and 2009: UK Industry and Parliament Trust; Titan Corporation, UK LTD; Conservative Shadow Homeland Security Spokesman Patrick Mercer, MP (Homeland Security Advisory Panel); DKE Aerospace; Conservative Friends of America; and Localis.

- **Please describe in detail greater than you provided in your Office of Government Ethics letter how you will comply with the Federal Reserve Act requirement that you cannot hold stock in any bank, banking institution, or trust company?**

I will divest shares of bank stock currently held in my name in accordance with the ethics agreement following confirmation. In addition, following confirmation, in accordance with the ethics agreement, the two trusts containing bank stock will be rewritten with advice of counsel according to a provision in Missouri trust law that provides for "decanting"--or rewriting--the trusts to exclude me and my heirs as beneficiaries of the trusts. While serving as a member of the Board, I will not acquire any stock in a bank, banking institution, or trust company.

- **If confirmed, do you intend to serve for the entirety of your term?**

Should I be confirmed, I intend to serve the entirety of the term.

- **After your term as a member of the Federal Reserve Board of Governors, do you have any plans to resume employment or serve on the Board of your family's bank?**

At this time, I do not intend to, nor have I been asked to, return to employment or board service at my family's bank.

7. This is the first time this Committee has considered a nominee to fill the position on the Fed Board "with experience working in or supervising community banks having less than $10,000,000,000 in total assets."

- **If confirmed, do you believe it is your role to advocate for the community banking industry?**

The Federal Reserve seeks to foster a strong and stable financial system that serves banking needs in a fair and transparent manner. I believe that this objective can best be achieved when we have a diversified and competitive banking industry that includes a healthy community bank segment. My experience as a banker and state supervisor has shown me the vital role community banks play in providing credit and services to small businesses and communities both large and small. Consequently, I believe it is important to support the community bank model and avoid imposing regulatory burdens that are unnecessary to ensure their safe, sound, and fair operation.

- **If confirmed, what would you like to achieve for community banks?**

I am strongly committed to working to tailor the regulation and supervision of community banks in a manner that ensures their safety and soundness but is appropriate to their size and simplicity. I am particularly interested in working on simplifying capital rules for these banks and reducing the burden of their regulatory reporting requirements. As a community banker and state bank supervisor, I have seen small banks struggle with the burdens imposed by regulation. If confirmed, I want to ensure that the Federal Reserve Board fully considers the perspectives and challenges faced by these banks when it formulates and implements its regulations.

- **Can you clarify your answer to Senator Scott on whether or not you believe the stock market is a pillar of monetary policy?**

Current law requires the Federal Reserve's monetary policy decisions to be guided by its obligation to promote maximum employment and price stability. Many factors must be considered as inputs into monetary policy decision making, and the financial conditions facing business and households, including stock market performance, are often relevant aspects of the outlook for macroeconomic performance. However, the FOMC should not take into account stock market performance for any purpose outside of what is necessary to achieve its goals as established by Congress. Fortunately, the United States economy is strong and inflation is close to 2 percent, and financial market conditions currently appear sufficiently accommodative to further support macroeconomic performance.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

Questions for Ms. Michelle Bowman, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Ranking Member Brown:

- What is your view on what caused the 2008 financial crisis? What responsibility does the Federal Reserve share in terms of failures in regulatory and supervisory policy?

- How did large bank and investment bank leverage contribute to the 2008 financial crisis?

- How would you characterize current risk-weighted and leverage capital levels for the largest U.S. banks – too low, too high, or the correct amount?

As you know, the Federal Reserve recently proposed reducing leverage requirements for the eight biggest U.S. global systemically important banks (GSIBs).1 In discussing the impact of its proposal, the Federal Reserve noted that it would reduce the amount of tier 1 capital required across the lead insured depository institution (IDI) subsidiaries of the GSIBs by approximately $121 billion.

- Could a reduction in IDI capital pose any risks to depositors, taxpayers, or financial stability? Why or why not?

- What is your view on raising the enhanced prudential standards threshold pursuant to Dodd-Frank section 165 from $50 billion to $250 billion in total consolidated assets, as contemplated in S.2155?

- Federal Reserve Vice Chair Quarles has said that the Volcker Rule "is an example of a complex regulation that is not working well."2 Do you agree or disagree? Why?

- What is your view of the Community Reinvestment Act? Does it need to be altered or modernized by the Federal Reserve? If so, what changes do you support?

On May 23, the FDIC released their Quarterly Banking Profile. It shows that that bank profits increased 28 percent over the last year, and even more for community banks.

- Do you think it is sound policy to reduce capital requirements for banks that have profit levels this high?

- If confirmed, you will be a member of the Federal Open Market Committee. What experience will you bring to this role? Are there any changes in how monetary policy is currently conducted that you will advocate for?

[1] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm
[2] https://www.reuters.com/article/us-usa-fed-quarles/u-s-considering-material-changes-to-volcker-rule-feds-quarles-idUSKBN1GH2U8

- Since the crisis, do you think the Federal Open Market Committee has been on the right course by gradually increasing interest rates?

As you know, the Federal Reserve currently uses a variety of monetary policy rules, including the Taylor rule, in its analysis and monetary policy decisionmaking, but does not rely solely on rules to determine interest rate adjustments.

- Do you agree with the Federal Reserve's current approach, or will you advocate that the Fed use a single rule?

- While the unemployment rate continues to fall, the labor force participation rate remains at about its lowest level in 40 years. What do you think is contributing to this?

- Do think the opioid addiction epidemic is related to the decline in labor force participation among prime-age workers?

- Over the past forty years the link between productivity and wage increases has eroded. More and more, productivity gains aren't shared with workers. Why do you think wage growth has not kept pace with productivity growth? Is there anything the Fed can do to increase wages? Can the Federal Reserve, through monetary policy or regulatory policy, do more for individuals and communities that have not experienced the benefits from the economic recovery?

- If confirmed, how will you advocate for increased diversity in the Federal Reserve System?

- Federal Reserve Board of Governors nominee Marvin Goodfriend, has recommended that the "central bank put in place systems to raise the cost of storing money by imposing a carry tax on its monetary liabilities." Do you believe that there should be a currency tax, or that there are financial conditions that would call for a currency tax?

- Please provide a complete list of The Bowman Group's clients.

- Please describe in detail greater than you provided in your Office of Government Ethics letter how you will comply with the Federal Reserve Act requirement that you cannot hold stock in any bank, banking institution, or trust company?

- If confirmed, do you intend to serve for the entirety of your term?

- After your term as a member of the Federal Reserve Board of Governors, do you have any plans to resume employment or serve on the Board of your family's bank?

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

This is the first time this Committee has considered a nominee to fill the position on the Fed Board "with experience working in or supervising community banks having less than $10,000,000,000 in total assets."

- If confirmed, do you believe it is your role to advocate for the community banking industry?

- If confirmed, what would you like to achieve for community banks?

- Can you clarify your answer to Senator Scott on whether or not you believe the stock market is a pillar of monetary policy?

May 30, 2018

The Honorable Sherrod Brown
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 15, 2018[1], hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Rich Clarida

Enclosure

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[1] Questions for the record related to this hearing were received on May 23, 2018.

<u>Questions for Mr. Richard Clarida, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Ranking Member Brown:</u>

1. What is your view on what caused the 2008 financial crisis? What responsibility does the Federal Reserve share in terms of failures in regulatory and supervisory policy?

Put simply, by 2007 the U.S. financial system was highly fragile. A build-up of leverage and maturity transformation in the years leading up to the crisis left the U.S. and global economy vulnerable to negative surprises. When the downturn in the U.S. housing market occurred, these vulnerabilities amplified the effects of the initial shocks and the result was the financial crisis.

The crisis revealed shortcomings and failures at private institutions, in the overall regulatory framework, and in the actions of specific agencies, including the Federal Reserve.

In response to the crisis, the Federal Reserve increased its regulatory and supervisory scrutiny of the largest financial institutions, for example, putting in place a comprehensive stress-testing regime. In my view, this response has, broadly speaking, increased the resilience of the system.

The new regulatory regime for large banks ensures that the largest institutions are sufficiently strong to continue to function effectively as intermediaries even in periods of substantial financial stress. Capital is critical to ensuring resiliency, as are the availability of high-quality liquid assets, appropriate management of risks, and the presence of a plan for resolution in case needed. Progress has been made in all of these areas, and newer tools like the stress testing regime and the countercyclical capital buffer should also contribute to the resiliency of the system going forward.

2. How did large bank and investment bank leverage contribute to the 2008 financial crisis?

The build-up of leverage to excessive levels was a key contributor to the spread of the financial crisis. In the run up to the crisis, the firms that experienced the worst problems also had some of the highest leverage ratios. And when the problems at Bear Stearns were resolved through its acquisition by JPMorgan, market participants turned their attention to other firms with similarly high levels of leverage.

However, leverage at large financial institutions alone was not responsible for the 2008 financial crisis. When the housing market turned down and housing-related assets fell in value, a series of vulnerabilities amplified the effects of that shock, including the reliance on short-term wholesale funding at large financial institutions. Some of these institutions faced runs by investors and had to sharply cut back their activities in support of the real economy. And, more broadly, the financial system was highly interconnected in opaque and surprising ways.

3. How would you characterize current risk-weighted and leverage capital levels for the largest U.S. banks – too low, too high, or the correct amount?

It is critical to the safety and soundness of the largest U.S. banks and to the broader U.S. financial system and economy that these firms are well capitalized. Since the financial crisis, the U.S. banking agencies have significantly strengthened regulatory capital requirements for large banking firms, which has made them much more resilient and able to continue lending even when under financial stress.

If confirmed, I look forward to examining this question more closely and consulting with my colleagues. Absent critical supervisory information, it would be premature for me to judge the precise appropriate capital levels. However, given its importance, I am very encouraged by the steps that I have observed the Federal Reserve has taken.

4. As you know, the Federal Reserve recently proposed reducing leverage requirements for the eight biggest U.S. global systemically important banks (GSIBs).[1] In discussing the impact of its proposal, the Federal Reserve noted that it would reduce the amount of tier 1 capital required across the lead insured depository institution (IDI) subsidiaries of the GSIBs by approximately $121 billion.

- **Could a reduction in IDI capital pose any risks to depositors, taxpayers, or financial stability? Why or why not?**

In setting capital requirements, there is a risk that leverage ratios may become too binding. When a leverage ratio becomes a binding constraint, it can create incentives for firms to increase their investments in higher-risk, higher-return assets and, conversely, reduce their participation in lower-risk activities.

- **What is your view on raising the enhanced prudential standards threshold pursuant to Dodd-Frank section 165 from $50 billion to $250 billion in total consolidated assets, as contemplated in S.2155?**

I support increased tailoring of regulation and supervision. I believe that it was prudent for the Congress to raise the $50 billion asset threshold for larger bank holding companies in order to limit the scope of enhanced prudential standards. In general, regulation and supervision should continue to be tailored to the size, systemic footprint, and risk profiles of institutions, and my understanding of the Economic Growth, Regulatory Relief, and Consumer Protection Act is that while it adjusts the $50 billion threshold, it still allows the Federal Reserve to subject a firm with a higher risk profile to more rigorous regulation.

- **Federal Reserve Vice Chair Quarles has said that the Volcker Rule "is an example of a complex regulation that is not working well."[2] Do you agree or disagree? Why?**

I think it makes sense to explore whether or not the Volcker Rule can be implemented in a simpler, less burdensome way while still achieving the objectives of the statute.

- **What is your view of the Community Reinvestment Act? Does it need to be altered or modernized by the Federal Reserve? If so, what changes do you support?**

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[1] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm.

[2] https://www.reuters.com/article/us-usa-fed-quarles/u-s-considering-material-changes-to-volcker-rule-feds-quarles-idUSKBN1GH2U8.

The Community Reinvestment Act (CRA) has been a part of banking regulation for 40 years. It would be a very high priority of mine, if confirmed, to make sure that it is enforced.

I support the CRA's goal of encouraging banks to meet their affirmative obligation to serve their entire community, and in particular, the credit needs of low-and moderate-income communities. Doing so benefits low-and moderate-income communities and helps them to thrive by providing opportunities for community members, for example, to buy and improve their homes and to start and expand small businesses.

If confirmed, I would be open-minded to discussions for improving or bringing the CRA up to date, but the essential mission of the act needs to be respected.

5. On May 23, the FDIC released their Quarterly Banking Profile. It shows that that bank profits increased 28 percent over the last year, and even more for community banks.

- **Do you think it is sound policy to reduce capital requirements for banks that have profit levels this high?**

The financial crisis demonstrated the importance of a financial system that has sufficient capital to absorb losses and allow banks to continue lending in an economic downturn. Stronger and higher-quality regulatory capital requirements for U.S. banking firms have therefore been an essential post-crisis reform. However, I believe the banking agencies should continue to examine whether the requirements remain effective over time and adjust the capital framework as appropriate while preserving the essential gains in resiliency and stability of our financial system that have resulted from the reforms put in place since the financial crisis.

- **If confirmed, you will be a member of the Federal Open Market Committee. What experience will you bring to this role? Are there any changes in how monetary policy is currently conducted that you will advocate for?**

In my 35-year professional career, I have achieved recognition among academics, policymakers, and financial market participants as an expert on the economics of monetary policy. My academic work on monetary policy as a professor of economics and international affairs since 1988 at Columbia University (and before that at Yale University) has been frequently cited, and the framework for a more effective monetary policy developed in these papers has been widely consulted by economists at the Federal Reserve and as well as at other major central banks around the world. In this regard, since 2007 I have served as a member of the Deutsche Bundesbank Academic Research Council and have been chairman of this group since 2012. In 2009-2010, I served as an external member of the Norges Bank monetary policy review committee, and since 2012 have served on the Academic Advisory Board of the Hong Kong Monetary Authority's Institute for Monetary Research. Earlier in my career--from 1991 to 1992 and again between 1995 and 1997--I was a consultant at the economic research department of the Federal Reserve Bank of New York as part of a group of academic experts that included Ben Bernanke and future Nobel laureate Christopher Sims. And in 1999, I served as a consultant to Paul Volcker and the Group of 30 and contributed to their Project on Exchange Rate Regimes.

I have been an active member of the National Bureau of Economic Research (NBER) since 1983, and since 2004 have served as a co-organizer of the NBER's annual International Seminar on Macroeconomics, which is typically hosted by a central bank in Europe. I am also a regular participant in the annual Hoover Institution Conference on Monetary Policy, and, last summer, delivered a keynote address at the Bank for International Settlements Annual Research Conference.

Although I have spent most of my career in academia, I have had two opportunities to serve in economic policy positions in the executive branch of the U.S. government: first, as a Senior Staff Economist with Council of Economic Advisers from 1986 to 1987 and second, as Assistant Treasury Secretary for Economic Policy from 2002 to 2003. These experiences were invaluable in providing me a perspective that places a premium on doing economic analysis that is practical, robust, and relevant to better understanding how economic policy impacts individual American and their communities.

Since 2006, I have had the opportunity to advise Pacific Investment Management on global economics and strategy, with a particular focus on global monetary policy. While I myself do not manage portfolios, I have worked with the firm's investment committee to help them interpret and assess global economic and monetary policy trends. I believe this experience has given me an appreciation for the interaction between macroeconomic developments and financial markets that I would not otherwise have obtained.

The Federal Reserve's monetary policy decisions are guided by its statutory mandate to promote maximum employment and price stability. Over the past few years, the Federal Open Market Committee (FOMC) has been gradually reducing monetary policy accommodation. Last year, it raised the target range for the federal funds rate by 3/4 percentage point, and in October it initiated a balance sheet normalization program to gradually reduce its securities holdings. These steps to normalize the stance of monetary policy are welcome, as they reflect the economy's recovery from the financial crisis and recession, the durability of the economic expansion, and the Committee's confidence that inflation will return to 2 percent on a sustained basis. If confirmed, I look forward to working with my colleagues on the FOMC to continue to promote maximum employment and price stability.

- **Since the crisis, do you think the Federal Open Market Committee has been on the right course by gradually increasing interest rates?**

I believe that the gradual increases that the FOMC has made since December 2015 in the target range for the federal funds rate have been consistent with its statutory mandate to promote maximum employment and price stability. Over the past few years, the FOMC has been gradually reducing monetary policy accommodation, reflecting the improvement in the U.S. economy. During 2017, it raised the target range for the federal funds rate by 3/4 percentage point, and in October 2017, it initiated a balance sheet normalization program that is gradually reducing the Federal Reserve's securities holdings.

As I noted previously, these steps to normalize the stance of monetary policy are welcome developments, as they are responses to the U.S. economy's recovery from the financial crisis and recession, the sustained nature of the economic expansion, and the FOMC's confidence that inflation will return to 2 percent on a sustained basis. In addition, as decisions on the pace of policy firming have reflected the FOMC's assessment of incoming data and the outlook for the economy, recent years' monetary policy developments have underlined the fact that monetary policy is not on a preset course; rather, it is data dependent and is chosen to promote outcomes for the U.S. economy most consistent with the statutory goals of maximum employment and price stability. If confirmed, I look forward to working with FOMC colleagues on shaping policy decisions in pursuit of these goals.

6. As you know, the Federal Reserve currently uses a variety of monetary policy rules, including the Taylor rule, in its analysis and monetary policy decisionmaking, but does not rely solely on rules to determine interest rate adjustments.

- **Do you agree with the Federal Reserve's current approach, or will you advocate that the Fed use a single rule?**

I understand that the simplicity of monetary policy rules has some appeal. But the economy is very complex.

Conducting monetary policy based on simple formulas has a long tradition in the research literature on monetary policy. But economic models are, of necessity, always simplifications of reality, and we need to ask ourselves whether adhering to any simple rule--even if it worked well in an economic mode--would in practice mean that we were implementing the monetary policy that was most consistent with meeting our statutory objectives.

No simple policy rule can capture the full range of considerations that the FOMC must take into consideration when making monetary policy decisions. For example, policymakers must consider not just the current levels of economic variable--which are the variables that appear in many simple policy rule--but also the expected future paths of such variables. In addition, we need to take account of possible risks surrounding those paths and whether the costs associated with particular economic outcomes could be especially high.

We also need to take account of unobservable structural factors that may affect the economy. For example, factors that may persistently lower the level of the neutral federal funds rate or that may affect the longer-run normal level of the unemployment rate. In contrast, simple monetary policy rules often embed the assumption that these longer-run levels of the real interest rate or the unemployment rate are fixed.

In sum, policy rules' prescriptions can be useful inputs in the FOMC's policy deliberations, but they are not an adequate or satisfactory substitute for FOMC decisions on monetary policy based on a wide range of information.

- **While the unemployment rate continues to fall, the labor force participation rate remains at about its lowest level in 40 years. What do you think is contributing to this?**

Although we have seen solid job growth this year and further declines in the unemployment rate, the labor force participation rate is still quite low by historical standards. Much of this is due to the movement of the large baby boom cohort into ages when participation rates tend to fall sharply as workers retire. That said, the labor force participation rate for prime-age workers--especially men--has also not rebounded to pre-recession levels. A recent survey paper by Katherine Abraham and Melissa Kearney[3] attributes much of the longer-run decline in participation among prime-age men to factors such as technical change and globalization. However, I also think that this group could represent an additional margin of slack in the sense that some of them could be enticed to reenter the labor force as the demand for labor continues to strengthen.

- **Do think the opioid addiction epidemic is related to the decline in labor force participation among prime-age workers?**

Yes I do. Economists Anne Case and Angus Deaton[4] have carefully documented the rise in "deaths of despair" in the United States, to which the opioid epidemic has contributed. In addition, Alan Krueger's research[5] on the decline in labor force participation among adult men suggests that the proportion of adult men taking pain medication has risen sharply over the past two decades and is one reason for the decline in labor force participation among this population. More generally, opioid addiction has adversely affected both the health and economic situation of many individuals and their families and is an important issue that needs to be addressed by policymakers.

- **Over the past forty years the link between productivity and wage increases has eroded. More and more, productivity gains aren't shared with workers. Why do you think wage growth has not kept pace with productivity growth? Is there anything the Fed can do to increase wages? Can the Federal Reserve, through monetary policy or regulatory policy, do more for individuals and communities that have not experienced the benefits from the economic recovery?**

It is the case in recent decades that there has been more dispersion between workers in different categories and that some workers have fallen behind. There is no consensus on the primary reason for this divergence, but economists tend to attribute this to a number of factors, including globalization, technological change, and a need to better equip workers with the skills needed in today's labor market.

In the aggregate, wage growth is a function of the strength of the economy and the growth in productivity. I think the Federal Reserve can best promote faster wage growth by focusing on its full employment mandate--that is, by getting the unemployment rate to a level that is, on average, consistent with a healthy labor market, but acknowledging that there are factors at work that are impacting different workers in different ways.

- **If confirmed, how will you advocate for increased diversity in the Federal Reserve System?**

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3 http://www.nber.org/papers/w24333.

4 http://www.princeton.edu/~accase/downloads/Mortality_and_Morbidity_in_21st_Century_Case-Deaton-BPEA-published.pdf.

5 https://www.brookings.edu/wp-content/uploads/2018/02/kruegertextfa17bpea.pdf.

Diversity is a critical aspect of all successful organizations, and it is important to have a diverse workforce at all levels of an organization. I believe that better decisions are made, including in the policy space, when there are individuals with a broad range of backgrounds and perspectives engaged in the process.

If confirmed, I will have the opportunity meet and speak with individuals and groups throughout the Federal Reserve System, the financial and banking sectors, and regional and community organizations. I will use those opportunities to advocate for career opportunities at the Federal Reserve Board (Board) and the System for individuals with diverse backgrounds, experience, and perspectives. And I plan to actively support Board and Federal Reserve Bank (Reserve Bank) initiatives to identify and recruit individuals with diverse backgrounds and perspectives for careers at the Board and the Reserve Banks. Of course, I also recognize that attracting diverse talent is only the first step. To meet our objectives, we need to create an environment where all will thrive and contribute.

- **Federal Reserve Board of Governors nominee Marvin Goodfriend, has recommended that the "central bank put in place systems to raise the cost of storing money by imposing a carry tax on its monetary liabilities." Do you believe that there should be a currency tax, or that there are financial conditions that would call for a currency tax?**

I am very skeptical that the real-world effects of a tax on currency could justify imposing such a tax.

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

Questions for Mr. Richard Clarida, Member-Designate, Board of Governors of the Federal Reserve System on behalf of Ranking Member Brown:

- What is your view on what caused the 2008 financial crisis? What responsibility does the Federal Reserve share in terms of failures in regulatory and supervisory policy?

- How did large bank and investment bank leverage contribute to the 2008 financial crisis?

- How would you characterize current risk-weighted and leverage capital levels for the largest U.S. banks – too low, too high, or the correct amount?

As you know, the Federal Reserve recently proposed reducing leverage requirements for the eight biggest U.S. global systemically important banks (GSIBs).1 In discussing the impact of its proposal, the Federal Reserve noted that it would reduce the amount of tier 1 capital required across the lead insured depository institution (IDI) subsidiaries of the GSIBs by approximately $121 billion.

- Could a reduction in IDI capital pose any risks to depositors, taxpayers, or financial stability? Why or why not?

- What is your view on raising the enhanced prudential standards threshold pursuant to Dodd-Frank section 165 from $50 billion to $250 billion in total consolidated assets, as contemplated in S.2155?

- Federal Reserve Vice Chair Quarles has said that the Volcker Rule "is an example of a complex regulation that is not working well."2 Do you agree or disagree? Why?

- What is your view of the Community Reinvestment Act? Does it need to be altered or modernized by the Federal Reserve? If so, what changes do you support?

On May 23, the FDIC released their Quarterly Banking Profile. It shows that that bank profits increased 28 percent over the last year, and even more for community banks.

- Do you think it is sound policy to reduce capital requirements for banks that have profit levels this high?

- If confirmed, you will be a member of the Federal Open Market Committee. What experience will you bring to this role? Are there any changes in how monetary policy is currently conducted that you will advocate for?

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[1] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm
[2] https://www.reuters.com/article/us-usa-fed-quarles/u-s-considering-material-changes-to-volcker-rule-feds-quarles-idUSKBN1GH2U8

Committee on Banking, Housing, and Urban Affairs
Nomination Hearing
May 15, 2018

- Since the crisis, do you think the Federal Open Market Committee has been on the right course by gradually increasing interest rates?

As you know, the Federal Reserve currently uses a variety of monetary policy rules, including the Taylor rule, in its analysis and monetary policy decisionmaking, but does not rely solely on rules to determine interest rate adjustments.

- Do you agree with the Federal Reserve's current approach, or will you advocate that the Fed use a single rule?

- While the unemployment rate continues to fall, the labor force participation rate remains at about its lowest level in 40 years. What do you think is contributing to this?

- Do think the opioid addiction epidemic is related to the decline in labor force participation among prime-age workers?

- Over the past forty years the link between productivity and wage increases has eroded. More and more, productivity gains aren't shared with workers. Why do you think wage growth has not kept pace with productivity growth? Is there anything the Fed can do to increase wages? Can the Federal Reserve, through monetary policy or regulatory policy, do more for individuals and communities that have not experienced the benefits from the economic recovery?

- If confirmed, how will you advocate for increased diversity in the Federal Reserve System?

- Federal Reserve Board of Governors nominee Marvin Goodfriend, has recommended that the "central bank put in place systems to raise the cost of storing money by imposing a carry tax on its monetary liabilities." Do you believe that there should be a currency tax, or that there are financial conditions that would call for a currency tax?

May 24, 2018

Mr. Richard Clarida
Member-Designate
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Mr. Clarida:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs on May 15, 2018 at our nomination hearing. In order to complete the hearing record, we would appreciate your answers to the enclosed questions by 10:00 am on Wednesday, May 30, 2018. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo
Chairman

MC/dr

May 24, 2018

Commissioner Michelle Bowman
Member-Designate
Board of Governors of the Federal Reserve System
20^{th} Street and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Ms. Bowman:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs on May 15, 2018 at our nomination hearing. In order to complete the hearing record, we would appreciate your answers to the enclosed questions by 10:00 am on Wednesday, May 30, 2018. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk. She will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Dawn_Ratliff@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo
Chairman

MC/dr

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 18, 2018

The Honorable Jack Reed
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the question that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Reed:

1. If changes are made to the Community Reinvestment Act that lead to financial institutions, including those that have an online presence, to take deposits from communities but actually make less of an effort to reinvest in these same communities, would you consider that to be a good or bad outcome?

I would view revisions to the regulation that cause financial institutions to make less of an effort to reinvestment in these communities as an undesirable outcome. In addition, a successful update to the Community Reinvestment Act (CRA) regulations should encourage banks to spread their community investment activities across the areas they serve and encourage them to seek opportunities in areas that are underserved.

Currently, a bank's performance in its major markets is evaluated most closely and weighs most heavily in its CRA rating. This emphasis has resulted in what banks and community organizations refer to as credit "hot spots" where there is a high density of banks relative to investment opportunities. Meanwhile, other areas have a difficult time attracting capital because they are not in a bank's major market, if they are served by a bank at all.

We believe that any new set of regulations should eliminate such market distortions and avoid creating new ones. No matter how we define a bank's assessment area in the future, new regulations need to be designed and implemented in a way that encourages performance throughout the areas banks serve.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Senator Jack Reed:</u>

- If changes are made to the Community Reinvestment Act that lead to financial institutions, including those that have an online presence, to take deposits from communities but actually make less of an effort to reinvest in these same communities, would you consider that to be a good or bad outcome?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 16, 2018

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 3 of the questions that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On September 28, 2018, I provided responses to questions 1, 2, and 4 through 7. Copies of all responses have also been forwarded to the Committee for inclusion in the hearing record. This submission constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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[1] Questions for the record related to this hearing were received on July 25, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Ranking Member Brown</u>:

3. In your testimony, you noted that the banking industry is well-capitalized. Recent research from the Fed system suggests that large banks may hold less capital than is optimal in terms of balancing the cost of another financial crisis with any incremental increase in bank lending rates.[1]

a. What do you think of this research? Do GSIBs need to hold additional capital?

Maintaining the safety and soundness of the largest U.S. banks is critical to maintaining the stability of the U.S. financial system and the broader economy. These firms must be well-capitalized in order to be considered safe and sound. Accordingly, the U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms, thereby improving the quality and increasing the amount of capital in the banking system. From before the crisis to today, large U.S. banking firms have roughly doubled their capital positions, making them significantly more resilient, as well as able to support lending and financial intermediation in times of financial stress.

Firestone et al., the staff working paper that you cite, analyzes aggregate capital levels across the U.S. banking sector and does not address targeted capital requirements that apply to specific banks. A firm identified as a global systematically important bank (GSIB) is currently subject to more stringent capital requirements than those required of other, less systemic firms.

Under the Federal Reserve's final GSIB surcharge rule, a GSIB is required to hold an additional amount of risk-based capital that is calibrated to its overall systemic risk as well as an additional supplementary leverage ratio buffer of 2 percent above the 3 percent minimum in order to avoid restrictions on distributions and certain discretionary bonus payments. GSIBs, together with certain other large banks, also are subject to annual examination of capital planning practices through the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) and to a supervisory stress test. Finally, GSIBs are required to maintain minimum levels of unsecured, long-term debt and total loss-absorbing capacity (TLAC), which is made up of both capital and long-term debt, in order to further help reduce the systemic impact of the failure of a GSIB. The purpose of these more stringent requirements is to increase a GSIB's resiliency in light of the greater threat it poses to U.S. financial stability. This capital regulatory framework is designed to ensure that GSIBs, as well as the banking industry as a whole, maintain strong capital positions.

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[1] Former Fed Chair Yellen cited research noting that "research points to benefits from capital requirements in excess of those adopted." See remarks by Chair Janet L. Yellen. "Financial Stability a Decade After the Onset of the Crisis." Speech at the 'Fostering a Dynamic Global Recovery' Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 25, 2017. Available at: https://www.federalreserve.gov/newsevents/speech/yellen20170825a.htm; Firestone, Simon, Amy Lorenc, and Ben Ranish. "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S." Board of Governors of the Federal Reserve System, 2017. Available at: https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf; Federal Reserve Bank of Minneapolis. "The Minneapolis Plan to End Too Big to Fail." December 2017. Available at: https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-final.pdf?la=en.

b. When asked at the July 17 hearing about your plans to implement S. 2155, you said it is your intention "implement the bill as quickly as we possibly can." Does that mean you are going to move to the rulemakings and implementation of S. 2155 before you finish the remaining unfinished rulemakings required by the Wall Street Reform and Consumer Protection Act enacted 8 years ago?

Many of Economic Growth, Regulatory Relief, and Consumer Protection Act's (EGRRCPA) changes require amendments to existing rules. The Board is working expeditiously on these rulemakings and plans to solicit public comment on the proposed rule changes. EGRRCPA includes a number of statutory deadlines for implementing certain sections of the law. It is our intention to prioritize rulemakings with statutory deadlines in order to ensure that the Board's rules are compliant with the law in the time frame mandated by Congress.

The Board has implemented the majority of its assigned provisions from the Dodd-Frank Act. Sections of EGRRCPA, along with the remaining unimplemented sections of the Dodd-Frank Act, which do not have statutory deadlines, may take longer to complete.

c. Does the Fed view any provisions in S.2155 as providing a statutory requirement to revisit or recalibrate the enhanced prudential standards applicable to bank holding companies with more than $250 billion in total consolidated assets?

One of the fundamental lessons from the financial crisis was that the largest, most interconnected financial firms needed to maintain substantially more capital, take substantially less liquidity risk, and face an effective orderly resolution regime if they fail. Firms with assets of $250 billion or more can present a range of safety and soundness and financial stability concerns. Therefore, the Board has tailored, and will continue to tailor, as appropriate, our regulations to the risk profiles of the firms subject to those regulations.

In light of EGRRCPA's amendments, and consistent with the Board's ongoing refinement and evaluation of its supervisory program, the Board is evaluating whether any changes to the enhanced prudential standards applicable to bank holding companies with more than $250 billion in total consolidated assets are appropriate. In doing so, the Board will consider individual firms' capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board deems appropriate, as provided in EGRRCPA.

d. Either pursuant to S.2155 or pursuant to other authority conferred to the Fed, does the Board intend to alter the threshold at which foreign banking organizations must establish a U.S. Intermediate Holding Company? Does the Fed intend to provide any regulatory relief to foreign banking organizations that have more than $50 billion in domestic assets? If so, what regulatory relief is the Fed planning to propose?

Pursuant to the Board's regulations, foreign bank organizations (FBOs) with global assets of at least $100 billion and U.S. non-branch assets of at least $50 billion are required to establish or designate a U.S. intermediate holding company (IHC). In our supervisory experience, the requirement to establish an IHC has worked effectively, providing for appropriate application of capital, liquidity, and other prudential requirements across the U.S. non-branch operations of the FBO, as well as a single nexus for risk management of those U.S. non-branch operations. The Board presently sees no reason to modify this threshold. We continue to review our regulatory framework to improve the manner in which we deal with the particular risks of FBOs in light of the distinct characteristics of such institutions.

e. Does the Fed have any economic evidence suggesting that the recently-enacted tax bill, S.2155, or any deregulation finalized by regulators since 2017 has benefitted the overall economy through increased lending?

Economic conditions remain strong. Gross domestic product growth thus far this year is estimated to have averaged a little above 3 percent at an annual rate. Households and businesses have been able to obtain the financing needed to support this growth. Financial institutions are well-positioned to meet the needs of borrowers. However, it is too early to determine the economic effects of the tax bill or recently implemented changes in regulation. Generally speaking, it is difficult to isolate the effects of such changes given the myriad factors influencing the economy.

f. Does the Fed intend to revisit the calculation of the GSIB surcharge? If so, when and in what ways?

The Board's capital rules have been designed to reduce significantly the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure, were it to occur. Capital rules and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle, credit availability and economic growth. Consistent with these principles, the Board originally calibrated the GSIB surcharge so that—given the circumstances of the financial system—each GSIB would hold enough capital to lower its probability of failure so that the expected impact of its failure on the financial system would be approximately equal to that of a large non-GSIB.

The bulk of the post-crisis regulation is largely complete, with the exception of the U.S. implementation of the recently concluded Basel Committee agreement on bank capital standards. It is therefore a natural and appropriate time to step back and assess those efforts. The Board is conducting a comprehensive review of the regulations in the core areas of post-crisis reform, including capital, stress testing, liquidity, and resolution. The objective of this review is to consider the effect of those regulatory frameworks on the resiliency of the financial system, including improvements in the resolvability of banking organizations, and on credit availability and economic growth.

In general, I believe overall capital for our largest banking organizations is at about the right level. Critical elements of our capital structure for these organizations include stress testing, the stress capital buffer, and the enhanced supplementary leverage ratio. Work is underway to finalize the calibration of these fundamental building blocks, all of which form part of the system in which the GSIB surcharge has an effect. In this regard, I would note that the GSIB surcharge rule does not take full effect until January 2019.

g. When does the Fed intend to finalize a 2016 proposed rulemaking related to bank holding companies' allowable activities in physical commodities markets?

The Board undertook a review of the physical commodities activities of financial holding companies after a substantial increase in these activities during the financial crisis. In January 2014, the Board invited public comment on a range of issues related to these activities through an advance notice of proposed rulemaking. In response, the Board received a large number of comments from a variety of perspectives.

The Board considered those comments in developing the proposed rulemaking that was issued in September 2016. The proposed rulemaking would address the potential catastrophic, legal, and reputational risks of financial holding companies' (FHC) physical commodities activities by applying additional risk-based capital requirements to some of these activities; tightening some of the existing limitations on physical commodities trading by FHCs; and establishing new reporting requirements for physical commodities holdings and activities of FHCs. Under the proposal, FHCs would be permitted to continue to engage in a number of physical commodities trading activities with end users subject to new limits on physical commodities trading activities.

After providing an extended comment period (150 days) to allow commenters time to understand and address the important and complex issues raised by the proposal, the Board again received a large number of comments from a variety of perspectives, including Members of Congress, academics, users and producers of physical commodities, and banking organizations. The Board continues to consider the proposal in light of the many comments received.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 28, 2018

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1, 2, and 4 through 7 that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Ranking Member Brown:

1. In response to questions at your confirmation hearing on Federal Reserve efforts to increase diversity in the System, you said, "I assure you that diversity will remain a high priority objective for the Federal Reserve. Reserve banks, working closely with the Board, have also been looking at ways to further develop a diverse pool of talent in a thoughtful, strategic fashion, readying them for leadership roles through the Federal Reserve System."

a. Since you have become chair, what specific steps have you taken to encourage more diversity in the Federal Reserve System?

The Federal Reserve System (System) needs people with a variety of personal and professional backgrounds to be fully effective in discharging its responsibilities, and we have observed that better decisions are made when there are many different perspectives represented around the table. Since 2016, my colleagues and I on the Federal Reserve Board (Board) have implemented a framework to better understand and discuss a range of Board and System efforts that address diversity and inclusion as well as research on economic inclusion and economic disparities in the economy. Since becoming the Chairman in February, I have worked with Board staff to refresh the framework and prioritize our focus on diversity and economic inclusion initiatives both at the Board and elsewhere in the System and have ongoing discussions with staff, including the Board's Office of Minority and Women Inclusion (OMWI) Director, on ways to support various efforts.

I continue to stress to Federal Reserve leaders and staff the importance of having a diverse workforce and providing an inclusive work environment to our people. System leaders have fostered a range of diversity and inclusion initiatives, including the development of leadership pipelines and ongoing engagements with our own staff and with the financial services, economic, and academic communities more broadly. Of the various efforts, I would like to highlight the following:

- The System launched a leadership development initiative to provide a structured way to share information about our talent pool and to find opportunities throughout the System to more rapidly grow our talent and prepare them to take on expanded roles.

- Through the Financial Services Pipeline Initiative,[1] the Federal Reserve Bank of Chicago is working to increase the representation of people of color in the financial services industry in the Chicago region. Over the last several months, the Reserve Bank of Chicago has hosted events designed to develop leadership skills for high-performing people of color.

- Researchers throughout the System continue to produce cutting-edge research on how and why disparities exist for different demographic groups in their experiences in employment, education, and health, and in the housing and credit markets. In addition,

[1] For more information about the Financial Services Pipeline initiative, go to: https://www.fspchicago.org/.

seminars and panels about diversity and inclusion topics are being fostered by local leadership and employee resource networks and are shared across the System.

- Through the Opportunity & Inclusive Growth Institute,[2] the Reserve Bank of Minneapolis is conducting research on structural barriers that limit full participation in economic opportunity and advancement in the country. The Institute looks beyond aggregate economic indicators in order to examine how national policies impact diverse communities of people within the U.S. economy.

- The Board co-sponsored a *Gender and Career Progression*[3] conference with the European Central Bank and the Bank of England in May of this year. There were about 140 people in attendance, including participants from central banks, academia, think tanks, private industry, as well as a number of local students. The topics and papers from the conference focused on gender diversity in economics, finance, and central banking, including gender-based discrimination, the benefits of increased diversity, the role of culture, and the approaches that could be used to improve gender diversity. We continue to explore ways to leverage the knowledge gained from this event for the Board, the System, and the broader economic community. The Board subsequently held a panel discussion for its employees sharing key insights from the conference.

- Throughout the System, we continue to increase our outreach to local universities, with a particular focus on outreach to under-represented groups. The Board will soon be hosting *Exploring Careers in Economics*,[4] an event for high school and college students, in October. Organized to broaden awareness of careers in economics and to further develop a diverse pool of talent interested in the field, *Exploring Careers in Economics* will offer students a chance to learn about and discuss opportunities in economics generally, and learn about mentoring opportunities, resources, and career opportunities within the System. The agenda includes a discussion of why inclusion and diversity matter for economics. In addition to welcoming students to the Board in Washington, students from around the country will participate in this event via webcast.

- The Board's OMWI Office, in collaboration with the OMWI Directors from the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), and Consumer Financial Protection Bureau (CFPB) (collectively, the Agencies), hosted a Diversity and Inclusion Summit (Summit) on September 13 at the Federal Reserve Bank of New York for the institutions regulated by each regulatory agency. The primary purpose of the Summit was for the Agencies' OMWIs to provide feedback on submissions received from regulated entities responding to the questionnaire developed through the Policy Standards for Assessing Diversity Policies and Practices pursuant to section 342 of the Dodd-Frank Wall Street

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[2] For more information about the Opportunity & Inclusive Growth Institute, go to: https://www.minneapolisfed.org/institute.

[3] The conference program and discussion materials are available on the Bank of England's website at: https://www.bankofengland.co.uk/events/2018/may/gender-and-career-progression.

[4] For more information about the *Exploring Careers in Economics* event, go to https://www.federalreserve.gov/newsevents/pressreleases/other20180823a.htm.

Reform and Consumer Protection Act (Dodd-Frank Act). Additionally, an important aspect of the Summit was the dialogue and insights between representatives from the regulated entities and the OMWI Directors on leading diversity practices.

b. In your role as the head of the Reserve Bank Affairs Committee and now as Chair of the Board of Governors of the Federal Reserve System, did you ever ask the search committees in Atlanta, Richmond or New York for a lists of candidates under consideration? At any point did you urge the search committees at any of the Banks to broaden their searches to include more women or minority candidates?

As the Chair of the Reserve Bank Affairs Committee, I had worked closely with the search committees to ensure a strong and transparent process that identifies a broad and diverse slate of qualified candidates for president searches. Now as Chairman of the Board, I continue to work closely with my colleague Lael Brainard, Chair of the Reserve Bank Affairs Committee, to exercise the Board's oversight responsibility and stress the importance of conducting a broad search throughout the search process. We also recognize that the appointment of a president is, as a legal matter, a responsibility of the Class B and Class C directors.

During the recent Reserve Bank president searches, the search committees proactively sought out candidates from a variety of sources. The search committees have also carried out extensive outreach programs intended to solicit input and candidate recommendations from a range of constituencies across the districts. These engagement efforts were done with the goal of having as broad and diverse of candidate pools as possible for the searches. Throughout the search process, the chair of the search committee typically provides status updates, including information about the candidate pools, and discusses potential candidates with the Chair of the Reserve Bank Affairs Committee.

c. What is your role, directly and indirectly, in the San Francisco Federal Reserve Bank's search to select its next President?

The San Francisco Fed announced the appointment of Mary Daly as its new president on September 14. As Chairman of the Board, I stayed abreast of the search through the Chair of the Reserve Bank Affairs Committee. When the search committee settled on the finalist, my colleagues and I at the Board interviewed Ms. Daly. Upon final approval by all Class B and Class C directors of the Federal Reserve Bank of San Francisco, my colleagues and I at the Board voted on the Bank board's request for approval of the appointment of Ms. Daly as the new president for the Reserve Bank.

2. Recently proposed legislation would override the Securities and Exchange Commission's (SEC) 2014 reforms to money market funds. Specifically, that legislation would permit sponsors of money market funds that satisfy certain conditions to utilize a stable net asset value, or NAV. In addition, the proposal would exempt those funds from the liquidity fee requirements in the SEC's rules.

As you know, the SEC's 2014 reforms require institutional money market funds investing in corporate or municipal debt securities to use a floating NAV and provide non-government money market fund boards with new tools—liquidity fees and redemption

gates—to prevent runs. Those mechanisms are intended to prevent runs on money market funds and the freezing of the short-term liquidity market that occurred during the financial crisis.

Nellie Liang, who served for 11 years in senior roles at the Federal Reserve in the Division of Financial Stability and the Division of Research and Statistics, recently wrote an article titled, "Why Congress shouldn't roll back the SEC's money market rules" (attached).

Ms. Liang's article explains the market dislocation that occurred during the crisis that led to the SEC's implementation of the 2014 reforms. Ms. Liang highlights several important improvements to the structure of money funds, explaining that during the crisis "there was no doubt that the structure of prime MMF's amplified losses and spread problems to many companies when their investors ran." She concludes that the "post crisis rules aim not only to prevent a repeat of the last crisis but to reduce the probability and costs of the next one," and that, "reverting to pre-crisis rules would risk a return to high levels of private short-term liabilities and another destabilizing run on money market funds, and threaten stability in the financial system and the economy as a whole".

a. Do you agree with Ms. Liang's concerns that reverting to pre-crisis rules could create vulnerabilities in the stability of the financial system?

Susceptibility of money market funds (MMFs) to runs was a significant vulnerability and flashpoint in the U.S. financial system during the financial crisis and afterwards. The run on MMFs in September 2008 destabilized wholesale funding markets used by banks, dealers, nonfinancial firms, and municipalities for short-term financing. The Securities and Exchange Commission's (SEC) reforms were designed to mitigate these risks. In part due to these regulatory changes, funding markets have undergone significant shifts; while markets have largely adjusted to these shifts, considering additional changes at this moment would likely be unhelpful to the funding markets.

4. At the July 17 hearing, when asked when the Fed will finalize the rulemaking required under Dodd-Frank related to incentive-based compensation at large bank holding companies, you stated that the interagency regulators have been unable to reach consensus and that the Fed has accomplished some of the goals of the rulemaking through the supervisory process.

a. Please provide specific examples.

Section 956 of the Dodd-Frank Act[5] prohibits incentive-based compensation arrangements that encourage inappropriate risks. Federal Reserve staff have worked with firms in the implementation of the 2010 Federal Banking Agency Guidance on Sound Incentive Compensation Policies,[6] a core principle of which is that incentive compensation should appropriately balance risk and reward. In so doing, Federal Reserve staff have observed improvement in incentive compensation practices in the following areas:

[5] Pub. L. 111-203, 124 Stat. 1376 (2010).
[6] 75 FR 36395.

- **Risk adjustment:** Firms have increasingly begun adjusting compensation to more appropriately take into account the risk an employee's activities may pose to the organization, including through use of deferral and forfeiture features in compensation arrangements. Firms also have increasingly focused on nonfinancial risk (e.g., compliance failures, misconduct, and operational challenges) in risk adjustment decisions.
- **Involvement of risk management and control personnel:** Risk management and control personnel generally play a greater role in the design and operation of incentive compensation programs than before the financial crisis.
- **Director oversight:** Boards of directors are now increasingly focused on the relationship between incentive compensation and risk. For example, at the board level, finance and audit committees generally work together with compensation committees with the goal of promoting prudent risk-taking.
- **Policies and procedures:** Firms have increasingly developed written policies and procedures to guide managers in making appropriate risk adjustments.

b. What is the your view on the Fed's role as the consolidated federal regulator for insurance companies that have a savings and loan holding company?

The Federal Reserve is charged with consolidated supervision of savings and loan holding companies to promote the safety and soundness of the subsidiary insured depository institution (IDI) and the holding company. Our principal supervisory objectives for consolidated supervision of insurance savings and loan holding companies (ISLHCs) are to ensure that they operate in a safe and sound manner so that the subsidiary insured depository institution is protected from risks related to nonbanking activities, including insurance, as well as intercompany transactions between the parent and IDI, and to ensure that the IDI is not adversely affected. To avoid duplication, we rely on the state insurance departments to the greatest extent possible, including their supervision of the business of insurance. In applying our consolidated supervision, we work to ensure that regulations, supervisory guidance, and expectations are appropriately tailored to account for the unique complexities and characteristics of ISLHCs. We remain committed to tailoring our supervision of ISLHCs to the firms and their insurance operations, as well as conducting our consolidated supervision of these firms in coordination with state insurance regulators. Moreover, the Board continues to welcome feedback from ISLHCs and other interested parties on the potential impact of our supervision and proposed rulemakings in the context of ISLHCs' business and practices.

5. Vice Chair Quarles recently gave a speech suggesting that the Fed should "consider scaling back or removing entirely resolution planning requirements for most of the firms" in the $100 billion to $250 billion total consolidated asset range. Please describe further the Fed's plans in this regard, along with any cost-benefit analysis suggesting that the economy would benefit from such a change.

a. How does the Fed view the directive in S.2155 that company-run and certain supervisory stress tests be made "periodic" rather than semi-annual or annual? Does the Fed anticipate changing the frequency of stress tests for banks with more than $250 billion in total consolidated assets?

Consistent with the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), the Board is considering the application of enhanced prudential standards, including resolution planning requirements, to firms in the $100 billion to $250 billion total consolidated assets range. Resolution planning is especially critical to ensure that the largest, most complex, and most interconnected banking firms structure their operations in ways that make it more possible for them to be resolved upon failure without causing systemic risks for the broader economy. The Board therefore anticipates focusing resolution planning requirements on these firms. Firms with total assets between $100 billion and $250 billion, especially those that are less complex and less interconnected, do not pose a high degree of resolvability risk. Therefore, we should consider no longer imposing the resolution planning requirement on at least a subset of the firms with total assets between $100 billion $250 billion. The Board will solicit feedback, including feedback on costs and benefits, on any proposed changes to the applicability of resolution planning requirements through the public notice and comment process.

The provisions of EGRRCPA are generally consistent with the Board's view that supervision and regulation should be appropriately tailored to the risks posed by firms to the financial system. The Board also recognizes that the complexity of banks can vary significantly from bank to bank, even for institutions within the $100 billion to $250 billion group. Those banks, which provide a significant amount of credit to the economy, range from large regional banks to an institution that has been designated a systemically important financial institution given its size and complexity. That suggests we may need to consider factors beyond size when we consider whether it is appropriate to reduce the frequency of the stress test.

Pursuant to the provisions of EGRRCPA, the Board will assess the necessary and appropriate frequency of supervisory and company-run stress tests to effectively ensure the safety, soundness, and resiliency of the financial system while concurrently minimizing regulatory burden. In general, firms that pose limited risk to financial stability would be expected to be subject to less frequent supervisory and company-run stress tests than those with a large systemic footprint. Of course, we would invite public comment on any proposal to change the frequency of the stress test.

b. Does the Fed intend to exempt any firms from the requirement to calculate risk-weighted assets according to Advanced Approaches?

The Board is currently focused on ways to simplify the existing capital rules and to reduce any unwarranted complexity of the applicable capital requirements overall, rather than on considering exemptions for particular firms. The Board believes there is room to simplify the capital framework, while preserving the stringency of the overall capital requirements. The Board is also actively reviewing the requirements applicable to firms with more than $250 billion in total assets to make sure they are appropriately tailored to the firms to which they are applied.

c. How does the Fed's planned rulemaking regarding "reach back" application of enhanced prudential standards anticipate expeditiously capturing quickly-growing firms whose risk to the economy may rapidly escalate? For example, Countrywide grew from $26 billion in total consolidated assets in 2000 to $211 billion in 2007, and posed systemic threat to the economy.

EGRRCPA tailors supervisory requirements to the size and complexity of banking organizations. As is reflected in EGRRCPA, regulations should be the most stringent for the largest and most complex institutions. Rulemakings proposed by the Board to tailor existing requirements would be designed to maintain a safe, sound, and stable banking system that supports economic growth without imposing unnecessary costs. Under this principle, if a bank grows in size and complexity, the Board's regulatory framework would apply increasingly stringent requirements to that banking organization commensurate with the organization's size and complexity.

d. In what ways, if any, does the Fed intend to revamp the Community Reinvestment Act (CRA)?

The Federal Reserve supports modernizing the Community Reinvestment Act (CRA) regulations so that they better reflect structural and technological changes in the banking industry and strengthen the rules to help address the credit needs of low- and moderate-income communities. We think an Advance Notice of Proposed Rulemaking (ANPR) is a good starting point to gather input on the impact of the significant advancements in technology and other changes in the financial services marketplace since the regulations were last revised. We value input from all stakeholders on the impact of the significant advancements in technology and other changes in the financial services marketplace since the regulations were last revised. We look forward to reviewing suggestions that result from the OCC's ANPR on possible refinements to CRA regulations.

While there are many positive aspects of the current regulations, we believe that there are opportunities to improve clarity and consistency through modernization efforts, which would benefit both banks and the communities they serve. The Board also believes that revised regulations should recognize that banks vary widely in size and business strategy and serve communities with different credit needs. An interagency modernization process is also an opportunity to define ways to evaluate a bank's CRA performance in light of its size, business strategy, capacity, and constraints, as well as its community's demographics, economic conditions, and credit needs and opportunities. To this end, more metrics could provide clarity. It is important that the use of metrics is sufficiently responsive to local credit needs and account for differences in performance expectations based on a bank's size, business model, and strategy.

The Board values the interagency process, and we look forward to working with the OCC and the FDIC on any regulatory revisions that would promote consistency in the implementation of CRA across the industry, as well as offer the greatest impact to benefit reinvestment in local communities, consistent with the spirit and intent of the law.

6. Assessment Areas under CRA are geographical areas where bank performance is evaluated on CRA exams. Currently, these areas include bank branches and deposit-taking ATMs. Many banks are making loans outside of branch networks, using alternative delivery channels including the Internet.

- **Has the Federal Reserve given thought to changing the definition of Assessment Areas to reflect the changing landscape of banking?**

Yes. The central focus of the law is on a bank's affirmative obligation to meet the credit needs of the communities it serves, including low-and moderate-income communities, consistent with safe and sound lending. The Board believes it is time to modernize the regulations, including making changes to the definition of a bank's "assessment area," in which its CRA performance is evaluated.

The banking environment has changed significantly since CRA's enactment and since the current CRA regulation was adopted. The regulation focuses on assessing performance where banks have branches, but many banks may now serve consumers in areas far from their physical branches. Therefore, the Board agrees that it is sensible for the agencies to consider expanding the assessment area definition to reflect the various ways a bank can serve local communities, while retaining the core focus on place.

7. Comptroller Otting, during Committee testimony in June, suggested reducing CRA performance measurement to a simple formula system comparing the sum of CRA activities to bank assets. Making this ratio the totality of a CRA exam would abandon current examination weights which judge certain activities as more important than others, based on local needs.

- **Do you support this single ratio approach?**

We support updating the CRA regulations to make them more effective in making credit available in low- and moderate-income areas. In enforcing CRA, we have identified principles to guide our work. For example, the Board believes that revised regulations should be tailored recognizing that banks vary widely in size and business strategy and serve communities with widely varying needs. We believe this can be done while retaining the flexibility to evaluate a bank's CRA performance in light of its size, business strategy, capacity, and constraints as well as its community's demographics, economic conditions, and credit needs and opportunities.

We recognize the importance of considering the ways in which a bank's business strategy, no matter its size, influences the types of activities it undertakes to meet its CRA obligations.

Committee on Banking, Housing, and Urban Aff
The Semiannual Monetary Policy Report to the Con
July 17, 2018

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Ranking Member Brown:

In response to questions at your confirmation hearing on Federal Reserve efforts to increase diversity in the System, you said, "I assure you that diversity will remain a high priority objective for the Federal Reserve. Reserve banks, working closely with the Board, have also been looking at ways to further develop a diverse pool of talent in a thoughtful, strategic fashion, readying them for leadership roles through the Federal Reserve System."

- Since you have become chair, what specific steps have you taken to encourage more diversity in the Federal Reserve System?

- In your role as the head of the Reserve Bank Affairs Committee and now as Chair of the Board of Governors of the Federal Reserve System, did you ever ask the search committees in Atlanta, Richmond or New York for a lists of candidates under consideration? At any point did you urge the search committees at any of the Banks to broaden their searches to include more women or minority candidates?

- What is your role, directly and indirectly, in the San Francisco Federal Reserve Bank's search to select its next President?

Recently proposed legislation would override the Securities and Exchange Commission's (SEC) 2014 reforms to money market funds. Specifically, that legislation would permit sponsors of money market funds that satisfy certain conditions to utilize a stable net asset value, or NAV. In addition, the proposal would exempt those funds from the liquidity fee requirements in the SEC's rules.

As you know, the SEC's 2014 reforms require institutional money market funds investing in corporate or municipal debt securities to use a floating NAV and provide non-government money market fund boards with new tools—liquidity fees and redemption gates—to prevent runs. Those mechanisms are intended to prevent runs on money market funds and the freezing of the short-term liquidity market that occurred during the financial crisis.

Nellie Liang, who served for 11 years in senior roles at the Federal Reserve in the Division of Financial Stability and the Division of Research and Statistics, recently wrote an article titled, "Why Congress shouldn't roll back the SEC's money market rules" (attached).

Ms. Liang's article explains the market dislocation that occurred during the crisis that led to the SEC's implementation of the 2014 reforms. Ms. Liang highlights several important improvements to the structure of money funds, explaining that during the crisis "there was no doubt that the structure of prime MMF's amplified losses and spread problems to many companies when their investors ran." She concludes that the "post crisis rules aim not only to prevent a repeat of the last crisis but to reduce the probability and costs of the next one," and that, "reverting to pre-crisis rules would risk a return to high levels of private short-term liabilities and another destabilizing run on money market funds, and threaten stability in the financial system and the economy as a whole".

- Do you agree with Ms. Liang's concerns that reverting to pre-crisis rules could create vulnerabilities in the stability of the financial system?

In your testimony, you noted that the banking industry is well-capitalized. Recent research from the Fed system suggests that large banks may hold less capital than is optimal in terms of balancing the cost of another financial crisis with any incremental increase in bank lending rates.1

- What do you think of this research? Do GSIBs need to hold additional capital?

- When asked at the July 17 hearing about your plans to implement S. 2155, you said it is your intention "implement the bill as quickly as we possibly can." Does that mean you are going to move to the rulemakings and implementation of S. 2155 before you finish the remaining unfinished rulemakings required by the Wall Street Reform and Consumer Protection Act enacted 8 years ago?

- Does the Fed view any provisions in S.2155 as providing a statutory requirement to revisit or recalibrate the enhanced prudential standards applicable to bank holding companies with more than $250 billion in total consolidated assets?

- Either pursuant to S.2155 or pursuant to other authority conferred to the Fed, does the Board intend to alter the threshold at which foreign banking organizations must establish a U.S. Intermediate Holding Company? Does the Fed intend to provide any regulatory relief to foreign banking organizations that have more than $50 billion in domestic assets? If so, what regulatory relief is the Fed planning to propose?

- Does the Fed have any economic evidence suggesting that the recently-enacted tax bill, S.2155, or any deregulation finalized by regulators since 2017 has benefitted the overall economy through increased lending?

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[1] Former Fed Chair Yellen cited research noting that "research points to benefits from capital requirements in excess of those adopted." *See* remarks by Chair Janet L. Yellen. "Financial Stability a Decade After the Onset of the Crisis." *Speech at the 'Fostering a Dynamic Global Recovery' Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming*, August 25, 2017. Available at: https://www.federalreserve.gov/newsevents/speech/yellen20170825a.htm; Firestone, Simon, Amy Lorenc, and Ben Ranish. "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S." Board of Governors of the Federal Reserve System, 2017. Available at: https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf; Federal Reserve Bank of Minneapolis. "The Minneapolis Plan to End Too Big to Fail." December 2017. Available at: https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-final.pdf?la=en

- Does the Fed intend to revisit the calculation of the GSIB surcharge? If so, when and in what ways?

- When does the Fed intend to finalize a 2016 proposed rulemaking related to bank holding companies' allowable activities in physical commodities markets?

At the July 17 hearing, when asked when the Fed will finalize the rulemaking required under Dodd-Frank related to incentive-based compensation at large bank holding companies, you stated that the interagency regulators have been unable to reach consensus and that the Fed has accomplished some of the goals of the rulemaking through the supervisory process.

- Please provide specific examples.

- What is the your view on the Fed's role as the consolidated federal regulator for insurance companies that have a savings and loan holding company?

Vice Chair Quarles recently gave a speech suggesting that the Fed should "consider scaling back or removing entirely resolution planning requirements for most of the firms" in the $100 billion to $250 billion total consolidated asset range. Please describe further the Fed's plans in this regard, along with any cost-benefit analysis suggesting that the economy would benefit from such a change.

- How does the Fed view the directive in S.2155 that company-run and certain supervisory stress tests be made "periodic" rather than semi-annual or annual? Does the Fed anticipate changing the frequency of stress tests for banks with more than $250 billion in total consolidated assets?

- Does the Fed intend to exempt any firms from the requirement to calculate risk-weighted assets according to Advanced Approaches?

- How does the Fed's planned rulemaking regarding "reach back" application of enhanced prudential standards anticipate expeditiously capturing quickly-growing firms whose risk to the economy may rapidly escalate? For example, Countrywide grew from $26 billion in total consolidated assets in 2000 to $211 billion in 2007, and posed systemic threat to the economy.

- In what ways, if any, does the Fed intend to revamp the Community Reinvestment Act (CRA)?

Assessment Areas under CRA are geographical areas where bank performance is evaluated on CRA exams. Currently, these areas include bank branches and deposit-taking ATMs. Many banks are making loans outside of branch networks, using alternative delivery channels including the Internet.

- Has the Federal Reserve given thought to changing the definition of Assessment Areas to reflect the changing landscape of banking?

Comptroller Otting, during Committee testimony in June, suggested reducing CRA performance measurement to a simple formula system comparing the sum of CRA activities to bank assets. Making this ratio the totality of a CRA exam would abandon current examination weights which judge certain activities as more important than others, based on local needs.

- Do you support this single ratio approach?

BROOKINGS

Up Front

Why Congress shouldn't roll back the SEC's money market rules

Nellie Liang Friday, January 12, 2018

At the height of the financial crisis in 2008, the Primary Reserve Fund ran into triggering a run on money market mutual funds. Investors pulled nearly $450 out of prime money market funds (MMFs) in just a few weeks, causing the fun stop lending to big banks and industrial giants General Electric and Ford and endangering their ability to promptly meet payrolls and other bills. The government responded, quickly and creatively, with both a guarantee for existing MMF investors to stop the run, as well as an emergency liquidity facility, the Commercial Paper Funding Facility, to provide financing to companies that lost their access to short-term funds amid the turmoil.

In 2014, the Securities and Exchange Commission changed the rules for money market funds so this would never happen again. Those rules are working well. But some in the industry want Congress to undo them. That would be a mistake.

Before the crisis, prime MMFs (those permitted to invest in short-term IOUs issued by borrowers other than governments) were allowed to promise investors $1 for their shares even when the value of their portfolios fell below $1 a share. If values fell to less than $0.995 a share, the fund could no longer round up to $1, and a board could close a fund. Unlike banks, the money market funds weren't required to hold capital or insurance to back up their $1 promise—even though they were investing in securities that fluctuated in value.

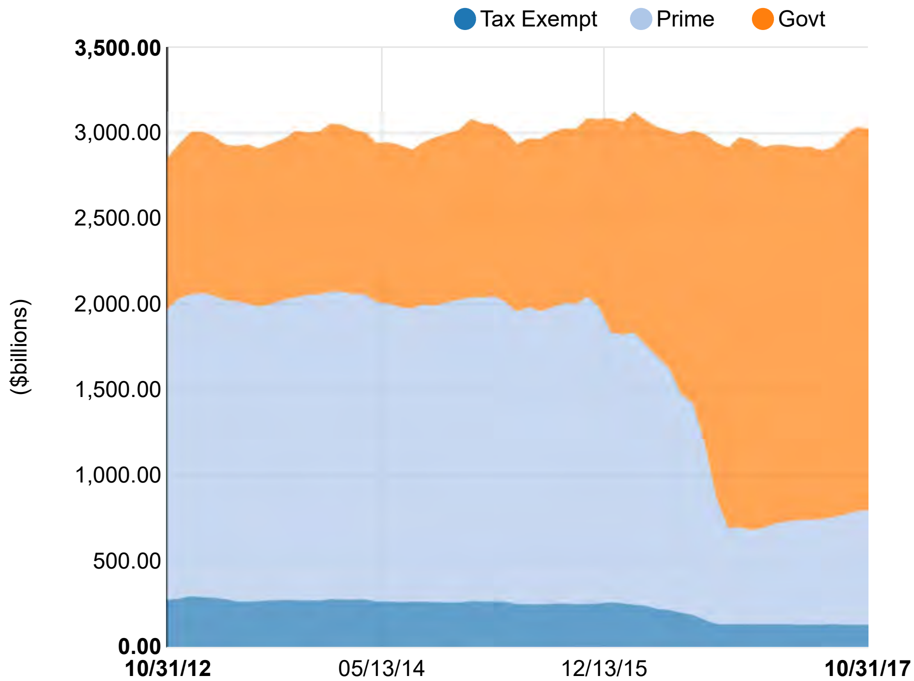
This structure created a classic investor run problem similar to the runs that banks faced before the creation of deposit insurance in the 1930s. Investors who believe the value of the investments will fall to less than $1 have an incentive to pull out their funds before others. The first investors to withdraw money will receive $1 per share. Those who wait will get only the (lower) market value—often with a delay. As investors run for the exits, funds sell assets to meet these redemptions. The sales cascade through the economy, pushing down the price of these assets and forcing big companies who borrow from money market funds to scramble for funding, making the problem worse.

In 2010, the SEC tightened the rules to reduce the credit and liquidity risk of the assets that prime money market mutual funds could hold. The SEC also required greater disclosure of the assets, but the rules cannot eliminate the risk of price fluctuations and thus the incentive for investors to be the first out the door.

So in 2014, the SEC changed the rules, which ultimately took effect in October 2016. Today, the value of both prime money market shares and shares of municipal tax-exempt securities sold to institutional investors float with the value of the securities in their portfolios. (The rules didn't apply to money market funds sold to retail investors.) Funds that invest in U.S. Treasury and other sovereign securities were permitted to maintain the fixed $1/share value.

Since the rules went into effect, short-term markets have been functioning smoothly—and in a much less risky environment. Anticipating the change, some money market investors moved money from institutional prime funds and tax-exempt funds to funds that invested in less risky Treasury and government securities. The total amount of money invested in money market funds—nearly $3 trillion—did not change. It just shifted from riskier prime investments to more stable government funds that can maintain the $1/share value.

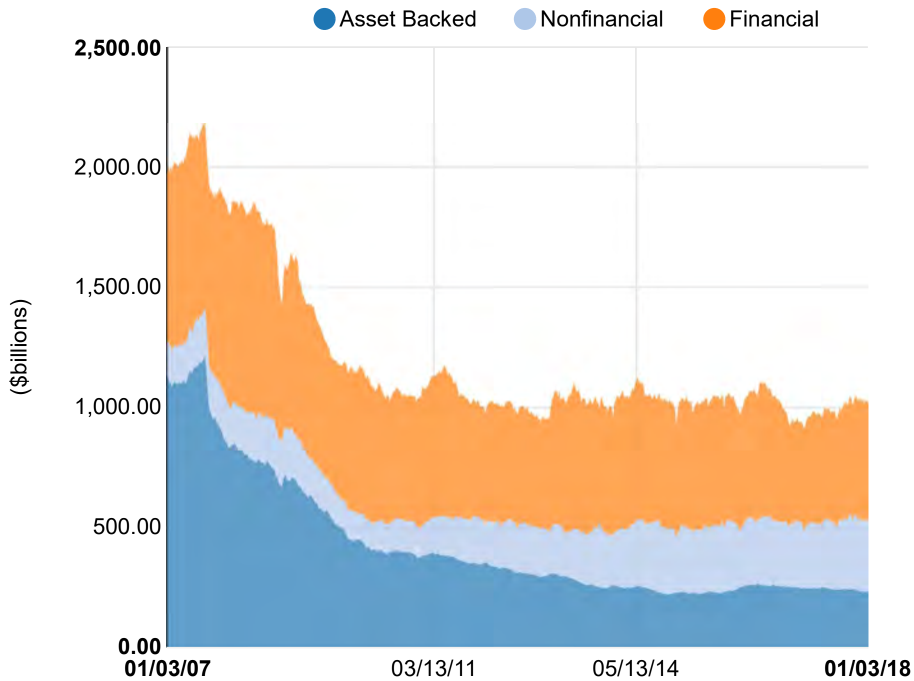
Money Market Mutual Fund Assets by Type of Fund



Source: Securities and Exchange Commission

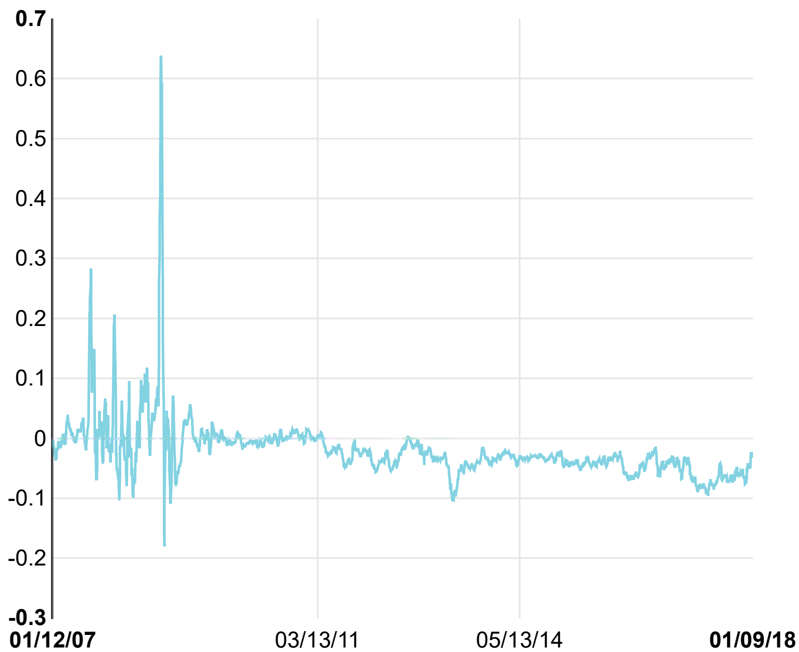
Moreover, the shift has not led to any notable disruptions in short-term funding markets. The commercial paper market, an important source of short-term funding for large corporations, remains at roughly $1 trillion outstanding, after having shrunk dramatically in the financial crisis. Nonfinancial companies have been increasing their commercial paper outstanding, despite the drop in prime MMF assets, and are issuing at spreads that have remained quite low.

Commercial Paper Outstanding



Source: Federal Reserve Board

Overnight CP Spreads, Nonfinancial 10 day moving average



Source: Federal Reserve Board

Most big money managers adjusted to the new rules, but a few—apparently unhappy that the changes have cut into their revenues—are pushing Congress to undo them. These managers want to allow institutional prime and tax-exempt funds to once again be able to promise to redeem shares at $1/share, even when they hold risky assets. Their argument is that these funds didn't cause the financial crisis and reforms have gone too far.

But there is no doubt that the structure of prime MMFs amplified losses and spread the problems to many companies when their investors ran. Prime MMFs that promise a fixed $1 are a source of systemic risk. Post-crisis rules aim not only to prevent a repeat of the last crisis, but to reduce the probability and costs of the next one. Reverting to pre-crisis rules would risk a return to high levels of private short-term liabilities and another destabilizing run on money market funds, and threaten stability in the financial system and the economy as a whole.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

August 29, 2018

The Honorable Tim Scott
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the written question that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Scott:

1. I appreciate your timely response to my written questions from your March 1, 2018, appearance for this Committee. In your reply, you wrote that "the state-based system of insurance regulation provides an invaluable service in protecting policyholders." I could not agree more – and believe that the U.S. system of insurance regulation is the best in the world.

That is why I'm concerned that recent International Association of Insurance Supervisors (IAIS) negotiations on the International Capital Standard (ICS) in Kula Lumpur (KL) suggest an embrace of a European-centric approach to insurance capital standards. For example, in the KL agreement, it was decided that the reference ICS shall have European-like capital requirements (Prescribed Capital Requirement) and use a European accounting method (Market Adjusted Valuation).

In the past, the Federal Reserve has stated that the IAIS does not have any authority to impose enforceable obligations on U.S. insurance firms and that there is no way that IAIS negotiations could result in the application of a capital standard on U.S. insurance firms that is inconsistent with U.S. laws and regulations. However, if U.S. negotiators agree to a standard at the IAIS that does not formally recognize the U.S. insurance regulatory system or, worse, requires that the U.S. change its regulatory system to match the agreed upon standard and we do not change our laws, then the EU or other jurisdictions could penalize U.S. firms operating in said jurisdictions.

Please answer the following with specificity:

What positions will you take during upcoming IAIS negotiations on the ICS to ensure the protection of the U.S. system of insurance regulation?

I agree that, in order for an Insurance Capital Standard (ICS) being developed through the International Association of Insurance Supervisors (IAIS) to be implementable, it cannot be unsuited or inappropriate for the United States, which remains the world's largest insurance market. As such, an overly European-centric ICS would face challenges to being readily implementable in the United States. As the Federal Reserve Board (Board) has suggested in relation to insurance firms supervised by the Board, such a framework may not adequately account for U.S. Generally Accepted Accounting Principles (GAAP), may introduce excessive volatility, and may involve excessive reliance on supervised firms' internal models.[1] Indeed, the Board strongly supports the U.S. state-based insurance supervisory system, which has proven its strength and resilience for well over a century.

Among other things, this motivates our advocacy of an aggregation alternative, and the use of the GAAP-plus valuation method, in the ICS. We continue to advocate, and contribute to developing, the GAAP-plus valuation method for inclusion in the ICS. In addition, we support the collection of information through the monitoring period on an aggregation-based approach.

[1] See Advance Notice of Proposed Rulemaking, Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 FR 38631, 38637 (June 14 2016).

We also participate along with the other U.S. members, together with other jurisdictions including Canada, Hong Kong, and South Africa, in the development of such an approach through the IAIS. Furthermore, the Federal Reserve continues to develop the Building Block Approach, an aggregation-based approach that, together with the Group Capital Calculation of the National Association of Insurance Commissioners (NAIC), can be used to advocate the aggregation method. Through field testing and monitoring, we will advocate that an aggregation method provides comparable outcomes in supervisory actions and insurance company results relative to the standard calculation method for ICS that is emerging from the IAIS.

As a member of the IAIS, the Federal Reserve, in partnership with the NAIC and Federal Insurance Office, remains committed to pursuing an engaged dialogue to achieve outcomes that are appropriate for the United States. As a general proposition, we believe in the utility of having effective global standards for regulation and supervision of internationally active financial firms. When implemented consistently across global jurisdictions, such standards help provide a level playing field for global financial institutions. Further, consistent global regulatory standards can help limit regulatory arbitrage and jurisdiction shopping, as well as promote financial stability. While we would refrain from agreeing to any international standard that is inappropriate for the United States, it is important to recall that the IAIS has no ability to impose requirements on any national jurisdiction, and any standards developed through this forum are not self-executing or binding upon the United States unless adopted by the appropriate U.S. lawmakers or regulators in accordance with applicable domestic laws and rulemaking procedures.

Committee on Banking, Housing, and Urban Aff
The Semiannual Monetary Policy Report to the Con
July 17, 2018

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Senator Tim Scott:

Insurance Capital Standards

I appreciate your timely response to my written questions from your March 1, 2018, appearance for this Committee. In your reply, you wrote that "the state-based system of insurance regulation provides an invaluable service in protecting policyholders." I could not agree more – and believe that the U.S. system of insurance regulation is the best in the world.

That is why I'm concerned that recent International Association of Insurance Supervisors (IAIS) negotiations on the International Capital Standard (ICS) in Kula Lumpur (KL) suggest an embrace of a European-centric approach to insurance capital standards. For example, in the KL agreement, it was decided that the reference ICS shall have European-like capital requirements (Prescribed Capital Requirement) and use a European accounting method (Market Adjusted Valuation).

In the past, the Federal Reserve has stated that the IAIS does not have any authority to impose enforceable obligations on U.S. insurance firms and that there is no way that IAIS negotiations could result in the application of a capital standard on U.S. insurance firms that is inconsistent with U.S. laws and regulations. However, if U.S. negotiators agree to a standard at the IAIS that does not formally recognize the U.S. insurance regulatory system or, worse, requires that the U.S. change its regulatory system to match the agreed upon standard and we do not change our laws, then the EU or other jurisdictions could penalize U.S. firms operating in said jurisdictions.

Please answer the following with specificity:

- What positions will you take during upcoming IAIS negotiations on the ICS to ensure the protection of the U.S. system of insurance regulation?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 18, 2018

The Honorable Bob Corker
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the written question that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Corker:

1. The Federal Housing Finance Agency ("FHFA") has proposed a new regulatory capital framework for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (each, an "enterprise"). See Proposed Rule, Enterprise Capital Requirements (83 Fed. Reg. 33,312) (Jul. 17, 2018). FHFA's proposed rule contemplates that the credit risk transfers ("CRT") of the enterprises would provide capital relief. Id. at 33,356. According to FHFA, with respect to capital relief for CRT, "the proposed approach is analogous to the Simplified Supervisory Formula Approach ('SSFA') under the banking regulators' capital rules applicable to banks, savings associations, and their holding companies." Id. at 33,358. But FHFA also acknowledges that "the proposed approach deviates from the SSFA in that it: (i) [p]rovides for a more refined view of risk differentiation across transactions by accounting for differences in maturities between the CRT and its underlying whole loans and guarantees, and (ii) does not discourage CRT transactions by elevating aggregate post-transaction risk-based capital requirements above risk-based capital requirements on the underlying whole loans and guarantees." Id.

- **What are the material differences between (i) the rules governing the capital relief afforded a CRT of an enterprise under FHFA's proposed rule and (ii) the rules governing the asset credit, liability reduction or other capital relief afforded a similar transaction of a banking organization under the rules of the Board of Governors of the Federal Reserve System (the "Board")?**

The Federal Housing Finance Agency's (FHFA) proposal on "Enterprise Capital Requirements" recognizes the risk mitigation effects of credit risk transfers (CRTs). CRTs are transfers of credit risk from Fannie Mae and Freddie Mac on a portion of their loan portfolio to private sector investors. If CRTs meet certain qualifying criteria, Fannie Mae and Freddie Mac are able to reduce the amount of capital held against those portfolios.

The treatment for CRTs proposed by the FHFA is tailored for two types of products: single-family home loans and multifamily loans. These products have standardized characteristics that are incorporated in the FHFA's proposed approach for risk weighting these exposures.

The regulatory capital rule, adopted by the Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, "banking agencies"), similarly recognizes credit risk mitigation effects of credit risk transfers and allows a banking organization to assign a lower risk weight to an exposure. However, relative to the approach proposed by the FHFA, the banking agencies' capital rule recognizes credit risk mitigation for a much broader variety of exposures.

The banking agencies' approach for recognizing credit risk transfer through a securitization needs to be flexible enough to accommodate a wide variety of securitized asset classes without standardized characteristics. The approach may require more capital on a transaction-wide basis than would be required if the underlying assets had not been securitized, in order to account for the complexity introduced by the securitization structure. Furthermore, the banking agencies' capital rule requires banking organizations to meet certain operational requirements. An inability by a banking organization to meet these operational requirements may lead to higher risk weighting, relative to the FHFA's proposed approach.

- **Does the Board expect to consider FHFA's approach to capital relief for CRT, and also the experience of the enterprises with CRT, when the Board next reviews its own rules governing the capital relief afforded to banking organizations for CRT and similar transactions?**

The FHFA's proposal is specifically designed for Fannie Mae and Freddie Mac and their specialized lending purposes. The FHFA has calibrated its proposed capital requirements and tailored its credit risk mitigation rules to two specific categories of exposures: single-family home loan and multifamily loan portfolios.

Banks have a wider variety of exposures than Fannie Mae and Freddie Mac. Thus, banks require a different calibration of capital requirements and a more general set of rules governing the recognition of credit risk mitigation.

Committee on Banking, Housing, and Urban Affa
The Semiannual Monetary Policy Report to the Cong
July 17, 2018

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Senator Bob Corker:</u>

The Federal Housing Finance Agency ("FHFA") has proposed a new regulatory capital framework for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (each, an "enterprise"). See Proposed Rule, Enterprise Capital Requirements (83 Fed. Reg. 33,312) (Jul. 17, 2018). FHFA's proposed rule contemplates that the credit risk transfers ("CRT") of the enterprises would provide capital relief. Id. at 33,356. According to FHFA, with respect to capital relief for CRT, "the proposed approach is analogous to the Simplified Supervisory Formula Approach ('SSFA') under the banking regulators' capital rules applicable to banks, savings associations, and their holding companies." Id. at 33,358. But FHFA also acknowledges that "the proposed approach deviates from the SSFA in that it: (i) [p]rovides for a more refined view of risk differentiation across transactions by accounting for differences in maturities between the CRT and its underlying whole loans and guarantees, and (ii) does not discourage CRT transactions by elevating aggregate post-transaction risk-based capital requirements above risk-based capital requirements on the underlying whole loans and guarantees." Id.

- What are the material differences between (i) the rules governing the capital relief afforded a CRT of an enterprise under FHFA's proposed rule and (ii) the rules governing the asset credit, liability reduction or other capital relief afforded a similar transaction of a banking organization under the rules of the Board of Governors of the Federal Reserve System (the "Board")?

- Does the Board expect to consider FHFA's approach to capital relief for CRT, and also the experience of the enterprises with CRT, when the Board next reviews its own rules governing the capital relief afforded to banking organizations for CRT and similar transactions?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 19, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 5 of the questions that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On August 29, 2018, I provided responses to questions 3, 4, and 13 through 15; on September 28, 2018, I provided responses to questions 1, 2, and 6 through 12. Copies of all responses have also been forwarded to the Committee for inclusion in the hearing record. This submission constitutes completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Cortez Masto:

5. *Regulation*

Chair Powell, at your nomination hearing, you told me that you supported strong consumer protections.

Please name at least five issues areas where the Federal Reserve will continue to lead in consumer protection.

The Federal Reserve has a strong commitment to promoting a fair and transparent financial services marketplace. We conduct consumer-focused supervision and enforcement; conduct research and policy analysis; develop and maintain relationships with a broad and diverse set of stakeholders; and work to foster community development.

Our consumer protection efforts include investigating consumer complaints, assuring consumers' fair and equal access to credit and treatment in financial markets, assessing the trends shaping consumers' financial situations, and offering consumer help via tools and resources developed by Reserve Banks and other agencies. Examples of the range of our consumer protection priorities and efforts are described below.

As part of our supervisory outreach, our Reserve Banks have various consumer and community advisory councils. Additionally, the Board meets semiannually with its Community Advisory Council (CAC) as well as with a wide range of consumer and community groups throughout the year. The CAC is a diverse group of experts and representatives of consumer and community development organizations and interests. This important line of communication provides the Board with broad perspectives on the economic circumstances and financial services needs of consumers and communities, with a particular focus on the concerns of low- and moderate-income populations.

With regard to our enforcement of fair lending laws and unfair or deceptive acts or practices (UDAP) laws, our supervisory program is rigorous and we are clear in our communications with firms about our expectations when we find weakness in their compliance management systems or violations of consumer laws. When we find consumer harm, we make sure that consumers are provided any appropriate restitution, and when the situations warrant, we also impose civil money penalties.

Fair lending violations may cause significant consumer harm as well as legal, financial, and reputational risk to the institution. The federal fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA)—prohibit discrimination in credit transactions, including transactions related to residential real estate. The ECOA, which is implemented by the Board's Regulation B (12 C.F.R. part 202), prohibits discrimination in any aspect of a credit transaction. It applies to any extension of credit, including residential real estate lending and extensions of credit to small businesses, corporations, partnerships, and trusts. Lending acts and practices that are specifically prohibited, permitted, or required are described in the regulation.

Official staff interpretations of the regulation are contained in Supplement I to the regulation. The FHA, which is implemented by regulations promulgated by the U.S. Department of Housing and Urban Development,[1] prohibits discrimination in all aspects of residential real estate-related transactions.

The Board is committed to ensuring that every bank it supervises complies fully with federal financial consumer protection laws, including the fair lending laws. A specialized Fair Lending Enforcement Section at the Board works closely with Reserve Bank staff to provide guidance on fair lending matters and to ensure that the fair lending laws are enforced consistently and rigorously throughout the Federal Reserve System (System). Fair lending risk is evaluated at every consumer compliance examination. Additionally, examiners may conduct fair lending reviews outside of the usual supervisory cycle, if warranted by elevated risk.

Section 5 of the Federal Trade Commission Act (FTC Act) prohibits UDAP and applies to all persons engaged in commerce, including banks, and the law extends to bank arrangements with third parties. The Federal Reserve has the authority to take appropriate supervisory or enforcement action when unfair or deceptive acts or practices are discovered at institutions under the Federal Reserve's jurisdiction, regardless of asset size. We apply longstanding standards when weighing the need to take supervisory and enforcement actions and when seeking to ensure that unfair or deceptive practices do not recur. Examples of practices the Federal Reserve has found to be unfair or deceptive include certain practices related to overdrafts and student financial products and services.

With respect to these and other UDAP issues, the Federal Reserve's enforcement actions have collectively benefited hundreds of thousands of consumers and provided millions of dollars in restitution.

In addition to carrying out enforcement actions, we provide training, direction and support to Reserve Bank examiners in assessing institutions' compliance with applicable laws and regulations.

On the consumer level, the System also has a robust process for responding to consumer complaints about the banks we supervise. We investigate every complaint of an institution under our supervisory jurisdiction and refer them to the appropriate agency if it involves an institution that we do not supervise. Reserve Banks must respond in writing in a timely manner.

For the financial institutions we regulate, we develop and offer guidance to help reduce risk to consumers that supports our desire to ensure equitable treatment of all consumers, including those in underserved and economically vulnerable populations.

We collect and analyze risk data and trends in the financial services sector affecting consumers and the financial institutions that we supervise, and we identify emerging consumer protection issues and promote compliance by highlighting these areas in publications, webinars and other outreach. Examples include our recently-launched Consumer Compliance Supervision Bulletin, which provides to banks and others high-level summaries of pertinent supervisory observations

[1] See 24 C.F.R. part 100.

related to consumer protections, as well as our Consumer Compliance Outlook, a System publication focused on consumer compliance issues, and its companion webinar series, Outlook Live, both of which are targeted to the industry to support banks' compliance efforts.

Another example is our annual Survey of Household Economic Decisions (SHED). The SHED is designed to enhance our understanding of how adults in the United States are faring financially, and the results of the survey are posted on our public website. Other areas include research particularly focused on the housing market, small business access to credit, and rural economic development issues.

Through a number of events and on a variety of matters, we provide outreach to consumer advocacy and community development organizations that outlines the risks in consumer financial product markets. Examples of such programs have focused on auto lending, fintech/marketplace lending, and student lending.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 28, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1, 2, and 6 through 12 that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On August 29, 2018, I provided responses to questions 3, 4, and 13 through 15. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Cortez Masto:

1. *Home Mortgage Disclosure Act*

I remain concerned about discrimination in mortgage lending, especially as we no longer have publicly-available data on loan quality for 85% of the banks and credit unions. This means we need to rely on the staff of regulators to ensure banks comply with the Equal Credit Opportunity Act and the Fair Housing Act.

- **How will you make sure that your bank examiners are looking at credit scores, loan-to-value ratios, interest rates, and other indicators of loan quality to ensure African Americans, Latinos and single women are not getting lower quality mortgage loans?**

The Federal Reserve's fair lending supervisory program reflects our commitment to promoting financial inclusion and ensuring that the financial institutions under our jurisdiction fully comply with applicable federal consumer protection laws and regulations. For all state member banks, we enforce the Fair Housing Act, which means we can review all Federal Reserve-regulated institutions for potential discrimination in mortgages, including potential redlining, pricing, and underwriting discrimination. For state member banks of $10 billion dollars or less in assets, we also enforce the Equal Credit Opportunity Act, which means we can review these state member banks for potential discrimination in any credit product. Together, these laws prohibit discrimination on the basis of race, color, national origin, sex, religion, marital status, familial status, age, handicap/disability, receipt of public assistance, and the good faith exercise of rights under the Consumer Credit Protection Act (collectively, the "prohibited basis").

We evaluate fair lending risk at every consumer compliance exam based on the risk factors set forth in the interagency fair lending examination procedures. Relevant to an evaluation of loan quality, those procedures include risk factors related to potential discrimination in pricing, underwriting, and steering. With respect to potential discrimination in the pricing or underwriting of mortgages, if warranted by risk factors, the Federal Reserve will request data beyond the public Home Mortgage Disclosure Act (HMDA) data, including any data related to relevant pricing or underwriting criteria, such as applicant interest rates and credit scores. This data can be requested from any Board-supervised institution, including the institutions that were exempted from reporting additional HMDA data by the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA).[1] The analysis then incorporates the additional data to determine whether applicants with similar characteristics received different pricing or underwriting outcomes on a prohibited basis (for example, on the basis of race), or whether legitimate pricing or underwriting criteria can explain the differences.

At every examination, the Federal Reserve evaluates whether a lender might be discriminatorily steering consumers towards certain loans. An institution that offers a variety of lending products or product features, either through one channel or through multiple channels, may benefit consumers by offering greater choices and meeting the diverse needs of applicants. Greater product offerings and multiple channels, however, may also create a fair lending risk that

[1] See Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub.L. 115–174, S. 2155 § 104(a) (May 24, 2018).

applicants will be illegally steered to certain choices based on prohibited characteristics. The distinction between guiding consumers toward a specific product or feature and illegal steering centers on whether the institution did so on a prohibited basis, rather than based on an applicant's needs or other legitimate factors. If warranted by risk factors, the Federal Reserve will request additional data, such as consumers' credit scores and loan-to-value ratios, to determine that consumers would not have qualified for conventional loans.

- **Is it your expectation that the Fed will have the time and resources to proactively monitor these banks, without the required reporting in place?**

Provisions in the recently enacted bill, EGRRCPA, related to HMDA data collection requirements for certain institutions will not impact the Federal Reserve's ability to fully evaluate the risk of mortgage pricing or underwriting discrimination. Although not included in the public HMDA data, if warranted by risk factors, the Federal Reserve will request any data related to relevant pricing and underwriting criteria, such as the interest rate and credit score. The Federal Reserve's practice of requesting data relevant to pricing and underwriting criteria where warranted by risk factors pre-dates EGRRCPA's enactment, and the practice will continue.

- **How many additional staff will it take to proactively monitor the more than 5,000 banks now exempted from reporting requirements?**

With respect to HMDA, the Federal Reserve supervises approximately 800 state member banks. Recently-enacted EGRRCPA exempts certain institutions from reporting the additional HMDA data fields required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). However, institutions exempted by EGRRCPA that meet HMDA's data reporting threshold[2] must continue to report the HMDA data fields that are not the additional fields required by the Dodd-Frank Act. As noted above in response subpart (b), the Federal Reserve's practice of requesting data relevant to pricing and underwriting criteria, where warranted by risk factors, pre-dates EGRRCPA's enactment, and the practice will continue. The Federal Reserve continually evaluates its workload and staffing needs to ensure that we are fulfilling our supervisory responsibilities.

2. *Volcker – postpone the deadline for comment*

Congress passed the Volcker Rule to prevent taxpayer backed banks from gambling with insured deposits, destabilizing the financial system and failing or requiring bailouts. Recently, the SEC, CFTC, Federal Reserve, the OCC, and the FDIC have issued a new Volcker Rule proposal. However, I am concerned that regulators have only allowed for a 60 day comment period to respond to a 689 page rule. That rule includes 342 enumerated questions, dozens of additional questions on the costs or benefits of aspects of the proposal, and invitations to comment on numerous technical concepts and provisions. A limited two

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[2] In general, if a financial institution has assets exceeding $45 million and originated at least 25 closed-end mortgage loans in each of the two preceding calendar years, or originated at least 500 open-end lines of credit in each of the two preceding calendar years, it must meet the HMDA reporting requirements for its asset size. *See* A Guide To HMDA Reporting: Getting it Right!, Federal Financial Institutions Examination Council (Eff. Jan. 1, 2018), https://www.ffiec.gov/Hmda/pdf/2018guide.pdf.

month comment period may not allow for outside groups, academics and researchers the full time needed to analyze the proposal.

Will you extend the comment period by an additional 90 days?

In early June 2018, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (together, the "agencies") proposed revisions to the rules implementing section 13 of the Bank Holding Company Act (12 U.S.C. § 1851), also known as the Volcker Rule. The proposal's comment period was for 60 days after publication in the Federal Register on July 17, 2018. On September 4, 2018, in response to requests from commenters, the agencies announced an extension of the comment period for an additional 30 days, until October 17, 2018. The extension will allow interested persons additional time to analyze the proposal and prepare their comments. The agencies will carefully consider all comments in formulating the final rule.

6. *Monetary Policy*

If the Fed usually cuts the federal funds rate by 5 percentage points to fight a recession and the neutral rate is around 2.5%, what steps can the Federal Reserve currently take to offset a recession?[3] Expand the balance sheet by buying treasuries?

The possibility that the federal funds rate could be constrained by the effective lower bound in future economic downturns appears larger than in the past because of an apparent decline in the neutral rate of interest in the United States and abroad. Several developments could have contributed to such a decline, including slower growth in the working-age populations of many countries, smaller productivity gains in the advanced economies, a decreased propensity to spend in the wake of the financial crises around the world since the late 1990s, and perhaps a paucity of attractive capital projects worldwide.

In any case, the Federal Reserve has a number of tools that it can use in the event that the federal funds rate is constrained by the effective lower bound. One such tool is explicit forward guidance about the path of future policy. By announcing that it intends to keep short-term interest rates lower for longer than might have otherwise been expected, the Federal Reserve can put significant downward pressure on longer-term borrowing rates for American families and businesses. Another tool is large-scale asset purchases, which can also put downward pressure on longer-term borrowing rates and ease financial conditions. These tools have been an important part of the Federal Reserve's efforts to support economic recovery over the past decade. Studies have found that these tools eased financial conditions and helped spur growth in demand for goods and services, lower the unemployment rate, and prevent inflation from falling further below the Federal Open Market Committee's (FOMC) 2 percent objective. The Federal Reserve is prepared to use its full range of tools if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate.

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[3] Bosley, Catherine. "Summers Warns Next U.S. Recession Could Outlast Previous One." Bloomberg. February 28, 2018. Available at: https://www.bloomberg.com/news/articles/2018-02-28/summers-warns-next-u-s-recession-could-outlast-the-previous-one.

7. Many Federal Reserve officials - including most recently outgoing New York Fed President Bill Dudley - have talked about the need for Congress to beef up fiscal stabilizers that can react automatically to a downturn.

- **Do you agree that Congress should be working on this? If so, which stabilizers do you think are most effective?[4]**

The current monetary policy tools available to the Federal Reserve can provide significant accommodation in the event of an economic downturn, although we recognize that there are limits stemming importantly from the effective lower bound on the nominal federal funds rate. As a matter of prudent planning, we continue to evaluate potential monetary policy options in advance of an episode in which our primary policy tool is constrained by the effective lower bound. Since monetary policy is not a panacea, counter-cyclical fiscal policy actions are a potentially important tool in addressing a future economic downturn. In particular, automatic fiscal stabilizers have been and continue to be helpful in providing timely accommodation and thus tempering the extent of a downturn. A range of fiscal policy tools and approaches could enhance their effectiveness in helping to provide cyclical stability to the economy. However, it is appropriate that the details of fiscal policy changes be left to the Congress and the Administration.

8. At your most recent press conference you said -- "we can't be too attached to these unobservable variables." If that's the case, do you think it is possible that the United States could sustain a long period of unemployment at 3% or even lower? Japan's unemployment has fallen to 2.7% and Germany is at 3.4%.

Monetary policy necessarily involves making judgments about aspects of the economy that cannot be measured directly but instead must be inferred. One of those aspects is the level of the unemployment rate that can be sustained in the longer term without generating either upward or downward pressure on inflation. That level is sometimes referred to as the natural rate of unemployment. Economic modelers have only a limited ability to estimate the natural rate of unemployment at any given moment; moreover, there is every reason to believe that the natural rate can and does change over time. For both of these reasons, policymakers must always be vigilant in looking for evidence that might cause them to revise their existing estimates of parameters such as the natural rate of unemployment.

As of today, most estimates of the natural rate of unemployment in the United States range between 4 percent and 5 percent. Other countries will have different rates of unemployment that are sustainable in the longer run (sometimes markedly so), depending on the characteristics of the workforces in those countries (such as age and education), the geographic mobility of jobs and workers, and structural labor market policies, to name a few factors.

- **At the last hearing you described the risks to the economy as balanced, but it seems like the Fed has much more room to tighten policy - by raising rates and running**

[4] "Officials on record: automatic stabilizers." Dudley, William C. "Speech: Important Choices for the Federal Reserve in the Years Ahead." The Federal Reserve in the Years Ahead. April 18, 2018. Available at: https://www.newyorkfed.org/newsevents/speeches/2018/dud180418a.

down the balance sheet - than it does to loosen policy. Doesn't that change the balance of risks? If you hike interest rates too fast, you have limited tools to address an economic slowdown. If you hike too slowly, you have ample tools to address the overheating.

The FOMC recognizes that the effective lower bound (ELB) on the federal funds rate can impose a significant constraint on the conduct of monetary policy. This is one of the reasons that the Committee has normalized the stance of monetary policy at a gradual pace during the current economic expansion. That said, the Federal Reserve has other tools at its disposal to provide economic stimulus when the federal funds rate is constrained by the ELB, including explicit forward guidance about the path of federal funds rate and large-scale asset purchases. Moreover, with strong labor market conditions, inflation close to 2 percent, and the level of the federal funds rate at a bit below 2 percent, the risk of returning to the ELB has diminished substantially since earlier in the recovery. Overall, the FOMC currently sees the risks to its economic outlook as roughly balanced.

History has shown that moving interest rates either too quickly or too slowly can lead to bad economic outcomes. If the FOMC raises interest rates too rapidly, the economy could weaken and inflation could run persistently below the FOMC's objective. Conversely, there are risks associated with raising interest rates too slowly. Waiting too long to remove policy accommodation could cause inflation expectations to begin ratcheting up, driving actual inflation higher and making it harder to control. Moreover, the combination of persistently low interest rates and strong labor market conditions could lead to undesirable increases in leverage and other financial excesses. While the Federal Reserve has tools to address such developments, these circumstances could require the FOMC to raise interest rates rapidly, which could risk disrupting financial markets and push the economy into recession.

9. *Fed Governance, Diversity, and the San Francisco Fed vacancy*

At your confirmation hearing, you expressed your support for more diversity among the Federal Reserve's leadership, saying, "We make better decisions when we have diverse voices around the table, and that's something we're very committed to at the Federal Reserve."[5] You also commented on the role that the Board of Governors plays in approving new Reserve Bank presidents, and assured the Senate Banking Committee that there is always a "diverse pool" in searching for candidates to fill those positions. However, the December selection of Thomas Barkin as the president of the Richmond Fed gives reason for doubt.[6] Press reports note that you were very involved in vetting candidates.[7]

Then, in April, John Williams was announced as the new New York Fed president. A source close to the process said that the New York Fed search committee just could not find

[5] CNBC. "Jerome Powell: I'm a big supporter of diversity." CNBC. November 28, 2017. Available at: https://www.cnbc.com/video/2017/11/28/jerome-powell-im-a-big-supporter-of-diversity.html.

[6] Sebastian, Shawn. "Fed Up Blasts Process, Outcome of Richmond Federal Reserve Presidential Appointment." The Center for Popular Democracy. Available at: https://populardemocracy.org/news-and-publications/fed-blasts-process-outcome-richmond-federal-reserve-presidential-appointment.

[7] Condon, Christopher. "Fed Documents Show Powell's Hand in Richmond President Search." Bloomberg. July 16, 2018. Available at: https://www.bloomberg.com/news/articles/2018-07-16/fed-documents-show-powell-s-hand-in-richmond-president-search.

qualified candidates who were interested in this position, even though community groups had given a list of qualified and diverse candidates to the New York Fed board in January.[8]

- **Can you explain why these candidates were not considered?**

It is crucial for us to conduct search processes that are transparent and open to public input, and that encourage interest and applications from qualified candidates with as wide a variety of personal and professional backgrounds as possible. The Federal Reserve System needs such diversity to be fully effective in discharging its responsibilities, and we have observed that better decisions are made when there are many different perspectives represented around the table. I am firmly committed to conducting each president search in as open a manner as possible. However, I also recognize the importance of maintaining the privacy of candidates and the confidentiality of the composition of the candidate pool in order to encourage as many qualified individuals to apply as possible. Therefore, it is not appropriate for me to comment on the qualification of individual candidates.

During the recent Reserve Bank president searches, the search committees proactively sought out candidates from a variety of sources. More specifically, in addition to engaging the search firm Spencer Stuart, the Federal Reserve Bank of New York (FRBNY) search committee engaged Bridge Partners, which has a specific expertise in the identification of diverse talent. The FRBNY search committee itself also undertook an extensive program of outreach intended to solicit input and views from a range of constituencies across the district:

- The search committee sent approximately 400 letters soliciting feedback on the attributes that would enable success in the role of FRBNY president, as well as specific names for consideration.
- Members of the search committee met with the FRBNY's standing advisory committees, including the Advisory Council on Small Business and Agriculture, the Community Advisory Group (comprised of nonprofit organizations), the Economic Advisory Panel (comprised of academic economists), and the Upstate New York Regional Advisory Board.
- The search committee also held two meetings at the FRBNY with ad hoc groups of invitees, one focused on labor and advocacy organizations and the other on business and industry.

Out of these large candidate pools, the search committees identified candidates who not only had the desired experiences and key attributes but also confirmed their interests in the president positions. The FRBNY search committee, at the conclusion of its search process, published the process timeline and the characteristics of the candidate pool.[9]

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[8] Guida, Victoria, and Aubree Eliza Weaver. "In defense of the NY Fed search committee." Politico. March 30, 2018. Available at: https://www.politico.com/newsletters/morning-money/2018/03/30/in-defense-of-the-ny-fed-search-committee-154624. Guida, Victoria. "Warren leads crusade for diversity at Fed." Politico. April 2, 2018. Available at: https://www.politico.com/story/2018/04/02/federal-reserve-diversity-elizabeth-warren-452122.

[9] For more information about the FRBNY's president search timeline, see https://www.newyorkfed.org/aboutthefed/presidential-search-timeline.

10. Former Honeywell CEO David Cote served as a banker-elected member of the New York Fed board and search committee, but abruptly stepped down in mid-March. We later learned he had resigned this position to take a job with Goldman Sachs.[10] According to the New York Fed, the search committee had already settled on John Williams by the time that Cote resigned from the board. The outgoing New York Fed president was formerly Goldman Sachs' chief economist, and there have been many reported instances of an overly cozy relationship between the Fed and Goldman Sachs, including tapes that leaked in 2014 showing that the New York Fed was very lenient in supervising Goldman.[11]

- **Do you think it is appropriate that one of the people responsible for choosing a top Wall Street regulating position was negotiating a job with Goldman Sachs at the very moment he was making the decision about who the next New York Fed president should be?**

- **Does this event raise concerns that the financial industry has too much influence on regional Reserve Banks boards?**

The process for selecting a Federal Reserve Bank president is set forth in the Federal Reserve Act. Subject to the approval of the Board of Governors, a Reserve Bank president is appointed by that Bank's Class B and Class C directors. These are the directors who are not affiliated with banks or other entities supervised by the Federal Reserve. Class A directors, who are bankers, are not involved in the search process.

Since 2014, Mr. Cote served on the board of the FRBNY and on the search committee as a Class B director, representing the public. Mr. Cote brought to the board his background in the manufacturing and represented the industry while serving as a director. Mr. Cote promptly resigned his position on the FRBNY board of directors, recognizing that pursuing new business opportunities in the banking sector would affect his eligibility to serve as a Class B director.[12]

11. A recent analysis by the Center for Popular Democracy found that although there has been an increase in the gender and racial diversity of the Federal Reserve Bank's directors, the Fed is still falling short of true public representativeness.[13] Williams' selection has opened up a vacancy at the San Francisco Federal Reserve Bank. The twelfth Federal Reserve district is the largest and most diverse in the country, including a significant Latino population. Latinos comprise 30% of the district. There has never in the Fed's

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[10] Campbell, Dakin. "Goldman Sacks Teaming Up With Former Honeywell CEO Cote To Strike An Unusual Acquisition" Business Insider. Accessed July 16, 2018. Available at: http://www.businessinsider.com/goldman-sachs-and-former-honeywell-ceo-cote-teaming-up-to-buy-an-industrial-company-filing-2018-5.

[11] Haedtler, Jordan. "Why Do Former Golden Sachs Bankers Keep Landing Top Slots at the Federal Reserve." The Nation. November 30, 2015. Available at: https://www.thenation.com/article/why-do-former-goldman-sachs-bankers-keep-landing-top-slots-at-the-federal-reserve/. Bernstein, Jake. "The Carmen Segarra Tapes." ProPublica. November 17, 2014. Available at: https://www.propublica.org/article/the-carmen-segarra-tapes.

[12] For more information about our policies governing the directors, see https://www.federalreserve.gov/aboutthefed/directors/policy-governing-directors.htm.

[13] Fed Up. "New Report Analyzes Diversity at the Federal Reserve in 2018." The Center for Popular Democracy. February 14, 2018. Available at: https://populardemocracy.org/blog/new-report-analyzes-diversity-federal-reserve-2018.

history been a Latino Federal Open Markets Committee participant, either as a governor or as a Reserve Bank president.

- **Do you think it would be valuable for you and your colleagues to hear the perspective of a Latino FOMC participant?**

As I have said, we make better decisions when we have diverse voices around the table, and that is something we are very committed to at the Federal Reserve. The Federal Reserve seeks diversity in personal and professional backgrounds to be more effective in discharging its responsibilities. We value a broad representation of perspectives, and are working hard towards greater diversity at all levels of the Federal Reserve. Recognizing that the appointment of a Reserve Bank president is, as a legal matter, the responsibility of the Class B and Class C directors who are by definition not affiliated with financial institutions in the district, we at the Board worked closely with the search committee to ensure a strong and transparent process that identified a broad and diverse slate of qualified candidates.

As you know, the Federal Reserve Bank of San Francisco (FRBSF) recently selected Mary Daly as its next president. The processes of the FRBSF search committee were fair, transparent, and inclusive.[14] The FRBSF search committee included eligible directors from its board who brought diverse backgrounds and experiences to the process. Further, the search committee partnered with Diversified Search, the largest female-founded and owned firm that specializes in identifying candidates from diverse backgrounds. The search committee carried out an extensive outreach program, both in person and virtually, with a range of constituencies across the district, to gain their input on the search process, obtain their views on the most important attributes for the Bank president role, and solicit their recommendations of potential candidates.

At the conclusion of its search process, the FRBSF published additional information about the outreach conducted, timeline, and characteristics of the candidate pool. The FRBSF noted that of 283 prospective candidates 33 percent were from a minority background and 33 percent were female.

12. *Inflation Target*

In a paper that was recently presented to Atlanta Fed President Raphael Bostic, economist Dean Baker argued that the Fed should consider removing the shelter component from its core inflation indexes.[15] The reason is that higher housing costs, particularly in a handful of metropolitan areas, are significantly outpacing other measures of inflation—and that these increase stem from a lack of supply. Baker further argues that continued interest rate increases from the Fed might have the perverse effect of sapping housing construction, thereby exacerbating the very problem (rising inflation) that the Fed is trying to address. What do you make of this analysis?

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[14] For more information about the San Francisco search, go to: https://www.frbsf.org/our-district/press/news-releases/2018/mary-c-daly-named-federal-reserve-bank-of-san-francisco-president-and-chief-executive-officer/?utm_source=frbsf-home-in-the-news&utm_medium=frbsf&utm_campaign=in-the-news.

[15] Baker, Dean. "Measuring the Inflation Rate: Is Housing Different?" Center for Economic and Policy Research. June 2018. Available at: http://cepr.net/publications/reports/measuring-the-inflation-rate-is-housing-different.

We interpret the Federal Reserve's price-stability mandate as applying to a broad measure of the price of goods and services purchased by consumers. Shelter makes up a large component of consumers' expenditures, and a price index that excludes shelter would provide a highly incomplete measure of the cost of living.

To be sure, because monetary policymakers need to be forward looking in setting policy, we also pay attention to less-comprehensive inflation measures to help gauge whether a particular inflation movement is likely to persist. For example, we examine price indexes excluding food and energy items, as food and energy prices often exhibit large transitory movements. But idiosyncratic price movements are by no means limited to food and energy, and they could well occur in shelter prices at times; we need to be attentive to whether such movements might be providing a misleading signal about inflation's likely future course. My fellow policymakers and I will continue to factor such judgments into our analyses, even as we remember that overall consumer price inflation must be the ultimate focus of our policy.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

August 29, 2018

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 3 through 4 and 13 through 15 that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Cortez Masto:

3. *Wage Stagnation*

For the past eight years, we have added jobs every quarter. However, wages are not going up. In fact, worker pay in the second quarter dropped nearly one percent below its first-quarter level, according to the PayScale Index, one measure of worker pay. When accounting for inflation, the drop is even steeper. Year-over-year, rising prices have eaten up still-modest pay gains for many workers, with the result that real wages fell 1.4 percent from the prior year, according to PayScale. The drop was broad, with 80 percent of industries and two-thirds of metro areas affected.

Meanwhile, many corporate profits have never been stronger. Banks are making record profits. Companies spent more than $480 billion buying their own stocks. The increased profits are not going to workers' salaries. Additionally, productivity has increased by 73.7% from 1973 to 2016.

- **Please expand on your views about the connection between wages and productivity.**

Over long periods of time, I believe that the best way to get faster sustainable wage growth (adjusted for inflation) is to raise productivity growth. The linkage between real wages and productivity is well-grounded in economic theory and both tended to rise together in the several decades following World War II. However, wage growth and productivity growth do not necessarily track closely over shorter periods, and even over a longer period of time, higher productivity growth does not guarantee a faster rise in real wages, as there are other factors that influence wages as well. This was evident between 1990 and 2010, when real wage growth for the average worker lagged despite a pickup in productivity growth.[1] That said, in recent years, both productivity growth and wage growth have been disappointing, and my sense is that efforts to boost productivity growth will be needed to support a faster sustained pace of real wage gains.

4. At the hearing, you said that investment in education and skills were "the single best" way to increase wages for workers. But many have found that connection to be overstated. For example, Thomas Picketty, author of Capitalism in the 21st Century, wrote in a blogpost:[2]

"there's a lot of hypocrisy" in the rhetoric of conservatives who condemn inequality while failing to support policies like an increased minimum wage and ramped-up infrastructure spending....You're saying let's tax the top and invest that money into education for all.

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[1] This pattern is evident in many other industrialized countries as well. Economists have been actively researching this issue, but thus far have not come to a consensus about the cause. Plausible explanations include the rapid advances in information and computing technologies during that period, increased international trade and outsourcing, and increased product market concentration among firms. But this is clearly an issue that warrants further study.

[2] Brinker, Luke. "Thomas Picketty slams Jeb Bush on education and inequality: "I think there's a lot of hypocrisy." Salon. March 11, 2015. Available at: https://www.salon.com/2015/03/11/thomas_piketty_slams_jeb_bush_on_education_and_inequality_i_think_there s_a_lot_of_hypocrisy/.

[Jeb Bush] is a proponent of school choice, of giving schools vouchers so they can attend public school or private school, whatever they want. Is this a good solution in terms of dealing with what he calls the opportunity gap?" Ball asks Piketty.

"From what I can see, he doesn't want to invest more resources into education. He just wants more competition… there's limited evidence that this is working. And I think most of all what we need is to put more public resources in the education system. Again, if you look at the kind of school, high school, community college that middle social groups in America have access to, this has nothing to do with the very top schools and universities that some other groups have access to," Piketty replies. "[I]f we want to have more growth in the future and more equitable growth in the future, we need to put more resources in the education available to the bottom 50% or 80% of America. So it's not enough just say it, as Jeb Bush seems to be saying, but you need to act on it, and for this you need to invest resources," he says. Asked about claims by Bush and other conservatives that a so-called "skills gap" is responsible for the growth in inequality, Piketty dings that narrative as simplistic. "The minimum wage today is lower than it was 50 years ago, unions are very weak, so you need to increase the minimum wage in this country today. The views that $7 and hour is the most you can pay low-skilled worker in America today… I think is just wrong — it was more 50 years ago and there was no more unemployment 50 years ago than there is today. So I think we could increase the minimum wage," Piketty says, adding that the U.S. should also invest in "high-productivity jobs that produce more than the minimum wage." Education is important, Piketty acknowledges, but education alone is not enough to ameliorate inequality. "You need wage policy and you need education policy," he says. "And in order to have adequate education policy, you also need a proper tax policy so that you have the proper public resources to invest in these public services. Also you need infrastructure. Many of the public infrastructure in this country are not at the level of what the very developed should have. You cannot say, like many of the Republicans are saying, we can keep cutting tax on these top income groups who have already benefitted a lot from growth and globalization over the past 30 years." Data from the Survey of Consumer Finances indicates that, even when accounting for educational and racial disparities, black households headed by a college graduate are still less wealthy than less-educated white ones.[3]

- **Please provide citations for your argument that education is the main driver for falling wages.**
- **How do you respond to analysis from other economists that say other reasons – tax policies, weakening unions, regulations that benefit the financial sector – are a stronger predictor for wage stagnation?**
- **Can you further elaborate on the wage inequities between racial and educational disparities?**

I would like to start by noting two good references detailing the important link between education and wages are: *The Race between Education and Technology* by Claudia Goldin and

[3] Reeves, Richard V and Katherine Guyot. "Black women are earning more college degrees, but that alone won't close race gaps." Brookings. December 4, 2017. Available at: https://www.brookings.edu/blog/social-mobility-memos/2017/12/04/black-women-are-earning-more-college-degrees-but-that-alone-wont-close-race-gaps.

Lawrence F. Katz;[4] and "The Polarization of Job Opportunities in the US Labor Market: Implications for Employment and Earnings" by David Autor.[5] The book by Goldin and Katz traces the co-evolution of educational attainment and the wage structure in the United States through the twentieth century. They argue, in particular, that the demand for educated workers outpaced the supply beginning in about 1980, and that this supply-demand imbalance resulted in a rise in the wage premium for college-educated workers. In addition, both resources note that increases in educational attainment have not kept pace with rising educational returns, suggesting that the slowing pace of educational attainment has contributed to the rising gap between college and high school earnings. And, although the college wage premium has leveled off in recent years, it remains large.[6]

Of course, education is not the only factor that influences wage growth. For example, the paper by David Autor points out that that the rise in the relative earnings of college graduates reflected both rising real earnings for college workers and falling real earnings for noncollege workers. He attributes these trends to the polarization of job growth, with job opportunities concentrated in relatively high-skill, high-wage jobs and low-skill, low-wage jobs, and cites the automation of routine work and the increased globalization of labor markets through trade and outsourcing as the primary influences on this trend. He acknowledges that changes in labor market institutions, in particular, weaker labor unions and a falling real minimum wage, may also play a role but argues that these factors are less important, in part because these wage trends are evident in many industrialized countries.

With regard to racial disparities in wages, research by economists at the Federal Reserve Bank of San Francisco shows that African American men and women earn persistently lower wages compared with their white counterparts and that these gaps cannot be fully explained by differences in age, education, job type, or location.[7] I agree with their conclusion that these disparities are troubling and warrant greater attention by policymakers.

13. *Immigration*

Neel Kashkari, the chief of the Minneapolis Fed, stated that immigration has a net benefit on economic growth. He said slowing down immigration may slow down job growth and the U.S. economy as a whole.

- **Do you agree with President Kashkari?**

Immigration is an important contributor to the rise in the U.S. population, accounting for roughly one-half of population growth annually. And population growth, in turn, affects the growth rate of the labor force as well as the growth of the overall economy. Thus, from an economic growth

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[4] Claudia Goldin and Lawrence F. Katz, *The Race between Education and Technology*, Belknap Press, 2010.

[5] David Autor, "The Polarization of Job Opportunities in the US Labor Market: Implications for Employment and Earnings," Brookings, April 2010 https://www.brookings.edu/wp-content/uploads/2016/06/04_jobs_autor.pdf.

[6] A recent paper by Robert Valletta estimates that the wage premium for a college-educated worker (relative to a high school graduate) rose from about 30 percent in 1980 to 57 percent in 2010 and has leveled off since then. See Robert Valetta, "Recent Flattening in the Higher Education Wage Premium: Polarization, Skill Downgrading, or Both?," Working Paper No. 2016-17, Federal Reserve Bank of San Francisco, August 2016.

[7] Mary C. Daly, Bart Hobijn, and Joseph H. Pedtke, "Disappointing Facts about the Black-White Wage Gap," FRBSF Economic Letter No. 2017-26, Federal Reserve Bank of San Francisco.

standpoint, reduced immigration would result in lower population growth and thus, all else equal, slower trend economic growth. However, as you know, immigration policy is for Congress and the Administration to decide.

14. *SIFI Designation*

As a voting member of FSOC, you and your fellow members are tasked with the mission of identifying and responding to risks that threaten the financial stability of the United States, particularly in the shadowy non-bank ecosystem that required numerous massive bailouts following the 2008 financial crisis. Despite the large number of bail-outs conferred, only four nonbanks were designated as systematically significant by the FSOC.

- **As you considering whether to reduce monitoring and oversight of one of those institutions?**
- **What about the financial state or inherent systemic risk of large non-bank institutions has changed since FSOC made the considerations that warrants removing any enhanced prudential oversight?**

The financial crisis showed that the distress of large and systemic nonbank financial companies could imperil the financial stability of the United States, ultimately putting the American economy at risk. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) gave regulators new tools to address this problem, including authorizing the Financial Stability Oversight Council (FSOC) to determine that a nonbank financial company's material financial distress would threaten the financial stability of the United States. If such a determination is made, such firms are then subject to supervision by the Federal Reserve Board (Board). The Dodd-Frank Act authorizes the Board, in consultation with the FSOC, to establish enhanced prudential requirements and to supervise nonbank financial companies that have been designated as systemically important. Further, the Dodd-Frank Act requires the FSOC to reevaluate each determination of a nonbank financial institution as systemically important on at least an annual basis. The FSOC is also responsible for making the determination to retain or rescind the designation of a nonbank financial institution.

Financial vulnerabilities, such as high leverage levels and maturity mismatches between assets and liabilities, are not at the elevated levels they were prior to the crisis. Regulators have developed a deeper understanding of the ways in which nonbank financial institutions differ from banks, particularly in terms of their vulnerability to runs and the potential systemic impact this may have on the U.S. financial system. Further, several nonbank financial institutions have made significant changes to the organizational structure of their firms as well as the markets that they participate in, which has further reduced their overall risk to the U.S. financial system.

However, the regulatory community has learned from the experience of the financial crisis that it is important to focus on potential regulatory gaps and to deal with vulnerabilities that may build in nonbank financial institutions before the risks become material. In this context, it is important to continue to monitor large nonbank financial firms to ensure that, should they encounter distress, the functioning of the broader economy is not threatened. Finally, the possibility of de-designation provides an incentive for designated firms to significantly reduce their systemic footprint.

15. *Stock Buybacks*

The Fed's 2018 CCAR cycle allowed the 22 largest banks to payout $170 billion in dividends and buybacks, around a quarter more than 2017. Banks subject to the CCAR process are likewise paying out close to 102% in buybacks and dividends as a percentage of forecasted earnings.[8]

In the wake of the Federal Reserve's annual stress testing, Wells Fargo announced plans to buy back up to $24.5 billion in stock, and boost its quarterly dividend. Twenty-eight other firms were also allowed to proceed with additional proposals to boost stock buybacks and dividends.[9]

In your testimony before the Committee, you noted that investments in training and education were "the single best thing we can do to have a productive workforce."

- **What does research suggest about whether dividends and buybacks raise wages for American workers?**
- **Does the Fed have any researching suggesting the impact on economic growth if a larger percentage of bank earnings instead went to raise wages of non-managerial and/or front-line bank workers?**

Productivity growth is a key determinant of wage growth, and investments in new capital equipment or innovative technologies are important factors for improving productivity growth. Similarly, increased worker compensation can be a factor in encouraging individuals to join or remain in the labor force and to develop new skills, which can further increase productivity and wage growth. However, comparing the economic effects of these uses of a company's earnings to the eventual economic effects of stock buybacks is difficult because we do not know where the gains from buybacks will ultimately turn up. In particular, when a company buys back its shares or pays higher dividends, the resources do not disappear. Rather, they are redistributed to other uses in the economy. For instance, shareholders may decide to invest the windfall in another company, which may in turn make productivity-enhancing investments. Or they may decide to spend the windfall on goods and services that are produced by other companies, who may in turn hire new workers. In these ways, stock repurchases would also be likely to boost economic growth. Ultimately, companies themselves are the best judges of what to do with their profits, whether it is to invest in their business or increase returns to shareholders through dividends or share buybacks.

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[8] Larkin, Michael. "All Banks Clear Stress Test – But This Big Name's Payout Plan At Risk." Investor's Business Daily. June 21, 2018. Available at: https://www.investors.com/news/stress-test-results-federal-reserve-bank-dividends-buybacks//.

[9] Bloomberg. "Wells Fargo plans $24.5 billion in stock buybacks after passing Fed stress test." Los Angeles Times. June 28, 2018. Available at: http://www.latimes.com/business/la-fi-wells-fargo-stock-buyback-20180628-story.html.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Senator Catherine Cortez Masto:

Home Mortgage Disclosure Act

I remain concerned about discrimination in mortgage lending, especially as we no longer have publicly-available data on loan quality for 85% of the banks and credit unions. This means we need to rely on the staff of regulators to ensure banks comply with the Equal Credit Opportunity Act and the Fair Housing Act.

- How will you make sure that your bank examiners are looking at credit scores, loan-to-value ratios, interest rates, and other indicators of loan quality to ensure African Americans, Latinos and single women are not getting lower quality mortgage loans?

- Is it your expectation that the Fed will have the time and resources to proactively monitor these banks, without the required reporting in place?

- How many additional staff will it take to proactively monitor the more than 5,000 banks now exempted from reporting requirements?

Volcker – postpone the deadline for comment

Congress passed the Volcker Rule to prevent taxpayer backed banks from gambling with insured deposits, destabilizing the financial system and failing or requiring bailouts. Recently, the SEC, CFTC, Federal Reserve, the OCC, and the FDIC have issued a new Volcker Rule proposal. However, I am concerned that regulators have only allowed for a 60 day comment period to respond to a 689 page rule. That rule includes 342 enumerated questions, dozens of additional questions on the costs or benefits of aspects of the proposal, and invitations to comment on numerous technical concepts and provisions. A limited two month comment period may not allow for outside groups, academics and researchers the full time needed to analyze the proposal.

- Will you extend the comment period by an additional 90 days?

Wage Stagnation

For the past eight years, we have added jobs every quarter. However, wages are not going up. In fact, worker pay in the second quarter dropped nearly one percent below its first-quarter level, according to the PayScale Index, one measure of worker pay. When accounting for inflation, the drop is even steeper. Year-over-year, rising prices have eaten up still-modest pay gains for many workers, with the result that real wages fell 1.4 percent from the prior year, according to PayScale. The drop was broad, with 80 percent of industries and two-thirds of metro areas affected.

Meanwhile, many corporate profits have never been stronger. Banks are making record profits. Companies spent more than $480 billion buying their own stocks. The increased profits are not going to workers' salaries. Additionally, productivity has increased by 73.7% from 1973 to 2016.

- Please expand on your views about the connection between wages and productivity.

At the hearing, you said that investment in education and skills were "the single best" way to increase wages for workers. But many have found that connection to be overstated. For example, Thomas Picketty, author of Capitalism in the 21st Century, wrote in a blogpost:2

> "there's a lot of hypocrisy" in the rhetoric of conservatives who condemn inequality while failing to support policies like an increased minimum wage and ramped-up infrastructure spending....You're saying let's tax the top and invest that money into education for all. [Jeb Bush] is a proponent of school choice, of giving schools vouchers so they can attend public school or private school, whatever they want. Is this a good solution in terms of dealing with what he calls the opportunity gap?" Ball asks Piketty. "From what I can see, he doesn't want to invest more resources into education. He just wants more competition... there's limited evidence that this is working. And I think most of all what we need is to put more public resources in the education system. Again, if you look at the kind of school, high school, community college that middle social groups in America have access to, this has nothing to do with the very top schools and universities that some other groups have access to," Piketty replies. "[I]f we want to have more growth in the future and more equitable growth in the future, we need to put more resources in the education available to the bottom 50% or 80% of America. So it's not enough just say it, as Jeb Bush seems to be saying, but you need to act on it, and for this you need to invest resources," he says. Asked about claims by Bush and other conservatives that a so-called "skills gap" is responsible for the growth in inequality, Piketty dings that narrative as simplistic. "The minimum wage today is lower than it was 50 years ago, unions are very weak, so you need to increase the minimum wage in this country today. The views that $7 and hour is the most you can pay low-skilled worker in America today... I think is just wrong — it was more 50 years ago and there was no more unemployment 50 years ago than there is today. So I think we could increase the minimum wage," Piketty says, adding that the U.S. should also invest in "high-productivity jobs that produce more than the minimum wage." Education is important, Piketty acknowledges, but education alone is not enough to ameliorate inequality. "You need wage policy and you need education policy," he says. "And in order to have adequate education policy, you also need a proper tax policy so that you have the proper public resources to invest in these public services. Also you need infrastructure. Many of

[2] Brinker, Luke. "Thomas Picketty slams Jeb Bush on education and inequality: "I think there's a lot of hypocrisy." Salon. March 11, 2015. Available at: https://www.salon.com/2015/03/11/thomas_piketty_slams_jeb_bush_on_education_and_inequality_i_think_theres_a_lot_of_hypocrisy/

the public infrastructure in this country are not at the level of what the very developed should have. You cannot say, like many of the Republicans are saying, we can keep cutting tax on these top income groups who have already benefitted a lot from growth and globalization over the past 30 years." Data from the Survey of Consumer Finances indicates that, even when accounting for educational and racial disparities, black households headed by a college graduate are still less wealthy than less-educated white ones.3

- Please provide citations for your argument that education is the main driver for falling wages.

- How do you respond to analysis from other economists that say other reasons – tax policies, weakening unions, regulations that benefit the financial sector – are a stronger predictor for wage stagnation?

- Can you further elaborate on the wage inequities between racial and educational disparities?

Regulation

Chair Powell, at your nomination hearing, you told me that you supported strong consumer protections.

- Please name at least five issue areas where the Federal Reserve will continue to lead in consumer protection.

Monetary Policy

- If the Fed usually cuts the federal funds rate by 5 percentage points to fight a recession and the neutral rate is around 2.5%, what steps can the Federal Reserve currently take to offset a recession?4 Expand the balance sheet by buying treasuries?

Many Federal Reserve officials - including most recently outgoing New York Fed President Bill Dudley - have talked about the need for Congress to beef up fiscal stabilizers that can react automatically to a downturn.

- Do you agree that Congress should be working on this? If so, which stabilizers do you think are most effective?5

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[3] Reeves, Richard V and Katherine Guyot. "Black women are earning more college degrees, but that alone won't close race gaps." *Brookings*. December 4, 2017. Available at: https://www.brookings.edu/blog/social-mobility-memos/2017/12/04/black-women-are-earning-more-college-degrees-but-that-alone-wont-close-race-gaps/

[4] Bosley, Catherine. "Summers Warns Next U.S. Recession Could Outlast Previous One." *Bloomberg*. February 28, 2018. Available at: https://www.bloomberg.com/news/articles/2018-02-28/summers-warns-next-u-s-recession-could-outlast-the-previous-one

[5] "Officials on record: automatic stabilizers."

At your most recent press conference you said -- "we can't be too attached to these unobservable variables." If that's the case, do you think it is possible that the United States could sustain a long period of unemployment at 3% or even lower? Japan's unemployment has fallen to 2.7% and Germany is at 3.4%.

- At the last hearing you described the risks to the economy as balanced, but it seems like the Fed has much more room to tighten policy - by raising rates and running down the balance sheet - than it does to loosen policy. Doesn't that change the balance of risks? If you hike interest rates too fast, you have limited tools to address an economic slowdown. If you hike too slowly, you have ample tools to address the overheating.

Fed Governance, Diversity, and the San Francisco Fed vacancy

At your confirmation hearing, you expressed your support for more diversity among the Federal Reserve's leadership, saying, "We make better decisions when we have diverse voices around the table, and that's something we're very committed to at the Federal Reserve."[6] You also commented on the role that the Board of Governors plays in approving new Reserve Bank presidents, and assured the Senate Banking Committee that there is always a "diverse pool" in searching for candidates to fill those positions. However, the December selection of Thomas Barkin as the president of the Richmond Fed gives reason for doubt.[7] Press reports note that you were very involved in vetting candidates.[8]

Then, in April, John Williams was announced as the new New York Fed president. A source close to the process said that the New York Fed search committee just could not find qualified candidates who were interested in this position, even though community groups had given a list of qualified and diverse candidates to the New York Fed board in January.[9]

- Can you explain why these candidates were not considered?

Dudley, William C. "Speech: Important Choices for the Federal Reserve in the Years Ahead." *The Federal Reserve in the Years Ahead.* April 18, 2018. Available at: https://www.newyorkfed.org/newsevents/speeches/2018/dud180418a

[6] CNBC. "Jerome Powell: I'm a big supporter of diversity." *CNBC.* November 28, 2017. Available at: https://www.cnbc.com/video/2017/11/28/jerome-powell-im-a-big-supporter-of-diversity.html

[7] Sebastian, Shawn. "Fed Up Blasts Process, Outcome of Richmond Federal Reserve Presidential Appointment." *The Center for Popular Democracy.* Available at: https://populardemocracy.org/news-and-publications/fed-blasts-process-outcome-richmond-federal-reserve-presidential-appointment

[8] Condon, Christopher. "Fed Documents Show Powell's Hand in Richmond President Search." *Bloomberg.* July 16, 2018. Available at: https://www.bloomberg.com/news/articles/2018-07-16/fed-documents-show-powell-s-hand-in-richmond-president-search

[9] Guida, Victoria, and Aubree Eliza Weaver. "In defense of the NY Fed search committee." *Politico.* March 30, 2018. Available at: https://www.politico.com/newsletters/morning-money/2018/03/30/in-defense-of-the-ny-fed-search-committee-154624

Guida, Victoria. "Warren leads crusade for diversity at Fed." *Politico.* April 2, 2018. Available at: https://www.politico.com/story/2018/04/02/federal-reserve-diversity-elizabeth-warren-452122

Former Honeywell CEO David Cote served as a banker-elected member of the New York Fed board and search committee, but abruptly stepped down in mid-March. We later learned he had resigned this position to take a job with Goldman Sachs.10 According to the New York Fed, the search committee had already settled on John Williams by the time that Cote resigned from the board. The outgoing New York Fed president was formerly Goldman Sachs' chief economist, and there have been many reported instances of an overly cozy relationship between the Fed and Goldman Sachs, including tapes that leaked in 2014 showing that the New York Fed was very lenient in supervising Goldman.11

- Do you think it is appropriate that one of the people responsible for choosing a top Wall Street regulating position was negotiating a job with Goldman Sachs at the very moment he was making the decision about who the next New York Fed president should be?

- Does this event raise concerns that the financial industry has too much influence on regional Reserve Banks boards?

A recent analysis by the Center for Popular Democracy found that although there has been an increase in the gender and racial diversity of the Federal Reserve Bank's directors, the Fed is still falling short of true public representativeness.12 Williams' selection has opened up a vacancy at the San Francisco Federal Reserve Bank. The twelfth Federal Reserve district is the largest and most diverse in the country, including a significant Latino population. Latinos comprise 30% of the district. There has never in the Fed's history been a Latino Federal Open Markets Committee participant, either as a governor or as a Reserve Bank president.

- Do you think it would be valuable for you and your colleagues to hear the perspective of a Latino FOMC participant?

Inflation Target

- In a paper that was recently presented to Atlanta Fed President Raphael Bostic, economist Dean Baker argued that the Fed should consider removing the shelter component from its core inflation indexes.13 The reason is that higher housing costs, particularly in a handful

[10] Campbell, Dakin. "Goldman Sacks Teaming Up With Former Honeywell CEO Cote To Strike An Unusual Acquisition" *Business Insider*. Accessed July 16, 2018. Available at: http://www.businessinsider.com/goldman-sachs-and-former-honeywell-ceo-cote-teaming-up-to-buy-an-industrial-company-filing-2018-5
[11] Haedtler, Jordan. "Why Do Former Golden Sachs Bankers Keep Landing Top Slots at the Federal Reserve." *The Nation*. November 30, 2015. Available at: https://www.thenation.com/article/why-do-former-goldman-sachs-bankers-keep-landing-top-slots-at-the-federal-reserve/
Bernstein, Jake. "The Carmen Segarra Tapes." *ProPublica*. November 17, 2014. Available at: https://www.propublica.org/article/the-carmen-segarra-tapes
[12] Fed Up. "New Report Analyzes Diversity at the Federal Reserve in 2018." *The Center for Popular Democracy*. February 14, 2018. Available at: https://populardemocracy.org/blog/new-report-analyzes-diversity-federal-reserve-2018
[13] Baker, Dean. "Measuring the Inflation Rate: Is Housing Different?" *Center for Economic and Policy Research*. June 2018. Available at: http://cepr.net/publications/reports/measuring-the-inflation-rate-is-housing-different

of metropolitan areas, are significantly outpacing other measures of inflation—and that these increase stem from a lack of supply. Baker further argues that continued interest rate increases from the Fed might have the perverse effect of sapping housing construction, thereby exacerbating the very problem (rising inflation) that the Fed is trying to address. What do you make of this analysis?

Immigration

Neel Kashkari, the chief of the Minneapolis Fed, stated that immigration has a net benefit on economic growth. He said slowing down immigration may slow down job growth and the U.S. economy as a whole.

- Do you agree with President Kashkari?

SIFI Designation

As a voting member of FSOC, you and your fellow members are tasked with the mission of identifying and responding to risks that threaten the financial stability of the United States, particularly in the shadowy non-bank ecosystem that required numerous massive bailouts following the 2008 financial crisis. Despite the large number of bail-outs conferred, only four nonbanks were designated as systematically significant by the FSOC.

- As you considering whether to reduce monitoring and oversight of one of those institutions?

- What about the financial state or inherent systemic risk of large non-bank institutions has changed since FSOC made the considerations that warrants removing any enhanced prudential oversight?

Stock Buybacks

The Fed's 2018 CCAR cycle allowed the 22 largest banks to payout $170 billion in dividends and buybacks, around a quarter more than 2017. Banks subject to the CCAR process are likewise paying out close to 102% in buybacks and dividends as a percentage of forecasted earnings.14

In the wake of the Federal Reserve's annual stress testing, Wells Fargo announced plans to buy back up to $24.5 billion in stock, and boost its quarterly dividend. Twenty-eight other firms were also allowed to proceed with additional proposals to boost stock buybacks and dividends.15

[14] Larkin, Michael. "All Banks Clear Stress Test – But This Big Name's Payout Plan At Risk." *Investor's Business Daily*. June 21, 2018. Available at: https://www.investors.com/news/stress-test-results-federal-reserve-bank-dividends-buybacks/

[15] Bloomberg. "Wells Fargo plans $24.5 billion in stock buybacks after passing Fed stress test." *Los Angeles Times*. June 28, 2018. Available at: http://www.latimes.com/business/la-fi-wells-fargo-stock-buyback-20180628-story.html

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 17, 2018

In your testimony before the Committee, you noted that investments in training and education were "the single best thing we can do to have a productive workforce."

- What does research suggest about whether dividends and buybacks raise wages for American workers?

- Does the Fed have any researching suggesting the impact on economic growth if a larger percentage of bank earnings instead went to raise wages of non-managerial and/or front-line bank workers?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 18, 2018

The Honorable Doug Jones
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the written question that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Jones:

1. In the Federal Reserve's 2018 Report on the Economic Well-Being of U.S. Households, the report finds that 40% of Americans do not have the sources to cover an unexpected $400 expense.

While the number of Americans responding in this manner has shrunk since 2013, as noted in the report, it is still an alarmingly high number.

The report notes that the most common response among those who could not cover an expense is to place the purchase on a credit card.

- **Are there broader economic implications of such a reliance on potentially high priced consumer credit?**

According to the survey, conducted in the fourth quarter of 2017, 18 percent of U.S. adults report that they would pay a hypothetical $400 emergency expense with a credit card that they then pay off over time.[1] In the initial survey in 2013, this fraction was 17 percent. The fraction of adults who said they would not be able to meet a $400 expense by any means declined to 12 percent in 2017 from 19 percent in 2013.

Broader implications of such responses are difficult to gauge. The costs of financing such an expense would add financial burden on these households, relative to paying in cash. However, for some households, such credit access may act as a relief valve of sorts, allowing them to meet the emergency or avoiding even costlier forms of credit such as payday loans.

- **Does the Federal Reserve have further context on this response – how does the number of Americans unable to cover a $400 expense compare to previous decades, or to other advanced economies?**

The Federal Reserve first asked how individuals would handle a $400 unexpected expense in 2013. While we do not have an exact comparison in prior decades or in other countries, the Federal Reserve Board's triennial Survey of Consumer Finances (SCF) reports that the share of households with easily accessible savings remains low and has changed little in recent decades.[2] Liquid savings, such as cash, checking or saving accounts, are the least costly and easiest assets to use for unexpected expenses. The 2016 SCF reports that nearly half of all families did not have $3,000 in liquid savings, almost the same fraction since 1989 in inflation-adjusted terms.

- **Does this inability to cover expenses increase dramatically across certain groups – for example, seniors, young people, or minorities?**

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[1] For the survey and report, see the Federal Reserve Board's *Survey of Household Economics and Decisionmaking* at www.federalreserve.gov/consumerscommunities/shed.htm.

[2] For more information, see reports and research on the Federal Reserve Board's Survey of Consumer Finance at www.federalreserve.gov/econres/scfindex.htm.

Yes, financial security and the ability to cover expenses, differs across demographic groups. As one example, in 2017, one quarter of white adults without education beyond a high school degree did not expect to pay their current month's bills in full. Among African Americans and Hispanics with the same education level, that fraction was 41 percent and 35 percent respectively.

Financial security is more common with more education, but a gap by race and ethnicity remains. As a second example, only half of young adults (under the age of thirty) would use cash or its equivalent to cover an unexpected $400 expense, versus 57 percent of middle-aged adults (ages 30 to 64) and 71 percent of seniors (age 65 and older). Even with such differences by age, race, and education, the economic recovery has improved the finances across many groups.

2. I am concerned that for Americans that live paycheck to paycheck, the United States' payment system can, at times, fall short. In particular, I believe there is great need for faster payments, including quicker access to consumer funds after deposit. When consumers do not access to their own funds, they often resort to and rely on high-cost products that are outside of the traditional banking system.

- **The Federal Reserve has acknowledged the need to help foster a faster payments system with its work and creation of the Faster Payments Task Force. What are the next steps and future priorities for the Task Force?**

In July 2017, the Faster Payments Task Force (FPTF) concluded its work upon release of its final report. The FPTF's Final Report reflected the task force's perspectives on challenges and opportunities with implementing faster payments in the United States, outlined its recommendations for next steps, and included the proposals and assessments for the 16 participants that opted to be included in the final report.[3] The FPTF recommendations identified the need for ongoing industry collaboration to address infrastructure gaps; to develop models for governance, rules and standards; and to consider actions and investments that will contribute to a healthy and sustainable payments ecosystem. A number of recommendations called for Federal Reserve support to facilitate this ongoing collaboration.

Following up on the work of the FPTF and other efforts to advance the Federal Reserve's desired outcomes (focused on speed, security, efficiency, international payments, and collaboration) for the payment system, the Federal Reserve published, in September 2017, a paper presenting refreshed strategies and tactics that the Federal Reserve is employing in collaboration with payment system stakeholders.[4]

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

[4] The desired outcomes are outlined in the Federal Reserve System's "Strategies for Improving the U.S. Payment System," January 26, 2015. Available at https://fedpaymentsimprovement.org/wp-content/uploads/strategies-improving-us-payment-system.pdf. The refreshed strategies and tactics are outlined in the Federal Reserve System's "Strategies for Improving the U.S. Payment System: Federal Reserve Next Steps in the Payments Improvement Journey," September 6, 2017. Available at https://fedpaymentsimprovement.org/wp-content/uploads/next-step-payments-journey.pdf.

The Federal Reserve kicked off these refreshed strategies and tactics in the summer of 2017, by facilitating the industry's work to address the FPTF recommendations related to governance, directories, rules, standards, and regulations. In addition, consistent with the FPTF recommendations, the Federal Reserve has been assessing the needs and gaps to enabling 24x7x365 settlement in support of a future ubiquitous real-time retail payments environment.

Further, the Federal Reserve has started to explore and assess the need, if any, for any other operational roles to support ubiquitous, real-time retail payments. These efforts are being pursued in alignment with Federal Reserve's longstanding principles and criteria for the provision of payment services.

3. As you know, new accounting standards, based on a "current expected credit loss" (CECL) model, developed by the Financial Accounting Standards Board (FASB) will go into effect in 2020. While the new accounting standards underwent multiple years of study, the implementation of these standards will result in one of the larger changes to banking accounting in recent memory.

- **The CECL standard is likely to affect bank capital in uncertain and potentially volatile ways, especially as banks begin the transition process to this new accounting standard. Did FASB consult with the Federal Reserve for how these changes might impact bank capital?**

The Federal Reserve Board (Board) along with the other U.S. federal financial institution regulatory agencies have supported the Financial Accounting Standards Board's (FASB) efforts to improve the accounting for credit losses and provide financial statement users with more decision-useful information about the expected credits losses on loans and certain other financial instruments.

Throughout the development of the current expected credit loss (CECL), the FASB conducted extensive outreach with a diverse group of stakeholders, including the Federal Reserve System. Stakeholders provided input and feedback through the public comment letters and participation in public forums. The FASB did not specifically consult the Board regarding CECL's impact to bank capital since their mandate is to establish and improve financial accounting and reporting standards to provide decision-useful information to investors and other users of financial reports.

In response to CECL, the Board, with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) (together, "the agencies"), recently issued a joint proposal that would address the forthcoming changes. In particular, the proposal would provide firms the option to phase in the day-one regulatory capital effects of CECL over a three-year period.

The agencies intend for this transition provision to address firms' challenges in capital planning for CECL implementation, particularly due to the uncertainty of economic conditions at the time a firm adopts CECL.

The agencies are currently reviewing comments to the proposal in preparation for finalizing it. In addition, the agencies will continue to monitor the effects of CECL implementation on regulatory capital and bank lending practices to help determine whether any further changes to the capital rules are warranted.

- **Is the Federal Reserve taking into these rule changes as it continues to implement capital rules created by the Dodd-Frank financial reform law?**

The Board is indeed taking into consideration the impact of CECL in connection with the Board's ongoing regulatory and supervisory functions. For example, the agencies, earlier this year issued a joint proposal entitled Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations.[5] In the joint proposal, the agencies proposed to amend the regulatory capital rules of the agencies to address changes to U.S. generally accepted accounting principles (GAAP) resulting from the FASB's issuance of CECL. The proposal would provide firms subject to the capital rules with the option to phase in, over a three-year period, the day-one adverse regulatory capital effects of CECL that may result from the adoption of the new accounting standard. This transition period is intended to address the potential challenges in planning for CECL implementation, including the uncertainty of economic conditions at the time that a firm adopts CECL. In addition, the proposal identifies certain credit loss allowances under the new accounting standard that would be eligible for inclusion in regulatory capital.

The agencies are currently reviewing comments received from the public on the proposal. The Board will continue to monitor the effects of CECL implementation on firms supervised by the Board and on the U.S. financial system.

4. As the CECL requirements go into effect in 2020, the first tests of how they impact bank capital may come during annual CCAR process.

- **Will the Federal Reserve be taking into account these rule changes as it undertakes the 2019 and 2020 CCAR process?**

In May 2018, the Board published a joint notice of proposed rulemaking with the OCC and FDIC to address changes to U.S. GAAP associated with CECL, issued by FASB in June 2016. Under the proposal, the Board would not incorporate CECL into the supervisory stress tests, and would not require a firm to incorporate CECL into its stress tests, until the 2020 cycle. If a banking organization were to adopt CECL for the first time in 2021, it would not be required to include provisioning for credit losses under the new standard until the 2021 stress test cycle.

This proposal avoids "pulling forward" the effect of CECL, by aligning the dates that firms are expected to include CECL in their comprehensive capital analysis and review projections with the actual date of implementation for those firms implementing in 2020 and 2021.

In advance of CECL implementation, the Federal Reserve is considering feedback received during outreach discussions with industry representatives, developing approaches for incorporating provision for credit losses in its supervisory models, and preparing for parallel testing of those models.

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[5] 83 Fed. Reg. 22312 (May 14, 2018).

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Senator Doug Jones:

In the Federal Reserve's 2018 Report on the Economic Well-Being of U.S. Households, the report finds that 40% of Americans do not have the sources to cover an unexpected $400 expense.

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The report notes that the most common response among those who could not cover an expense is to place the purchase on a credit card.

- Are there broader economic implications of such a reliance on potentially high priced consumer credit?

- Does the Federal Reserve have further context on this response – how does the number of Americans unable to cover a $400 expense compare to previous decades, or to other advanced economies?

- Does this inability to cover expenses increase dramatically across certain groups – for example, seniors, young people, or minorities?

I am concerned that for Americans that live paycheck to paycheck, the United States' payment system can, at times, fall short. In particular, I believe there is great need for faster payments, including quicker access to consumer funds after deposit. When consumers do not access to their own funds, they often resort to and rely on high-cost products that are outside of the traditional banking system.

- The Federal Reserve has acknowledged the need to help foster a faster payments system with its work and creation of the Faster Payments Task Force. What are the next steps and future priorities for the Task Force?

As you know, new accounting standards, based on a "current expected credit loss" (CECL) model, developed by the Financial Accounting Standards Board (FASB) will go into effect in 2020. While the new accounting standards underwent multiple years of study, the implementation of these standards will result in one of the larger changes to banking accounting in recent memory.

- The CECL standard is likely to affect bank capital in uncertain and potentially volatile ways, especially as banks begin the transition process to this new accounting standard. Did FASB consult with the Federal Reserve for how these changes might impact bank capital?

- Is the Federal Reserve taking into these rule changes as it continues to implement capital rules created by the Dodd-Frank financial reform law?

As the CECL requirements go into effect in 2020, the first tests of how they impact bank capital may come during annual CCAR process.

- Will the Federal Reserve be taking into account these rule changes as it undertakes the 2019 and 2020 CCAR process?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 6, 2018

The Honorable Mark Warner
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Warner:</u>

1. Alternative Reference Rate: Some underappreciated work that you have guided at the Federal Reserve is that of the Alternative Reference Rate Committee. Global regulators have acknowledged that at the end of 2021, banks will no longer be required to submit to the panel that determines LIBOR, meaning that the rate could stop publication at that time. LIBOR is currently critical to the smooth functioning of our financial system, as it underlies $200 trillion in notional value, or ten times US GDP, including a significant amount of floating-rate mortgages. As the FSOC's annual report highlighted, if LIBOR disappears without a liquid market in the replacement rate, the effects could be catastrophic. Yet a switch to an alternative rate, the secured overnight financing rate, requires tremendous collaboration by the private sector and the official sector and the creation of financial markets that would facilitate the arbitrage between LIBOR and the secured rate, and the creation of new products in the new secured rate.

Do you believe end users will demand products in the new secured rate sufficient to build a deep and liquid market in the secured rate before the end of 2021, even though first movers in this space are likely to pay a premium for the product before the market is fully developed? Why?

As you note, the Financial Stability Oversight Council (FSOC) has highlighted the potential risks to U.S. financial stability from the London Interbank Offered Rate (LIBOR) since 2014. These concerns led the Federal Reserve to convene the Alternative Reference Rates Committee (or ARRC) at that time. The ARRC is a diverse group of private sector firms and institutions that has widespread support from the U.S. official sector. In addition to the Federal Reserve Board, the Consumer Financial Protection Bureau, the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Commission (FDIC), the Federal Housing Finance Authority, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency (OCC), the Office of Financial Research, the Securities and Exchange Commission (SEC), and the U.S. Treasury Department (U.S. Treasury) all act as ex officio members of the ARRC. The ARRC's work in identifying the secured overnight financing rate (SOFR) as a recommended alternative to U.S. dollar LIBOR and developing a plan to promote use of SOFR on a voluntary basis has unquestionably been necessary in helping to make sure that the financial stability risks identified by the FSOC do not materialize.

I have been greatly encouraged by the response of the private sector since SOFR began publication in April of this year. Even in this short period of time, we have already seen evidence that SOFR can and will be used by a wide range of market participants. The Chicago Mercantile Exchange is offering futures contracts on SOFR, and trading activity has already risen to above five thousand contracts (or about $15 billion) per day with a total open interest of $75 billion. SOFR futures already have far more daily transactions underlying them than LIBOR. In addition, the London Clearing House group has begun offering clearing of SOFR swaps. And importantly, we have already seen two recent issuances of debt tied to SOFR. Both of these issuances were met with high demand and were oversubscribed, indicating that there is a robust part of the market that recognizes that SOFR instruments have value to them.

There are several reasons that I believe we will see liquidity in SOFR instruments continue to grow. First, as a fully transactions-based, International Organization of Securities Commissions compliant benchmark based on the overnight U.S. Treasury repo market -- the largest rates market in the world -- SOFR really does represent a robust alternative to U.S. dollar LIBOR. Because so many firms are active in the Treasury repo market, they naturally have incentives to trade SOFR instruments. Second, many market participants have come to realize that the risks the FSOC has pointed to in LIBOR are quite likely to materialize, and I believe they see that it is in their own interest to move away from LIBOR and toward SOFR. The ARRC and the official sector will need to continue to educate market participants about the risks to LIBOR, and work to make sure that this transition is a smooth one.

2. Foreign banks and prudential rules: I noticed that in the single-counterparty credit limit (SCCL) final rule, the Fed applied limitations on domestic bank holding companies that have $250 billion or more in total assets and the intermediate holding companies of foreign banks with at least $50 billion in total assets. And in the recent CCAR results, the Fed exempted three US banks with assets between $50 billion and $100 billion, but continued to apply CCAR to the intermediate holding company of one foreign bank that has nearly $900 billion in total assets but only $86 billion in the US.

Can you describe the philosophy guiding the Fed's decisions to keep foreign banks' U.S. holding companies covered by these important prudential rules?

In 2014, recognizing that the U.S. operations of foreign banking organizations (FBOs) had become more complex, interconnected, and concentrated, the Board adopted a final rule that established enhanced prudential standards for large U.S. bank holding companies (BHCs) and FBOs to help increase the resiliency of their operations. These standards include liquidity, risk management and capital, and require a FBO with a significant U.S. presence to establish an intermediate holding company (IHC) over its U.S. subsidiaries to facilitate consistent supervision and regulation of the U.S. operations of the foreign bank. The standards applied to the U.S. operations of FBOs are broadly consistent with the standards applicable to U.S. bank holding companies. However, the standards can also take into account the combined footprint of FBOs' U.S. operations, including their branches and agencies.

Accordingly, the 2018 final rule to implement single-counterparty credit limits (SCCL) for large U.S. bank holding companies tailors the application of SCCL to U.S. IHCs such that U.S. IHCs of similar size to U.S. BHCs covered under the rule are subject to the same SCCL, but the final rule also takes into account the IHC's role as one portion of a significantly larger banking organization.

Similarly, the Board's annual Comprehensive Capital Analysis and Review (CCAR) applies more stringent standards to an IHC based on whether it is large and complex, meaning it (1) has average total consolidated assets over $250 billion or (2) has average total nonbank assets of $75 billion or more, and (3) is not a U.S. global systemically important firm.

The Board monitors the impact of its regulations after implementation to assess whether the regulations continue to function as intended. In implementing enhanced prudential standards for FBOs with a large U.S. presence, the Board sought to ensure that FBOs hold capital and liquidity in the United States and have a risk management infrastructure commensurate with the risks in their U.S. operations. In general, FBOs with $50 billion in U.S. subsidiary assets are among the largest and most interconnected foreign banks operating in the United States. As a result of the IHC requirement, these firms have become less fragmented, hold capital and liquidity buffers in the United States that align with their U.S. footprint, and operate on more equal regulatory footing with their domestic counterparts. I believe our current IHC framework with the current threshold is working well.

3. Volcker Rule: The policy behind the Volcker Rule is to reduce risky activities in banks, in particular high risk proprietary trading. I've long been a supporter of the Volcker Rule, and I think this is a worthy goal, as we never want banks to go back to that type of risky trading. The rule aims to achieve this in part by prohibiting banks from investing in hedge funds and private equity funds. I've heard, however, that the current definition has captured investments that seem far removed from the statute's original concern—such as an incubator for women-run businesses—and prohibits bank investments in funds where banks are permitted to make the investment directly. The proposed rulemaking seems focused on easing compliance burdens that have been associated with the subjective intent test under the current rule, but it provides little clarity on the agencies' thinking on the covered fund side.

Can you describe how the Federal Reserve is thinking about changes to the covered fund rules?

The Board, along with the OCC, FDIC, CFTC, and SEC (the agencies) adopted regulations to implement section 13 of the BHC Act, the "Volcker Rule," in 2013. These regulations included a definition of "covered fund" that, in the agencies' view, was consistent with the statutory purpose of the Volcker Rule to limit certain investment activities of banking entities. Subsequently, and based on experience with the Volcker Rule regulations, the agencies identified opportunities for improvement and proposed amendments to the Volcker Rule regulations in June 2018.

The proposal requests comment on how to tailor the regulations governing a banking entity's covered fund activities. For example, the proposal asks whether a different definition of "covered fund" would be appropriate. In addition, the proposal requests comment on potential exemptions for particular types of funds, or funds with particular characteristics.

Since proposing the amendments in June, the agencies have held meetings with and received comments from interested parties regarding the treatment of covered funds. The agencies expect to meet with and receive comments from interested parties throughout the comment period, and will carefully consider each comment to determine whether any changes to the covered fund regulations would be appropriate.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Senator Mark Warner:

Alternative Reference Rate: Some underappreciated work that you have guided at the Federal Reserve is that of the Alternative Reference Rate Committee. Global regulators have acknowledged that at the end of 2021, banks will no longer be required to submit to the panel that determines LIBOR, meaning that the rate could stop publication at that time. LIBOR is currently critical to the smooth functioning of our financial system, as it underlies $200 trillion in notional value, or ten times US GDP, including a significant amount of floating-rate mortgages. As the FSOC's annual report highlighted, if LIBOR disappears without a liquid market in the replacement rate, the effects could be catastrophic. Yet a switch to an alternative rate, the secured overnight financing rate, requires tremendous collaboration by the private sector and the official sector and the creation of financial markets that would facilitate the arbitrage between LIBOR and the secured rate, and the creation of new products in the new secured rate.

- Do you believe end users will demand products in the new secured rate sufficient to build a deep and liquid market in the secured rate before the end of 2021, even though first movers in this space are likely to pay a premium for the product before the market is fully developed? Why?

Foreign banks and prudential rules: I noticed that in the single-counterparty credit limit (SCCL) final rule, the Fed applied limitations on domestic bank holding companies that have $250 billion or more in total assets and the intermediate holding companies of foreign banks with at least $50 billion in total assets. And in the recent CCAR results, the Fed exempted three US banks with assets between $50 billion and $100 billion, but continued to apply CCAR to the intermediate holding company of one foreign bank that has nearly $900 billion in total assets but only $86 billion in the US.

- Can you describe the philosophy guiding the Fed's decisions to keep foreign banks' U.S. holding companies covered by these important prudential rules?

Volcker Rule: The policy behind the Volcker Rule is to reduce risky activities in banks, in particular high risk proprietary trading. I've long been a supporter of the Volcker Rule, and I think this is a worthy goal, as we never want banks to go back to that type of risky trading. The rule aims to achieve this in part by prohibiting banks from investing in hedge funds and private equity funds. I've heard, however, that the current definition has captured investments that seem far removed from the statute's original concern—such as an incubator for women-run businesses—and prohibits bank investments in funds where banks are permitted to make the investment directly. The proposed rulemaking seems focused on easing compliance burdens that have been associated with the subjective intent test under the current rule, but it provides little clarity on the agencies' thinking on the covered fund side.

- Can you describe how the Federal Reserve is thinking about changes to the covered fund rules?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

August 20, 2018

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 2 that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Menendez:</u>

2. Many economists, including President Trump's Chair of the Council of Economic Advisers, have long advocated for less restrictive immigration policies to help grow the U.S. labor force, especially in light of an aging population and low birth rate. According to the Pew Research Center, without a steady stream of a total of 18 million immigrants between now and 2035, the share of the U.S. working-age population could decrease to 166 million.[1]

- **What repercussions would restrictive immigration policies have on our workforce and economy?**

Immigration is an important contributor to the rise in the U.S. population, accounting for roughly one-half of population growth annually. And population growth, in turn, affects the growth rate of the labor force as well as the growth of the overall economy. Thus, from an economic growth standpoint, reduced immigration would result in lower population growth and thus, all else equal, slower trend economic growth. However, immigration policy is not the purview of the Federal Reserve but rather is the responsibility of the Congress and the Administration.

[1] http://www.pewresearch.org/fact-tank/2017/03/08/immigration-projected-to-drive-growth-in-u-s-working-age-population-through-at-least-2035/.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 18, 2018

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 1 that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. On August 20, 2018, I provided response to question 2. Copies of all responses have also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Menendez:

1. In response to my question about the joint agency rulemaking required by Section 956 of Dodd-Frank, you said, "We tried -- we were not able to achieve consensus over a period of many years between the various regulatory agencies that need to sign off on that. But that didn't stop us from acting, you should know. We -- particularly, for the largest institutions, we do expect that they will have in place compensation plans that -- that do not provide incentives for excessive risk-taking. And we expect that the board of directors will make sure that that's the case. And so, it's not something that we haven't done. We've, in fact, moved ahead through supervisory practice to -- to make sure that these things are better than they were and they're substantially better than they were. You see much better compensation practices here, focusing mainly on the big firms where the problem really was."[1]

Your response suggests that the relevant agencies have ceased work on this rulemaking.

- **Is that correct?**

After the Federal Reserve Board (Board), Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities Exchange Committee, National Credit Union Association, and the Federal Housing Finance Agency (the agencies), jointly published and requested comment on the revised proposed rule in June 2016, the agencies received over one hundred comments. These comments raised many important and complicated questions. The agencies continue to consider the comments.

The Federal Reserve believes that supervision of incentive compensation programs at financial institutions can play an important role in helping safeguard financial institutions against practices that threaten safety and soundness, provide for excessive compensation, or could lead to material financial loss. In particular, supervision can help address incentive compensation practices that encourage inappropriate risk-taking, which may have effects on not only the institution in question, but also on other institutions or the broader economy.

Additionally, The Federal Reserve continues to work with firms to improve incentive compensation practices and promote prudent risk-taking at supervised entities.

- **Please provide a detailed explanation of how the Federal Reserve is either limiting or prohibiting incentive-based compensation practices that encourage excessive risk-taking through supervision.**

The Federal Reserve, along with the other federal banking agencies, issued Guidance on Sound Incentive Compensation Policies (Guidance) in June 2010. The interagency guidance is anchored by three principles:

[1] https://plus.cq.com/doc/congressionaltranscripts-5358712?4.

- Balance between risks and results: Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks;
- Processes and controls that reinforce balance: A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements; and
- Effective corporate governance: Banking organizations should have strong and effective corporate governance to help ensure sound incentive compensation practices, including active and effective oversight by the board of directors.

The Guidance explains how banking organizations should develop incentive compensation policies that take into account the full range of current and potential risks, and are consistent with safe and sound practices. Relevant risks would vary based on the organization, but could include credit, market, operational, liquidity, interest rate, legal, conduct and related risks. The Guidance also discusses the importance of considering compliance risks (including consumer compliance) when evaluating whether incentive compensation arrangements balance risk and rewards.

Currently, supervisory oversight focuses most intensively on large and complex banking organizations, which warrant the most intensive supervisory attention because they are significant users of incentive compensation arrangements and because flawed approaches at these organizations are more likely to have adverse effects on the broader financial system.

- **Please provide any guidance issued to regulated institutions or materials provided to bank examiners on incentive-based compensation practices.**

Attached to this response are:

- Guidance on Sound Incentive Compensation Policies, issued by the federal banking agencies in June 2010;[2] and
- A Report on the Horizontal Review of Practices at Large Banking Organizations, issued by the Board in October 2011.[3]

- **What metrics, thresholds, and standards is the Federal Reserve using to evaluate incentive-based compensation practices?**

The Federal Reserve's approach is principles-based, and recognizes that organizations have unique incentive compensation practices that vary depending on the firm's organizational model and operating structure. The supervisory process focuses on assessing how firms have integrated their approaches to incentive compensation arrangements with their risk-management and internal control frameworks to better monitor and control the risks these arrangements may create for the organization. Supervision also considers whether appropriate personnel, including risk-management personnel, have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.

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[2] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20100621a.htm.

[3] https://www.federalreserve.gov/publications/other-reports/incentive-compensation-report-201110.htm.

- **Which institutions are subject to the Federal Reserve's supervision of incentive-based compensation practices?**

The Guidance, issued by the federal banking agencies in June 2010, applies to global consolidated operations of all U.S.-headquartered banking organizations and to the U.S. operations of foreign banking organizations with a branch, agency, or commercial lending company in the United States that use incentive compensation. Because of the size and complexity of their operations, Federal Reserve supervision focuses on large banking organizations, those with the most significant use of incentive compensation, and those with the most complex operations.

- **Were those institutions selected for supervision by asset size or some other factor?**

The principles-based Guidance issued by the federal banking agencies in June 2010, applies regardless of size; however, the Federal Reserve focuses supervisory oversight on the largest banking organizations, those with the most significant use of incentive compensation, and those with the most complex operations.

The banking organizations involved in the horizontal reviews[4] were selected based on asset size and complexity of operations.

- **If there is no rule clearly delineating prohibited practices, how are you ensuring consistency across regulated institutions?**

Supervision of incentive compensation by the Federal Reserve is governed by the Guidance, which is integrated into the Bank Holding Company Supervision Manual. Federal Reserve understanding of incentive compensation practices was developed through the information collected during the horizontal reviews. With that understanding, the Federal Reserve has integrated incentive compensation in ongoing supervisory reviews, whether targeted (such as sales incentives or compliance reviews) or within individual lines of business (such as mortgage lending operations, or trading). A team at the Board monitors these reviews to encourage constituency.

To foster implementation of improved incentive compensation practices, the Federal Reserve initiated multidisciplinary, horizontal reviews of incentive compensation practices at larger banking organizations. The primary goal was to consistently guide firms in implementing the interagency guidance.

[4] For additional information on the Federal Reserve's horizontal reviews of compensation practices, see: Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations, October 2011, available at: https://www.federalreserve.gov/publications/other-reports/incentive-compensation-report-201110.htm.

an exemption under the Freedom of Information Act (5 U.S.C. 552(b)(4) and (b)(6)). The confidentiality status of the information submitted will be judged on a case-by-case basis.

Abstract: The information collected assists the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision in fulfilling their statutory responsibilities as supervisors. Each of these forms is used to collect information in connection with applications and notices filed prior to proposed changes in the ownership or management of banking organizations. The agencies use the information to evaluate the controlling owners, senior officers, and directors of the insured depository institutions subject to their oversight.

4. *Report title:* Recordkeeping and Disclosure Requirements Associated with Regulation R.

Agency form number: FR 4025.

OMB control number: 7100–0316.

Frequency: On occasion.

Reporters: Commercial banks and savings associations.

Estimated annual reporting hours: Section 701, disclosures to customers—12,500 hours; Section 701, disclosures to brokers—375 hours; Section 723, recordkeeping—188 hours; Section 741, disclosures to customers—62,500 hours.

Estimated average hours per response: Section 701, disclosures to customers—5 minutes; Section 701, disclosures to brokers—15 minutes; Section 723, recordkeeping—15 minutes; Section 741, disclosures to customers—5 minutes.

Number of respondents: Section 701, disclosures to customers—1,500; Section 701, disclosures to brokers—1,500; Section 723, recordkeeping—75; Section 741, disclosures to customers—750.

General description of report: This information collection is required to obtain a benefit pursuant to section 3(a)(4)(F) of the Securities Exchange Act (15 U.S.C. 78c(a)(4)(F)) and may be given confidential treatment under the authority of the Freedom of Information Act (5 U.S.C. 552(b)(4) and (b)(8)).

Abstract: Regulation R implements certain exceptions for banks from the definition of broker under Section 3(a)(4) of the Securities Exchange Act of 1934, as amended by the Gramm-Leach-Bliley Act. Sections 701, 723, and 741 of Regulation R contain information collection requirements. Section 701 requires banks that wish to utilize the exemption in that section to make certain disclosures to the high net worth customer or institutional customer. In addition, section 701 requires banks that wish to utilize the exemption in that section to provide a notice to its broker-dealer partner regarding names and other identifying information about bank employees. Section 723 requires a bank that chooses to rely on the exemption in that section to exclude certain trust or fiduciary accounts in determining its compliance with the chiefly compensated test in section 721 to maintain certain records relating to the excluded accounts. Section 741 requires a bank relying on the exemption provided by that section to provide customers with a prospectus for the money market fund securities, not later than the time the customer authorizes the bank to effect the transaction in such securities, if the class of series of securities are not no-load.

Board of Governors of the Federal Reserve System, June 22, 2010.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 2010–15492 Filed 6–24–10; 8:45 am]

BILLING CODE 6210–01–P

FEDERAL RESERVE SYSTEM

Formations of, Acquisitions by, and Mergers of Bank Holding Companies

The companies listed in this notice have applied to the Board for approval, pursuant to the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*) (BHC Act), Regulation Y (12 CFR Part 225), and all other applicable statutes and regulations to become a bank holding company and/or to acquire the assets or the ownership of, control of, or the power to vote shares of a bank or bank holding company and all of the banks and nonbanking companies owned by the bank holding company, including the companies listed below.

The applications listed below, as well as other related filings required by the Board, are available for immediate inspection at the Federal Reserve Bank indicated. The applications also will be available for inspection at the offices of the Board of Governors. Interested persons may express their views in writing on the standards enumerated in the BHC Act (12 U.S.C. 1842(c)). If the proposal also involves the acquisition of a nonbanking company, the review also includes whether the acquisition of the nonbanking company complies with the standards in section 4 of the BHC Act (12 U.S.C. 1843). Unless otherwise noted, nonbanking activities will be conducted throughout the United States. Additional information on all bank holding companies may be obtained from the National Information Center website at *www.ffiec.gov/nic/.*

Unless otherwise noted, comments regarding each of these applications must be received at the Reserve Bank indicated or the offices of the Board of Governors not later than July 22, 2010.

A. Federal Reserve Bank of Atlanta (Clifford Stanford, Vice President) 1000 Peachtree Street, N.E., Atlanta, Georgia 30309:

1. *USAmeriBancorp, Inc.*, Largo, Florida; to acquire at least 50 percent of the voting shares of Aliant Financial Corporation, and thereby indirectly acquire voting shares of Aliant Bank, both of Alexander City, Alabama.

B. Federal Reserve Bank of Minneapolis (Jacqueline G. King, Community Affairs Officer) 90 Hennepin Avenue, Minneapolis, Minnesota 55480–0291:

1. *First Holding Company of Park River, Inc.*, Park River, North Dakota; to establish a wholly owned subsidiary, Sheyenne Bancorp, Inc., Park River, North Dakota, and thereby acquire 100 percent of the voting shares of First Sharon Holding Company, Inc., Aneta, North Dakota, and indirectly acquire voting shares of First State Bank of Sharon, Sharon, North Dakota. In connection with this application, Sheyenne Bancorp, Inc., has also applied to become a bank holding company.

Board of Governors of the Federal Reserve System, June 22, 2010.

Robert deV. Frierson,

Deputy Secretary of the Board.

[FR Doc. 2010–15474 Filed 6–24–10; 8:45 am]

BILLING CODE 6210–01–S

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket ID OCC–2010–0013]

FEDERAL RESERVE SYSTEM

[Docket No. OP–1374]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[Docket ID OTS–2010–0020]

Guidance on Sound Incentive Compensation Policies

AGENCY: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System, (Board or Federal Reserve);

Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS).

ACTION: Final guidance.

SUMMARY: The OCC, Board, FDIC and OTS (collectively, the Agencies) are adopting final guidance designed to help ensure that incentive compensation policies at banking organizations do not encourage imprudent risk-taking and are consistent with the safety and soundness of the organization.

DATES: *Effective Date:* The guidance is effective on June 25, 2010.

FOR FURTHER INFORMATION CONTACT:

OCC: Karen M. Kwilosz, Director, Operational Risk Policy, (202) 874–9457, or Reggy Robinson, Policy Analyst, Operational Risk Policy, (202) 874–4438.

Board: William F. Treacy, Adviser, (202) 452–3859, Division of Banking Supervision and Regulation; Mark S. Carey, Adviser, (202) 452–2784, Division of International Finance; Kieran J. Fallon, Associate General Counsel, (202) 452–5270 or Michael W. Waldron, Counsel, (202) 452–2798, Legal Division. For users of Telecommunications Device for the Deaf ("TDD") only, contact (202) 263–4869.

FDIC: Mindy West, Chief, Policy and Program Development, Division of Supervision and Consumer Protection, (202) 898–7221, or Robert W. Walsh, Review Examiner, Policy and Program Development, Division of Supervision and Consumer Protection, (202) 898–6649.

OTS: Rich Gaffin, Financial Analyst, Risk Modeling and Analysis, (202) 906–6181, or Richard Bennett, Senior Compliance Counsel, Regulations and Legislation Division, (202) 906–7409; Donna Deale, Director, Holding Company and International Policy, (202) 906–7488, Grovetta Gardineer, Managing Director, Corporate and International Activities, (202) 906–6068; Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

Compensation arrangements are critical tools in the successful management of financial institutions. These arrangements serve several important and worthy objectives, including attracting skilled staff, promoting better organization-wide and employee performance, promoting employee retention, providing retirement security to employees, and allowing an organization's personnel costs to vary along with revenues.

It is clear, however, that compensation arrangements can provide executives and employees with incentives to take imprudent risks that are not consistent with the long-term health of the organization. For example, offering large payments to managers or employees to produce sizable increases in short-term revenue or profit—without regard for the potentially substantial short or long-term risks associated with that revenue or profit—can encourage managers or employees to take risks that are beyond the capability of the financial institution to manage and control.

Flawed incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the organization.

Having witnessed the damaging consequences that can result from misaligned incentives, many financial institutions are now re-examining their compensation structures with the goal of better aligning the interests of managers and other employees with the long-term health of the institution. Aligning the interests of shareholders and employees, however, is not always sufficient to protect the safety and soundness of a banking organization. Because banking organizations benefit directly or indirectly from the protections offered by the Federal safety net (including the ability of insured depository institutions to raise insured deposits and access the Federal Reserve's discount window and payment services), shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Thus, a review of incentive compensation arrangements and related corporate governance practices to ensure that they are effective from the standpoint of shareholders is not sufficient to ensure they adequately protect the safety and soundness of the organization.

A. Proposed Guidance

In October 2009, the Federal Reserve issued and requested comment on Proposed Guidance on Sound Incentive Compensation Policies ("proposed guidance") to help protect the safety and soundness of banking organizations supervised by the Federal Reserve and to promote the prompt improvement of incentive compensation practices throughout the banking industry.[1] The proposed guidance was based on three key principles. These principles provided that incentive compensation arrangements at a banking organization should—

- Provide employees incentives that appropriately balance risk and reward;
- Be compatible with effective controls and risk-management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

Because incentive compensation arrangements for executive and non-executive employees may pose safety and soundness risks if not properly structured, the proposed guidance applied to senior executives as well as other employees who, either individually or as part of a group, have the ability to expose the relevant banking organization to material amounts of risk.

With respect to the first principle, the proposed guidance, among other things, provided that a banking organization should ensure that its incentive compensation arrangements do not encourage short-term profits at the expense of short- and longer-term risks to the organization. Rather, the proposed guidance indicated that banking organizations should adjust the incentive compensation provided so that employees bear some of the risk associated with their activities. To be fully effective, these adjustments should take account of the full range of risks that the employees' activities may pose for the organization. The proposed guidance highlighted several methods that banking organizations could use to adjust incentive compensation awards or payments to take account of risk.

With respect to the second principle, the proposed guidance provided that banking organizations should integrate their approaches to incentive compensation arrangements with their risk-management and internal control frameworks to better monitor and control the risks these arrangements may create for the organization. Accordingly, the proposed guidance provided that banking organizations should ensure that risk-management personnel have an appropriate role in designing incentive compensation arrangements and assessing whether the arrangements may encourage imprudent risk-taking. In addition, the proposed guidance provided that banking organizations should track incentive compensation awards and payments, risks taken, and actual risk outcomes to

[1] 74 FR 55227 (October 27, 2009).

determine whether incentive compensation payments to employees are reduced or adjusted to reflect adverse risk outcomes.

With respect to the third principle, the proposed guidance provided that a banking organization's board of directors should play an informed and active role in ensuring that the organization's compensation arrangements strike the proper balance between risk and profit not only at the initiation of a compensation program, but on an ongoing basis. Thus, the proposed guidance provided that boards of directors should review and approve key elements of their organizations' incentive compensation systems across the organization, receive and review periodic evaluations of whether their organizations' compensation systems for all major segments of the organization are achieving their risk-mitigation objectives, and directly approve the incentive compensation arrangements for senior executives.

The Board's proposed guidance applied to all banking organizations supervised by the Federal Reserve. However, the proposed guidance also included provisions intended to reflect the diversity among banking organizations, both with respect to the scope and complexity of their activities, as well as the prevalence and scope of incentive compensation arrangements. Thus, for example, the proposed guidance provided that the reviews, policies, procedures, and systems implemented by a smaller banking organization that uses incentive compensation arrangements on a limited basis would be substantially less extensive, formalized, and detailed than those at a large, complex banking organization (LCBO)[2] that uses incentive compensation arrangements extensively. In addition, because sound incentive compensation practices are important to protect the safety and soundness of all banking organizations, the Federal Reserve announced that it would work with the other Federal banking agencies to promote application of the guidance to all banking organizations.

The Board invited comment on all aspects of the proposed guidance. The Board also specifically requested comments on a number of issues, including whether:

- The three core principles are appropriate and sufficient to help ensure that incentive compensation arrangements do not threaten the safety and soundness of banking organizations;
- There are any material legal, regulatory, or other impediments to the prompt implementation of incentive compensation arrangements and related processes that would be consistent with those principles;
- Formulaic limits on incentive compensation would likely promote the safety and soundness of banking organizations, whether applied generally or to specific types of employees or banking organizations;
- Market forces or practices in the broader financial services industry, such as the use of "golden parachute" or "golden handshake" arrangements to retain or attract employees, present challenges for banking organizations in developing and maintaining balanced incentive compensation arrangements;
- The proposed guidance would impose undue burdens on, or have unintended consequences for, banking organizations, particularly smaller, less complex organizations, and whether there are ways such potential burdens or consequences could be addressed in a manner consistent with safety and soundness; and
- There are types of incentive compensation plans, such as organization-wide profit sharing plans that provide for distributions in a manner that is not materially linked to the performance of specific employees or groups of employees, that could and should be exempted from, or treated differently under, the guidance because they are unlikely to affect the risk-taking incentives of all, or a significant number of employees.

B. Supervisory Initiatives

In connection with the issuance of the proposed guidance, the Federal Reserve announced two supervisory initiatives:

- A special horizontal review of incentive compensation practices at LCBO's; and
- A review of incentive compensation practices at other banking organizations as part of the regular, risk-focused examination process for these organizations.

The horizontal review was designed to assess: The potential for these arrangements or practices to encourage imprudent risk-taking; the actions an organization has taken or proposes to take to correct deficiencies in its incentive compensation practices; and the adequacy of the organization's compensation-related risk-management, control, and corporate governance processes.

II. Overview of Comments

The Board received 34 written comments on the proposed guidance, which were shared and reviewed by all of the Agencies. Commenters included banking organizations, financial services trade associations, service providers to financial organizations, representatives of institutional shareholders, labor organizations, and individuals. Most commenters supported the goal of the proposed guidance—to ensure that incentive compensation arrangements do not encourage imprudent or undue risk-taking at banking organizations. Commenters also generally supported the principles-based approach of the proposed guidance. For example, many commenters specifically supported the avoidance of formulaic or one-size-fits-all approaches to incentive compensation in the proposed guidance. These commenters noted financial organizations are very diverse and should be permitted to adopt incentive compensation measures that fit their needs, while also being consistent with safe and sound operations. Several commenters also asserted that a formulaic approach would inevitably lead to exaggerated risk-taking incentives in some situations while discouraging employees from taking reasonable and appropriate risks in others. One commenter also argued that unintended consequences would be more likely to result from a "rigid rulemaking" than from a flexible, principles-based approach.

Many commenters requested that the Board revise or clarify the proposed guidance in one or more respects. For example, several commenters asserted that the guidance should impose specific restrictions on incentive compensation at banking organizations or mandate certain corporate governance or risk-management practices. One commenter recommended a requirement that most compensation for senior executives be provided in the form of variable, performance-vested equity awards that are deferred for at least five years, and that stock option compensation be prohibited. Another commenter advocated a ban on "golden parachute" payments and on bonuses based on metrics related to one year or less of performance. Other commenters suggested that the guidance should require banking organizations to have an independent chairman of the board of directors, require annual majority voting for all directors, or provide for shareholders to have a vote (so called

[2] In the proposed guidance (issued by the Federal Reserve), the term LCBO was used as this is the term utilized by the Federal Reserve in describing such organizations. The final guidance uses the term Large Banking Organization (LBO), which encompasses terminology utilized by the OCC, FDIC and OTS.

"say-on-pay" voting provisions) on the incentive compensation arrangements for certain employees of banking organizations. Other commenters requested that certain types of compensation plans, such as organization-wide profit sharing plans or 401(k) plans or plans covered by the Employee Retirement Income Security Act (29 U.S.C. 1400 *et seq.*), be exempted from the scope of the guidance because they were unlikely to provide employees incentives to expose their banking organization to undue risk.

Several commenters, however, did not support the proposed guidance. Some of these commenters felt that the proposed guidance was unnecessary and that the principles used in the proposed guidance were not needed. These commenters argued that the existing system of financial regulation and enforcement is sufficient to address the concerns raised in the proposed guidance. Several commenters also thought that the proposed guidance was too vague to be helpful, and that the ambiguity of the proposed guidance would make compliance more difficult, leading to increased costs and regulatory uncertainty. Some commenters also argued that the guidance was not warranted because there is insufficient evidence that incentive compensation practices contributed to safety and soundness or financial stability problems, or questioned the authority of the Federal Reserve or the other Federal banking agencies to act in this area.

In addition, a number of commenters expressed concern that the proposed guidance would impose undue burden on banking organizations, particularly smaller, less complex organizations. These commenters believed that incentive compensation practices at smaller banking organizations were generally not problematic from a safety and soundness perspective.[3] A number of commenters suggested that all or most smaller banking organizations should be exempt from the guidance. A number of commenters expressed concerns that the proposed guidance would impose unreasonable demands on the boards of directors of banking organizations and especially smaller organizations.

Several commenters also expressed concern that the proposed guidance, if implemented, could impede the ability of banking organizations to attract or retain qualified staff and compete with other financial services providers. In light of these concerns, some commenters suggested that the guidance expressly allow banking organizations to enter into such compensation arrangements as they deem necessary for recruitment or retention purposes. A number of commenters also encouraged the Federal Reserve to work with other domestic and foreign supervisors and authorities to promote consistent standards for incentive compensation practices at financial institutions and a level competitive playing field for financial service providers.

The comments received on the proposed guidance are further discussed below.

III. Final Guidance

After carefully reviewing the comments on the proposed guidance, the Agencies have adopted final guidance that retains the same key principles embodied in the proposed guidance, with a number of adjustments and clarifications that address matters raised by the commenters. These principles are: (1) Incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk; (2) these arrangements should be compatible with effective controls and risk-management; and (3) these arrangements should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. The Agencies believe that it is important that incentive compensation arrangements at banking organizations do not provide incentives for employees to take risks that could jeopardize the safety and soundness of the organization. The final guidance seeks to address the safety and soundness risks of incentive compensation practices by focusing on the basic problem they can pose from a risk-management perspective, that is, incentive compensation arrangements—if improperly structured—can give employees incentives to take imprudent risks.

The Agencies believe the principles of the final guidance should help protect the safety and soundness of banking organizations and the stability of the financial system, and that adoption of the guidance is fully consistent with the Agencies' statutory mandate to protect the safety and soundness of banking organizations.[4]

The final guidance applies to all the banking organizations supervised by the Agencies, including national banks, State member banks, State nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, the U.S. operations of foreign banks with a branch, agency or commercial lending company in the United States, and Edge and agreement corporations (collectively, "banking organizations").

A number of changes have been made to the proposed guidance in response to comments. For example, the final guidance includes several provisions designed to reduce burden on smaller banking organizations and other banking organizations that are not significant users of incentive compensation. The Agencies also have made a number of changes to clarify the scope, intent, and terminology of the final guidance.

A. Scope of Guidance

Compensation practices were not the sole cause of the financial crisis, but they certainly were a contributing cause—a fact recognized by 98 percent of the respondents to a survey of banking organizations engaged in wholesale banking activities conducted in 2009 by the Institute of International Finance and publicly by a number of individual financial institutions.[5] Moreover, the problems caused by improper compensation practices were not limited to U.S. financial institutions, but were evident at major financial institutions worldwide, a fact recognized by international bodies such

[3] On the other hand, one commenter requested that the proposed guidance not be enforced differently at larger institutions solely because of their size.

[4] *See, e.g.* 12 U.S.C. 1818(b). The Agencies regularly issue supervisory guidance based on the authority in section 8 of the Federal Deposit Insurance (FDI) Act. Guidance is used to identify practices that the Agencies believe would constitute an unsafe or unsound practice and/or identify risk-management systems, controls, or other practices that the Agencies believe would assist banking organizations in ensuring that they operate in a safe and sound manner. Savings associations should also refer to OTS's rule on employment contracts 12 CFR 563.39.

[5] *See*, Institute of International Finance, Inc. (2009), *Compensation in Financial Services: Industry Progress and the Agenda for Change* (Washington: IIF, March) available at *http://www.oliverwyman.com/ow/pdf_files/OW_En_FS_Publ_2009_CompensationInFS.pdf*. *See also* UBS, Shareholder Report on UBS's Write-Downs, April 18, 2008, pp. 41–42 (identifies incentive effects of UBS compensation practices as contributing factors in losses suffered by UBS due to exposure to the subprime mortgage market) available at *http://www.ubs.com/1/ShowMedia/investors/agm?contentId=140333&name=080418ShareholderReport.pdf*.

as the Financial Stability Board (FSB) and the Senior Supervisors Group.[6]

Because compensation arrangements for executive and non-executive employees alike may pose safety and soundness risks if not properly structured, these principles and the final guidance apply to senior executives as well as other employees who, either individually or as part of a group, have the ability to expose the banking organization to material amounts of risk.[7] These employees are referred to as "covered employees" in the final guidance. In response to comments, the final guidance clarifies that an employee or group of employees has the ability to expose a banking organization to material amounts of risk if the employees' activities are material to the organization or are material to a business line or operating unit that is itself material to the organization.

Some commenters suggested that certain categories of employees, such as tellers, bookkeepers, administrative assistants, or employees who process but do not originate transactions, do not expose banking organizations to significant levels of risk and therefore should be exempted from coverage under the final guidance. The final guidance, like the proposed guidance, indicates that the facts and circumstances will determine which jobs or categories of employees have the ability to expose the organization to material risks and which jobs or categories of employees may be outside the scope of the guidance. The final guidance recognizes, for example, that tellers, bookkeepers, couriers, and data processing personnel would likely not expose organizations to significant risks of the types meant to be addressed by the guidance. On the other hand, employees or groups of employees who do not originate business or approve transactions could still expose a banking organization to material risk in some circumstances. Therefore, the Agencies do not believe it would be appropriate to provide a blanket exemption from the final guidance for any category of covered employees that would apply to all banking organizations.

After reviewing the comments, the Agencies have retained the principles-based framework of the proposed guidance. The Agencies believe this approach is the most effective way to address incentive compensation practices, given the differences in the size and complexity of banking organizations covered by the guidance and the complexity, diversity, and range of use of incentive compensation arrangements by those organizations. For example, activities and risks may vary significantly across banking organizations and across employees within a particular banking organization. For this reason, the methods used to achieve appropriately risk-sensitive compensation arrangements likely will differ across and within organizations, and use of a single, formulaic approach likely will provide at least some employees with incentives to take imprudent risks.

The Agencies, however, have not modified the guidance, as some commenters requested, to provide that a banking organization may enter into incentive compensation arrangements that are inconsistent with the principles of safety and soundness whenever the organization believes that such action is needed to retain or attract employees. The Agencies recognize that while incentive compensation serves a number of important goals for banking organizations, including attracting and retaining skilled staff, these goals do not override the requirement for banking organizations to have incentive compensation systems that are consistent with safe and sound operations and that do not encourage imprudent risk-taking. The final guidance provides banking organizations with considerable flexibility in structuring their incentive compensation arrangements in ways that both promote safety and soundness and that help achieve the arrangements' other objectives.

The Agencies are mindful, however, that banking organizations operate in both domestic and international competitive environments that include financial services providers that are not subject to prudential oversight by the Agencies and, thus, not subject to the final guidance. The Agencies also recognize that international coordination in this area is important both to promote competitive balance and to ensure that internationally active banking organizations are subject to consistent requirements. For this reason, the Agencies will continue to work with their domestic and international counterparts to foster sound compensation practices across the financial services industry. Importantly, the final guidance is consistent with both the Principles for Sound Compensation Practices and the related Implementation Standards adopted by the FSB in 2009.[8] A number of commenters expressed concern about the levels of compensation paid to some employees of banking organizations. As noted above, several commenters requested that the Board eliminate or limit certain types of incentive compensation for employees of banking organizations. Other commenters advocated that certain forms of compensation be required. For example, some commenters urged a ban on incentive compensation payments made in stock options, while others supported their mandatory use. Comments also were received with regard to the use of other types of stock-based compensation, such as restricted stock and stock appreciation rights. Consistent with its principles-based approach, the final guidance does not mandate or prohibit the use of any specific forms of payment for incentive compensation or establish mandatory compensation levels or caps. Rather, the forms and levels of incentive compensation payments at banking organizations are expected to reflect the principles of the final guidance in a manner tailored to the business, risk profile, and other attributes of the banking organization. Incentive compensation structures that offer employees rewards for increasing short-term profit or revenue, without taking into account risk, may encourage imprudent risk-taking even if they meet formulaic levels or include or exclude certain forms of compensation. On the other hand, incentive compensation arrangements of various forms and levels may be properly structured so as not to encourage imprudent risk-taking.

In response to comments, the final guidance clarifies in a number of respects the expectation of the Agencies that the impact of the final guidance on

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[6] *See*, Financial Stability Forum (2009), *FSF Principles for Sound Compensation Practices (87 KB PDF)* (Basel, Switzerland: FSF, April), available at *http://www.financialstabilityboard.org/publications/r_0904b.pdf;* and Senior Supervisors Group (2009), *Risk-management Lessons from the Global Banking Crisis of 2008* (Basel, Switzerland: SSG, October), available at *http://www.newyorkfed.org/newsevents/news/banking/2009/ma091021.html*. The Financial Stability Forum was renamed the Financial Stability Board in April 2009.

[7] In response to a number of comments requesting clarification regarding the scope of the term "senior executives" as used in the guidance, the final guidance states that "senior executive" includes, at a minimum, "executive officers" within the meaning of the Board's Regulation O (12 CFR 215.2(e)(1)) and, for publicly traded companies, "named officers" within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation (17 CFR 229.402(a)(3)). Savings associations should also refer to OTS's rule on loans by savings associations to their executive officers, directors, and principal shareholders. 12 CFR 563.43.

[8] *See*, Financial Stability Forum, FSF Principles for Sound Compensation Practices, in note 6; and Financial Stability Board (2009), FSB Principles for Sound Compensation Practices: Implementation Standards (35 KB PDF) (Basel, Switzerland: FSB, September), available at *http://www.financialstabilityboard.org/publications/r_090925c.pdf*.

banking organizations will vary depending on the size and complexity of the organization and its level of usage of incentive compensation arrangements. It is expected that the guidance will generally have less impact on smaller banking organizations, which typically are less complex and make less use of incentive compensation arrangements than larger banking organizations. Because of the size and complexity of their operations, large banking organizations (LBOs)[9] should have and adhere to systematic and formalized policies, procedures and processes. These are considered important in ensuring that incentive compensation arrangements for all covered employees are identified and reviewed by appropriate levels of management (including the board of directors where appropriate and control units), and that they appropriately balance risks and rewards . The final guidance highlights the types of policies, procedures, and systems that LBOs should have and maintain, but that are not expected of other banking organizations. It is expected that, particularly in the case of LBO's, adoption of this principles-based approach will require an iterative supervisory process to ensure that the embedded flexibility that allows for customized arrangements for each banking organization does not undermine effective implementation of the guidance.

With respect to U.S. operations of foreign banks, incentive compensation policies, including management, review, and approval requirements for a foreign bank's U.S. operations should be coordinated with the foreign banking organization's group-wide policies developed in accordance with the rules of the foreign banking organization's home country supervisor. These policies and practices should be consistent with the foreign bank's overall corporate and management structure and its framework for risk-management and internal controls, as well as with the final guidance.

B. Balanced Incentive Compensation Arrangements

The first principle of the final guidance is that incentive compensation arrangements should provide employees incentives that appropriately balance risks and rewards in a manner that does not encourage imprudent risk-taking. The amounts of incentive pay flowing to covered employees should take account of and adjust for the risks and losses—as well as gains—associated with employees' activities, so that employees do not have incentives to take imprudent risk. The formulation of this principle is slightly different from that used in the proposed guidance, which stated that organizations should provide employees incentives that do not encourage imprudent risk-taking beyond the organization's ability to effectively identify and manage risk. This change was made to clarify that risk-management procedures and control functions that ordinarily limit risk-taking do not obviate the need to identify covered employees and to develop incentive compensation arrangements that properly balance risk-taking incentives. To be fully effective, balancing adjustments to incentive compensation arrangements should take account of the full range of risks that employees' activities may pose for the organization, including credit, market, liquidity, operational, legal, compliance, and reputational risks.

A number of commenters expressed the view that increased controls could mitigate a lack of balance in incentive compensation arrangements. Under this view, unbalanced incentive compensation arrangements could be addressed either through the modification of the incentive compensation arrangements or through the application of additional or more effective risk controls to the business. The final guidance recognizes that strong and effective risk-management and internal control functions are critical to the safety and soundness of banking organizations. However, the Agencies believe that poorly designed or managed incentive compensation arrangements can themselves be a source of risk to banking organizations and undermine the controls in place. Unbalanced incentive compensation arrangements can place substantial strain on the risk-management and internal control functions of even well-managed organizations. Furthermore, poorly balanced incentive compensation arrangements can encourage employees to take affirmative actions to weaken the organization's risk-management or internal control functions.

The final guidance, like the proposed guidance, outlines four methods that are currently in use to make compensation more sensitive to risk. These are risk adjustment of awards; deferral of payment; longer performance periods; and reduced sensitivity to short-term performance. Each method has advantages and disadvantages. For example, incentive compensation arrangements for senior executives at LBOs are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period, with payment made in the form of stock or other equity-based instruments and with the number of instruments ultimately received dependent on the performance of the organization (or, ideally, the performance of the executive) during the deferral period. Deferral, however, may not be effective in constraining the incentives of employees who may have the ability to expose the organization to long-term risks, as these risks may not be realized during a reasonable deferral period. For this reason, the final guidance recognizes that in some cases, two or more methods may be needed in combination (*e.g.*, risk adjustment of awards and deferral of payment) to achieve an incentive compensation arrangement that properly balances risk and reward.

Furthermore, the few methods noted in the final guidance are not exclusive, and other effective methods or variations may exist or be developed. Methods for achieving balanced compensation arrangements at one organization may not be effective at another organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization. The guidance clarifies that LBOs should actively monitor industry, academic, and regulatory developments in incentive compensation practices and theory and be prepared to incorporate into their incentive compensation systems new or emerging methods that are likely to improve the organization's long-term financial well-being and safety and soundness.

In response to a question asked in the proposed guidance, several commenters requested that certain types of compensation plans be treated as beyond the scope of the final guidance because commenters believed these plans do not threaten the safety and soundness of banking organizations. These included organization-wide profit sharing plans, 401(k) plans, defined benefit plans, and ERISA plans.

[9] For purposes of the final guidance, LBOs include, in the case of banking organizations supervised by (i) the Federal Reserve, large, complex banking organizations as identified by the Federal Reserve for supervisory purposes; (ii) the OCC, the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (iii) the FDIC, large complex insured depository institutions (IDIs); and (iv) the OTS, the largest and most complex savings associations and savings and loan holding companies. The term "smaller banking organizations" is used to refer to banking organizations that are not LBOs under the relevant agency's standard.

The final guidance does not exempt any broad categories of compensation plans based on their tax structure, corporate form, or status as a retirement or other employee benefit plans, because any type of incentive compensation plan may be implemented in a way that increases risk inappropriately. In response to these comments, however, the final guidance recognizes that the term "incentive compensation" does not include arrangements that are based solely on the employees' level of compensation and that do not vary based on one or more performance metrics (*e.g.*, a 401(k) plan under which the organization contributes a set percentage of an employee's salary). In addition, the final guidance notes that incentive compensation plans that provide for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall performance, with unbalanced risk-taking incentives.

In many cases, there were comments on both sides of an issue, with some wanting less or no guidance and others wanting tough, or very specific prohibitions. For example, a number of commenters argued that the use of "golden parachutes" and similar retention and recruitment provisions to retain employees should be prohibited because such provisions have been abused in the past.[10] A larger number of commenters, however, argued against a per se ban on such arrangements, stating that these provisions were in some cases essential elements of effective recruiting and retention packages and are not necessarily a threat to safety and soundness. One commenter stated that golden parachute payments triggered by changes in control of a banking organization are too speculative to encourage imprudent risk-taking by employees.

The final guidance, like the proposed guidance, provides that banking organizations should carefully consider the potential for golden parachutes and similar arrangements to affect the risk-taking behavior of employees. The final guidance adds language noting that arrangements that provide an employee with a guaranteed payout upon departure from an organization regardless of performance may neutralize the effect of any balancing features included in the arrangement to help prevent imprudent risk-taking. Organizations should consider including balancing features—such as risk adjustments or deferral requirements—in golden parachutes and similar arrangements to mitigate the potential for the arrangements to encourage imprudent risk-taking.

Provisions that require a departing employee to forfeit deferred incentive compensation payments may also weaken the effectiveness of a deferral arrangement if the departing employee is able to negotiate a "golden handshake" arrangement with the employee's new organization.[11] Golden handshake provisions present special issues for banking organizations and supervisors, some of which are discussed in the final guidance, because it is the action of the employee's new employer—which may not be a regulated institution—that can affect the current employer's ability to properly align the employee's interest with the organization's long-term health. The final guidance states that LBOs should monitor whether golden handshake arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees. The Agencies will continue to work with banking organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

C. Compatibility With Effective Controls and Risk-Management

The second principle of the final guidance states that a banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements. Banking organizations should integrate incentive compensation arrangements into their risk-management and internal control frameworks to ensure that balance is achieved. In particular, banking organizations should have appropriate controls to ensure that processes for achieving balance are followed. Appropriate personnel, including risk-management personnel, should have input in the design and assessment of incentive compensation arrangements. Compensation for risk-management and control personnel should be sufficient to attract and retain appropriately qualified personnel and such compensation should not be based substantially on the financial performance of the business unit that they review. Rather, their performance should be based primarily on the achievement of the objectives of their functions (*e.g.*, adherence to internal controls).

Banking organizations should monitor incentive compensation awards, risks taken and actual risk outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes. Incentive compensation arrangements that are found not to appropriately reflect risk should be modified as necessary. Organizations should not only provide rewards when performance standards are met or exceeded, they should also reduce compensation when standards are not met. If senior executives or other employees are paid substantially all of their potential incentive compensation when risk outcomes are materially worse than expected, employees may be encouraged to take large risks in the hope of substantially increasing their personal compensation, knowing that their downside risks are limited. Simply put, incentive compensation arrangements should not create a "heads I win, tails the firm loses" expectation.

A significant number of comments expressed concerns about the scope of the applicability of the proposed guidance to smaller banking organizations as well as the burden the proposed guidance would impose on these organizations. In response to these comments, the final guidance has made more explicit the Agencies' view that the monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation. Thus, for example, a smaller organization that uses incentive compensation only to a limited extent may find that it can appropriately monitor its arrangements through normal management processes. The final guidance also discusses specific aspects of policies and procedures related to controls and risk-management that are applicable to LBOs and are not expected of other banking organizations.

D. Strong Corporate Governance

The third principle of the final guidance is that incentive compensation programs at banking organizations should be supported by strong corporate governance, including active and effective oversight by the organization's

[10] Arrangements that provide for an employee (typically a senior executive), upon departure from an organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes are sometimes called "golden parachutes."

[11] Golden handshakes are arrangements that compensate an employee for some or all of the estimated, non-adjusted value of deferred incentive compensation that would have been forfeited upon departure from the employee's previous employment.

board of directors.[12] The board of directors of an organization is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all covered employees—not solely senior executives—are appropriately balanced and do not jeopardize the safety and soundness of the organization. Boards of directors should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. These reviews and reports should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the prevalence and scope of its incentive compensation arrangements. The structure, composition, and resources of the board of directors should be constructed to permit effective oversight of incentive compensation. The board of directors should, for example, have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services sector that is appropriate for the nature, scope, and complexity of the organization's activities.[13]

Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors should directly approve compensation arrangements involving senior executives and closely monitor such payments and their sensitivity to risk outcomes. If the compensation arrangements for a senior executive include a deferral of payment or "clawback" provision, then the review should include sufficient information to determine if the provision has been triggered and executed as planned. The board also should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and should carefully consider and monitor the effects of any approved exceptions or adjustments to the arrangements.

In response to comments expressing concern about the impact of the proposed guidance on smaller banking organizations, the final guidance identifies specific aspects of the corporate governance provisions of the final guidance that are applicable to LBOs or other organizations that use incentive compensation to a significant degree, and are not expected of other banking organizations. In particular, boards of directors of LBOs and other organizations that use incentive compensation to a significant degree should actively oversee the development and operation of the organization's incentive compensation policies, systems and related control processes. If such an organization does not already have a compensation committee, reporting to the full board, with primary responsibility for incentive compensation arrangements, the board should consider establishing one. LBOs, in particular, should follow a systematic approach, outlined in the final guidance, in developing compensation systems that have balanced incentive compensation arrangements.

Several commenters expressed concern that the proposed guidance appeared to create a new substantive qualification for boards of directors that requires the boards of all banking organizations to have members with expertise in compensation and risk-management issues. A group of commenters noted that such a requirement could limit an already small pool of people suitable to serve on boards of directors of banking organizations and that smaller organizations may not have access to, or the resources to compensate, directors meeting these additional requirements. Some commenters also stated that terms such as "closely monitor" and "actively oversee" could be read to impose a higher standard on directors for their oversight of incentive compensation issues. On the other hand, one commenter noted that current law requires financial expertise on the boards of directors and audit committees of public companies and recommended that specialized risk-management competencies be required on the boards of all banking organizations.

To address concerns raised by these commenters, the final guidance clarifies that risk-management and compensation expertise and experience at the board level may be present collectively among the members of the board, and may come from formal training or from experience in addressing risk-management and compensation issues, including as a director, or may be obtained from advice received from outside counsel, consultants, or other experts with expertise in incentive compensation and risk-management. Furthermore, the final guidance recognizes that smaller organizations with less complex and extensive incentive compensation arrangements may not find it necessary or appropriate to require specially tailored board expertise or to retain and use outside experts in this area.

A banking organization's disclosure practices should support safe and sound incentive compensation arrangements. Specifically, a banking organization should supply an appropriate amount of information concerning its incentive compensation arrangements and related risk-management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements to encourage employees to take imprudent risks.

While some commenters supported increased public disclosure of the incentive compensation practices of banking organizations, a greater number expressed concerns that any required disclosures of incentive compensation information by banking organizations be tailored to protect the privacy of employees and take account of the impact of such disclosures on the ability of organizations to attract and retain talent. Several commenters supported an alignment of required disclosures with existing requirements for public companies, arguing that additional requirements would add to the regulatory burden on banking organizations.

The proposed guidance did not impose specific disclosure requirements on banking organizations. The final guidance makes no significant changes from the proposed guidance with regard to disclosures, and states that the scope and level of information disclosed by a banking organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements. The final guidance notes that banking organizations should comply with the incentive compensation disclosure requirements of the Federal securities law and other laws, as applicable.

A number of commenters supported additional governance requirements for banking organizations, such as "say on pay" provisions requiring shareholder approval of compensation plans, separation of the board chair and chief executive officer positions, majority voting for directors, annual elections for all directors, and improvements to the audit function. Some of these comments seek changes in Federal laws beyond the jurisdiction of the Agencies; others

[12] In the case of foreign banking organizations (FBOs), the term "board of directors" refers to the relevant oversight body for the firm's U.S. operations, consistent with the FBO's overall corporate and management structure.

[13] Savings associations should also refer to OTS's rule on directors, officers, and employees. 12 CFR 563.33.

address issues—such as "say on pay" requirements—that are currently under consideration by the Congress. The final guidance does not preempt or preclude these proposals, and indicates that the Agencies expect organizations to comply with all applicable statutory disclosure, voting and other requirements.

E. Continuing Supervisory Initiatives

The horizontal review of incentive compensation practices at LBOs is well underway. While this initiative is being led by the Federal Reserve, the other Federal banking agencies are participating in the work. Supervisory teams have collected substantial information from LBOs concerning existing incentive compensation practices and related risk-management and corporate governance processes. In addition, LBOs have submitted analyses of shortcomings or "gaps" in existing practices relative to the principles contained in the proposed guidance, as well as plans for addressing identified weaknesses. Some organizations already have implemented changes to make their incentive compensation arrangements more risk sensitive. Indeed, many organizations are recognizing that strong risk-management and control systems are not sufficient to protect the organization from undue risks, including risks arising from unbalanced incentive compensation arrangements. Other organizations have considerably more work to do, such as developing processes that can effectively compare incentive compensation payments to risks and risk outcomes. The Agencies intend to continue to regularly review incentive compensation arrangements and related risk-management, control, and corporate governance practices of LBOs and to work with these organizations through the supervisory process to promptly correct any deficiencies that may be inconsistent with safety and soundness.[14]

The Agencies intend to actively monitor the actions being taken by banking organizations with respect to incentive compensation arrangements and will review and update this guidance as appropriate to incorporate best practices that emerge. In addition, in order to monitor and encourage improvements, Federal Reserve staff will prepare a report, in consultation with the other Federal banking agencies, after the conclusion of 2010 on trends and developments in compensation practices at banking organizations.

IV. Other Matters

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR Part 1320 Appendix A.1), the Agencies have determined that certain aspects of the final guidance constitute a collection of information. The Board made this determination under the authority delegated to the Board by the Office of Management and Budget (OMB).

An agency may not conduct or sponsor, and an organization is not required to respond to, an information collection unless the information collection displays a currently valid OMB control number. Any changes to the Agencies' regulatory reporting forms that may be made in the future to collect information related to incentive compensation arrangements would be addressed in a separate **Federal Register** notice.

The final guidance includes provisions that state large banking organizations (LBOs) should (i) have policies and procedures that identify and describe the role(s) of the personnel and units authorized to be involved in incentive compensation arrangements, identify the source of significant risk-related inputs, establish appropriate controls governing these inputs to help ensure their integrity, and identify the individual(s) and unit(s) whose approval is necessary for the establishment or modification of incentive compensation arrangements; (ii) create and maintain sufficient documentation to permit an audit of the organization's processes for incentive compensation arrangements; (iii) have any material exceptions or adjustments to the incentive compensation arrangements established for senior executives approved and documented by its board of directors; and (iv) have its board of directors receive and review, on an annual or more frequent basis, an assessment by management of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness.

The OCC, FDIC, and OTS have obtained emergency approval under 5 CFR 1320.13 for issuance of the guidance and will issue a **Federal Register** notice shortly for 60 days of comment as part of the regular PRA clearance process. During the regular PRA clearance process the estimated average response time may be re-evaluated.

The Board has approved the collection of information under its delegated authority. As discussed earlier in this notice, on October 27, 2009, the Board published in the **Federal Register** a notice requesting comment on the proposed Guidance on Sound Incentive Compensation Policies (74 FR 55227). The comment period for this notice expired November 27, 2009. The Board received three comments that specifically addressed paperwork burden. The commenters asserted that the hourly estimate of the cost of compliance should be considerably higher than the Board projected.

The final guidance clarifies in a number of respects the expectation that the effect of the final guidance on banking organizations will vary depending on the size and complexity of the organization and its level of use of incentive compensation arrangements. For example, the final guidance makes more explicit the view that the monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation. In addition, the final guidance highlights the types of policies, procedures, systems, and specific aspects of corporate governance that LBOs should have and maintain, but that are not expected of other banking organizations.

In response to comments and taking into account the considerations discussed above, the Board is increasing the burden estimate for implementing or modifying policies and procedures to monitor incentive compensation. For this purpose, consideration of burden is limited to items in the final guidance constituting an information collection within the meaning of the PRA. The Board estimates that 1,502 large respondents would take, on average, 480 hours (two months) to modify policies and procedures to monitor incentive compensation. The Board estimates that 5,058 small respondents would take, on average, 80 hours (two business weeks)

[14] For smaller banking organizations, the Federal Reserve is gathering consistent information through regularly scheduled examinations and the normal supervisory process. The focus of the data gathering is to identify the types of incentive plans in place, the job types covered and the characteristics, prevalence and level of documentation available for those incentive compensation plans. After comparing and analyzing the information collected, supervisory efforts and expectations will be scaled appropriately to the size and complexity of the organization and its incentive compensation arrangements. For these smaller banking organizations, the expectation is that there will be very limited, if any, targeted examination work or supervisory follow-up. To the extent that any of these organizations has incentive compensation arrangements, the policies and systems necessary to monitor these arrangements are expected to be substantially less extensive, formalized and detailed than those of larger, more complex organizations.

to establish or modify policies and procedures to monitor incentive compensation. The total one-time burden is estimated to be 1,125,600 hours. In addition, the Board estimates that, on a continuing basis, respondents would take, on average, 40 hours (one business week) each year to maintain policies and procedures to monitor incentive compensation arrangements and estimates the annual on-going burden to be 262,400 hours. The total annual PRA burden for this information collection is estimated to be 1,388,000 hours.

General Description of Report

This information collection is authorized pursuant to:

Board—Sections 11(a), 11(i), 25, and 25A of the Federal Reserve Act (12 U.S.C. 248(a), 248(i), 602, and 611,), section 5 of the Bank Holding Company Act (12 U.S.C. 1844), and section 7(c) of the International Banking Act (12 U.S.C. 3105(c)).

OCC—12 U.S.C. 161, and Section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p–1).

FDIC—Section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p–1).

OTS—Section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p–1) and Sections 4, 5, and 10 of the Home Owners' Loan Act (12 U.S.C. 1463, 1464, and 1467a).

The Agencies expect to review the policies and procedures for incentive compensation arrangements as part of their supervisory processes. To the extent the Agencies collect information during an examination of a banking organization, confidential treatment may be afforded to the records under exemption 8 of the Freedom of Information Act (FOIA), 5 U.S.C. 552(b)(8).

Board

Title of Information Collection: Recordkeeping Provisions Associated with the Guidance on Sound Incentive Compensation Policies.

Agency form number: FR 4027.

OMB control number: 7100—to be assigned.

Frequency: Annually.

Affected Public: Businesses or other for-profit.

Respondents: U.S. bank holding companies, State member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the United States.

Estimated average hours per response: Implementing or modifying policies and procedures: large respondents 480 hours; small respondents 80 hours. Maintenance of policies and procedures: 40 hours.

Estimated number of respondents: Large respondents, 1,502; Small respondents, 5,058.

Estimated total annual burden: 1,388,000 hours.

As mentioned above, the OCC, FDIC, and OTS have obtained emergency approval under 5 CFR 1320.13. The OCC and OTS approvals were obtained prior to the Board revising its burden estimates based on the comments received. For this reason, the OCC and OTS are publishing in this notice the original burden estimates. They will issue a **Federal Register** notice shortly for 60 days of comment as part of the regular PRA clearance process. During the regular PRA clearance process the estimated average response time may be re-evaluated based on comments received. The FDIC is publishing in this notice the revised burden estimates developed by the Board based on the comments received. The FDIC will issue a **Federal Register** notice shortly for 60 days of comment as part of the regular PRA clearance process and, during the regular PRA clearance process, the estimated average response time may be re-evaluated based on comments received.

OCC

Title of Information Collection: Guidance on Sound Incentive Compensation Policies.

Agency form number: N/A.

OMB control number: 1557–0245.

Frequency: Annually.

Affected Public: Businesses or other for-profit.

Respondents: National banks.

Estimated average hours per response: 40 hours.

Estimated number of respondents: 1,650.

Estimated total annual burden: 66,000 hours.

FDIC

Title of Information Collection: Guidance on Sound Incentive Compensation Policies.

Agency form number: N/A.

OMB control number: 3064–0175.

Frequency: Annually.

Affected Public: Businesses or other for-profit.

Respondents: Insured State nonmember banks.

Estimated average hours per response: Implementing or modifying policies and procedures: large respondents 480 hours; small respondents 80 hours. Maintenance of policies and procedures: 40 hours.

Estimated number of respondents: Implementing or modifying policies and procedures: large respondents—20; small respondents—4,870; Maintenance of policies and procedures: 4,890.

Estimated total annual burden: 594,800 hours.

OTS

Title of Information Collection: Sound Incentive Compensation Guidance.

Agency form number: N/A.

OMB control number: 1550–0129.

Frequency: Annually.

Affected Public: Businesses or other for-profit.

Respondents: Savings associations.

Estimated average hours per response: 40 hours.

Estimated number of respondents: 765.

Estimated total annual burden: 30,600 hours.

The Agencies have a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to:

Board

Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

OCC

Communications Division, Office of the Comptroller of the Currency, Mailstop 2–3, Attention: 1557–0245, 250 E Street, SW., Washington, DC 20219. In addition, comments may be sent by fax to (202) 874–5274 or by electronic mail to *regs.comments@occ.treas.gov*. You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874–4700. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.

FDIC

All comments should refer to the name of the collection, "Guidance on Sound Incentive Compensation Policies." Comments may be submitted by any of the following methods:

- *http://www.FDIC.gov/regulations/laws/federal/propose.html.*
- *E-mail: comments@fdic.gov.*
- *Mail:* Gary Kuiper (202.898.3877), Counsel, Federal Deposit Insurance

Corporation, F–1072, 550 17th Street, NW., Washington, DC 20429.

• *Hand Delivery:* Comments may be hand-delivered to the guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.

OTS

Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552; send a facsimile transmission to (202) 906–6518; or send an e-mail to *infocollection.comments@ots.treas.gov.* OTS will post comments and the related index on the OTS Internet Site at *http://www.ots.treas.gov.* In addition, interested persons may inspect comments at the Public Reading Room, 1700 G Street, NW., Washington DC 20552 by appointment. To make an appointment, call (202) 906–5922, send an e-mail to *public.info@ots.treas.gov,* or send a facsimile transmission to (202) 906–7755.

OMB

Additionally, please send a copy of your comments by mail to: Office of Management and Budget, 725 17th Street, NW., #10235, Paperwork Reduction Project (insert Agency OMB control number), Washington, DC 20503. Comments can also be sent by fax to (202) 395–6974.

While the Regulatory Flexibility Act (5 U.S.C. 603(b)) does not apply to this guidance, because it is not being adopted as a rule, the Agencies have considered the potential impact of the proposed guidance on small banking organizations. For the reasons discussed in the SUPPLEMENTARY INFORMATION above, the Agencies believe that issuance of the proposed guidance is needed to help ensure that incentive compensation arrangements do not pose a threat to the safety and soundness of banking organizations, including small banking organizations. The Board in the proposed guidance sought comment on whether the guidance would impose undue burdens on, or have unintended consequences for, small organizations and whether there were ways such potential burdens or consequences could be addressed in a manner consistent with safety and soundness.

It is estimated that the guidance will apply to 8,763 small banking organizations. *See* 13 CFR 121.201. As noted in the "Supplementary Information" above, a number of commenters expressed concern that the proposed guidance would impose undue burden on smaller organizations. The Agencies have carefully considered the comments received on this issue. In response to these comments, the final guidance includes several provisions designed to reduce burden on smaller banking organizations. For example, the final guidance has made more explicit the Agencies' view that the monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation. The final guidance also highlights the types of policies, procedures, and systems that LBOs should have and maintain, but that are not expected of other banking organizations. Like the proposed guidance, the final guidance focuses on those employees who have the ability, either individually or as part of a group, to expose a banking organization to material amounts of risk and is tailored to account for the differences between large and small banking organizations.

V. Final Guidance

The text of the final guidance is as follows:

Guidance on Sound Incentive Compensation Policies

I. Introduction

Incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in mid-2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the organization.[1] These practices exacerbated the risks and losses at a number of banking organizations and resulted in the misalignment of the interests of employees with the long-term well-being and safety and soundness of their organizations. This document provides guidance on sound incentive compensation practices to banking organizations supervised by the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies").[2] This guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes.[3]

Alignment of incentives provided to employees with the interests of shareholders of the organization often also benefits safety and soundness. However, aligning employee incentives with the interests of shareholders is not always sufficient to address safety-and-soundness concerns. Because of the presence of the Federal safety net, (including the ability of insured depository institutions to raise insured deposits and access the Federal Reserve's discount window and payment services), shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Accordingly, the Agencies expect banking organizations to maintain incentive compensation practices that are consistent with safety and soundness, even when these practices go beyond those needed to align shareholder and employee interests.

To be consistent with safety and soundness, incentive compensation arrangements[4] at a banking organization should:

• Provide employees incentives that appropriately balance risk and reward;
• Be compatible with effective controls and risk-management; and
• Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles, and the types of policies, procedures, and systems that banking organizations should have to help ensure compliance with them, are discussed later in this guidance.

The Agencies expect banking organizations to regularly review their incentive compensation arrangements

[1] Examples of risks that may present a threat to the organization's safety and soundness include credit, market, liquidity, operational, legal, compliance, and reputational risks.

[2] As used in this guidance, the term "banking organization" includes national banks, State member banks, State nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, Edge and agreement corporations, and the U.S. operations of foreign banking organizations (FBOs) with a branch, agency, or commercial lending company in the United States.

[3] This guidance and the principles reflected herein are consistent with the *Principles for Sound Compensation Practices* issued by the Financial Stability Board (FSB) in April 2009, and with the FSB's *Implementation Standards* for those principles, issued in September 2009.

[4] In this guidance, the term "incentive compensation" refers to that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (*e.g.*, a level of sales, revenue, or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (*e.g.*, salary). In addition, the term does not include compensation arrangements that are determined based solely on the employee's level of compensation and does not vary based on one or more performance metrics (*e.g.*, a 401(k) plan under which the organization contributes a set percentage of an employee's salary).

for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk, as well as to regularly review the risk-management, control, and corporate governance processes related to these arrangements. Banking organizations should immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in this guidance and that they do not encourage employees to expose the organization to imprudent risks that may pose a threat to the safety and soundness of the organization.

The Agencies recognize that incentive compensation arrangements often seek to serve several important and worthy objectives. For example, incentive compensation arrangements may be used to help attract skilled staff, induce better organization-wide and employee performance, promote employee retention, provide retirement security to employees, or allow compensation expenses to vary with revenue on an organization-wide basis. Moreover, the analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to the size, complexity, business strategy, and risk tolerance of each organization. The resources required will depend upon the complexity of the firm and its use of incentive compensation arrangements. For some, the task of designing and implementing compensation arrangements that properly offer incentives for executive and non-executive employees to pursue the organization's long-term well-being and that do not encourage imprudent risk-taking is a complex task that will require the commitment of adequate resources.

While issues related to designing and implementing incentive compensation arrangements are complex, the Agencies are committed to ensuring that banking organizations move forward in incorporating the principles described in this guidance into their incentive compensation practices.[5]

As discussed further below, because of the size and complexity of their operations, LBOs[6] should have and adhere to systematic and formalized policies, procedures, and processes. These are considered important in ensuring that incentive compensation arrangements for all covered employees are identified and reviewed by appropriate levels of management (including the board of directors where appropriate and control units), and that they appropriately balance risks and rewards. In several places, this guidance specifically highlights the types of policies, procedures, and systems that LBOs should have and maintain, but that generally are not expected of smaller, less complex organizations. LBOs warrant the most intensive supervisory attention because they are significant users of incentive compensation arrangements and because flawed approaches at these organizations are more likely to have adverse effects on the broader financial system. The Agencies will work with LBOs as necessary through the supervisory process to ensure that they promptly correct any deficiencies that may be inconsistent with the safety and soundness of the organization.

The policies, procedures, and systems of smaller banking organizations that use incentive compensation arrangements[7] are expected to be less extensive, formalized, and detailed than those of LBOs. Supervisory reviews of incentive compensation arrangements at smaller, less-complex banking organizations will be conducted by the Agencies as part of the evaluation of those organizations' risk-management, internal controls, and corporate governance during the regular, risk-focused examination process. These reviews will be tailored to reflect the scope and complexity of an organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Little, if any, additional examination work is expected for smaller banking organizations that do not use, to a significant extent, incentive compensation arrangements.[8]

For all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization and included in the relevant report of examination or inspection. In addition, these findings will be incorporated, as appropriate, into the organization's rating component(s) and subcomponent(s) relating to risk-management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.

An organization's appropriate Federal supervisor may take enforcement action against a banking organization if its incentive compensation arrangements or related risk-management, control, or governance processes pose a risk to the safety and soundness of the organization, particularly when the organization is not taking prompt and effective measures to correct the deficiencies. For example, the appropriate Federal supervisor may take an enforcement action if material deficiencies are found to exist in the organization's incentive compensation arrangements or related risk-management, control, or governance processes, or the organization fails to promptly develop, submit, or adhere to an effective plan designed to ensure that its incentive compensation arrangements do not encourage imprudent risk-taking and are consistent with principles of safety and soundness. As provided under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), an enforcement action may, among other things, require an organization to take affirmative action, such as developing a corrective action plan that is acceptable to the appropriate Federal supervisor to rectify safety-and-soundness deficiencies in its incentive compensation arrangements or related processes. Where warranted, the appropriate Federal supervisor may require the organization to take additional affirmative action to correct or remedy deficiencies related to the

[5] In December 2009 the Federal Reserve, working with the other Agencies, initiated a special horizontal review of incentive compensation arrangements and related risk-management, control, and corporate governance practices of large banking organizations (LBOs). This initiative was designed to spur and monitor the industry's progress towards the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.

[6] For supervisory purposes, the Agencies segment organizations they supervise into different supervisory portfolios based on, among other things, size, complexity, and risk profile. For purposes of the final guidance, LBOs include, in the case of banking organizations supervised by (i) the Federal Reserve, large, complex banking organizations as identified by the Federal Reserve for supervisory purposes; (ii) the OCC, the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (iii) the FDIC, large, complex insured depository institutions (IDIs); and (iv) the OTS, the largest and most complex savings associations and savings and loan holding companies.

[7] This guidance does not apply to banking organizations that do not use incentive compensation.

[8] To facilitate these reviews, where appropriate, a smaller banking organization should review its compensation arrangements to determine whether it uses incentive compensation arrangements to a significant extent in its business operations. A smaller banking organization will not be considered a significant user of incentive compensation arrangements simply because the organization has a firm-wide profit-sharing or bonus plan that is based on the bank's profitability, even if the plan covers all or most of the organization's employees.

organization's incentive compensation practices.

Effective and balanced incentive compensation practices are likely to evolve significantly in the coming years, spurred by the efforts of banking organizations, supervisors, and other stakeholders. The Agencies will review and update this guidance as appropriate to incorporate best practices that emerge from these efforts.

II. Scope of Application

The incentive compensation arrangements and related policies and procedures of banking organizations should be consistent with principles of safety and soundness.[9] Incentive compensation arrangements for executive officers as well as for non-executive personnel who have the ability to expose a banking organization to material amounts of risk may, if not properly structured, pose a threat to the organization's safety and soundness. Accordingly, this guidance applies to incentive compensation arrangements for:

• Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;[10]

• Individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk (*e.g.*, traders with large position limits relative to the organization's overall risk tolerance); and

• Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk (*e.g.*, loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

[9] In the case of the U.S. operations of FBOs, the organization's policies, including management, review, and approval requirements for its U.S. operations, should be coordinated with the FBO's group-wide policies developed in accordance with the rules of the FBO's home country supervisor. The policies of the FBO's U.S. operations should also be consistent with the FBO's overall corporate and management structure, as well as its framework for risk-management and internal controls. In addition, the policies for the U.S. operations of FBOs should be consistent with this guidance.

[10] Senior executives include, at a minimum, "executive officers" within the meaning of the Federal Reserve's Regulation O (*see* 12 CFR 215.2(e)(1)) and, for publicly traded companies, "named officers" within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation (*see* 17 CFR 229.402(a)(3)). Savings associations should also refer to OTS's rule on loans by saving associations to their executive officers, directors, and principal shareholders. (12 CFR 563.43).

For ease of reference, these executive and non-executive employees are collectively referred to hereafter as "covered employees" or "employees." Depending on the facts and circumstances of the individual organization, the types of employees or categories of employees that are outside the scope of this guidance because they do not have the ability to expose the organization to material risks would likely include, for example, tellers, bookkeepers, couriers, or data processing personnel.

In determining whether an employee, or group of employees, may expose a banking organization to material risk, the organization should consider the full range of inherent risks arising from, or generated by, the employee's activities, even if the organization uses risk-management processes or controls to limit the risks such activities ultimately may pose to the organization. Moreover, risks should be considered to be material for purposes of this guidance if they are material to the organization, or are material to a business line or operating unit that is itself material to the organization.[11] For purposes of illustration, assume that a banking organization has a structured-finance unit that is material to the organization. A group of employees within that unit who originate structured-finance transactions that may expose the unit to material risks should be considered "covered employees" for purposes of this guidance even if those transactions must be approved by an independent risk function prior to consummation, or the organization uses other processes or methods to limit the risk that such transactions may present to the organization.

Strong and effective risk-management and internal control functions are critical to the safety and soundness of banking organizations. However, irrespective of the quality of these functions, poorly designed or managed incentive compensation arrangements can themselves be a source of risk to a banking organization. For example, incentive compensation arrangements that provide employees strong incentives to increase the organization's short-term revenues or profits, without regard to the short- or long-term risk associated with such business, can place substantial strain on the risk-management and internal control functions of even well-managed organizations.

[11] Thus, risks may be material to an organization even if they are not large enough to themselves threaten the solvency of the organization.

Moreover, poorly balanced incentive compensation arrangements can encourage employees to take affirmative actions to weaken or circumvent the organization's risk-management or internal control functions, such as by providing inaccurate or incomplete information to these functions, to boost the employee's personal compensation. Accordingly, sound compensation practices are an integral part of strong risk-management and internal control functions. A key goal of this guidance is to encourage banking organizations to incorporate the risks related to incentive compensation into their broader risk-management framework. Risk-management procedures and risk controls that ordinarily limit risk-taking do not obviate the need for incentive compensation arrangements to properly balance risk-taking incentives.

III. Principles of a Sound Incentive Compensation System

Principle 1: Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.

Incentive compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the organization. However, short-run revenue or profit can often diverge sharply from actual long-run profit because risk outcomes may become clear only over time. Activities that carry higher risk typically yield higher short-term revenue, and an employee who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to expose the organization to more risk.

An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks (including compliance risks), as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness. As an example, under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially. The employee whose activities create materially larger risks for the organization should receive less than the other employee, all else being equal.

The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage imprudent risk-taking. For example, if an employee's incentive compensation payments are closely tied to short-term revenue or profit of business generated by the employee, without any adjustments for the risks associated with the business generated, the potential for the arrangement to encourage imprudent risk-taking may be quite strong. Similarly, traders who work with positions that close at year-end could have an incentive to take large risks toward the end of a year if there is no mechanism for factoring how such positions perform over a longer period of time. The same result could ensue if the performance measures themselves lack integrity or can be manipulated inappropriately by the employees receiving incentive compensation.

On the other hand, if an employee's incentive compensation payments are determined based on performance measures that are only distantly linked to the employee's activities (*e.g.*, for most employees, organization-wide profit), the potential for the arrangement to encourage the employee to take imprudent risks on behalf of the organization may be weak. For this reason, plans that provide for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives.

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes. If, for example, employees are paid substantially all of their potential incentive compensation even when risk or risk outcomes are materially worse than expected, employees have less incentive to avoid activities with substantial risk.

• Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.

The activities of employees may create a wide range of risks for a banking organization, such as credit, market, liquidity, operational, legal, compliance, and reputational risks, as well as other risks to the viability or operation of the organization. Some of these risks may be realized in the short term, while others may become apparent only over the long term. For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (*e.g.*, the higher credit or compliance risk associated with subprime loans versus prime loans).[12] In addition, some risks (or combinations of risky strategies and positions) may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized ("bad tail risks"). While shareholders may have less incentive to guard against bad tail risks because of the infrequency of their realization and the existence of the Federal safety net, these risks warrant special attention for safety-and-soundness reasons given the threat they pose to the organization's solvency and the Federal safety net.

Banking organizations should consider the full range of current and potential risks associated with the activities of covered employees, including the cost and amount of capital and liquidity needed to support those risks, in developing balanced incentive compensation arrangements. Reliable quantitative measures of risk and risk outcomes ("quantitative measures"), where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced. However, reliable quantitative measures may not be available for all types of risk or for all activities, and their utility for use in compensation arrangements varies across business lines and employees. The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations should ignore such risks or outcomes for purposes of assessing whether an incentive compensation arrangement achieves balance. For example, while reliable quantitative measures may not exist for many bad-tail risks, it is important that such risks be considered given their potential effect on safety and soundness. As in other risk-management areas, banking organizations should rely on informed judgments, supported by available data, to estimate risks and risk outcomes in the absence of reliable quantitative risk measures.

Large banking organizations. In designing and modifying incentive compensation arrangements, LBOs should assess in advance of implementation whether such arrangements are likely to provide balanced risk-taking incentives. Simulation analysis of incentive compensation arrangements is one way of doing so. Such analysis uses forward-looking projections of incentive compensation awards and payments based on a range of performance levels, risk outcomes, and levels of risks taken. This type of analysis, or other analysis that results in assessments of likely effectiveness, can help an LBO assess whether incentive compensation awards and payments to an employee are likely to be reduced appropriately as the risks to the organization from the employee's activities increase.

• An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.

If an incentive compensation arrangement may encourage employees to expose their banking organization to imprudent risks, the organization should modify the arrangement as needed to ensure that it is consistent with safety and soundness. Four methods are often used to make compensation more sensitive to risk. These methods are:

○ *Risk Adjustment of Awards:* The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities may pose to the organization. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.

○ *Deferral of Payment:* The actual payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that are realized or become better known only during the deferral period.[13] Deferred payouts may be

[12] Importantly, the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure. For example, the ongoing reinvestment of funds by a cash management unit in commercial paper with a one-day maturity not only exposes the organization to one-day credit risk, but also exposes the organization to liquidity risk that may be realized only infrequently.

[13] The deferral-of-payment method is sometimes referred to in the industry as a "clawback." The term "clawback" also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur. Section 304 of the

altered according to risk outcomes either formulaically or judgmentally, subject to appropriate oversight. To be most effective, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.

○ *Longer Performance Periods:* The time period covered by the performance measures used in determining an employee's award is extended (for example, from one year to two or more years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes are realized or better known.

○ *Reduced Sensitivity to Short-Term Performance:* The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives. This method also can include improving the quality and reliability of performance measures in taking into account both short-term and long-term risks, for example improving the reliability and accuracy of estimates of revenues and long-term profits upon which performance measures depend.[14]

These methods for achieving balance are not exclusive, and additional methods or variations may exist or be developed. Moreover, each method has its own advantages and disadvantages. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for imprudent risk-taking. This is because risk adjustment potentially can take account of the full range and time horizon of risks, rather than just those risk outcomes that occur or become more evident during the deferral period. On the other hand, deferral of payment may be more effective than risk adjustment in mitigating incentives to take hard-to-measure risks (such as the risks of new activities or products, or certain risks such as reputational or operational risk that may be difficult to measure with respect to particular activities), especially if such risks are likely to be realized during the deferral period. Accordingly, in some cases two or more methods may be needed in combination for an incentive compensation arrangement to be balanced.

The greater the potential incentives an arrangement creates for an employee to increase the risks associated with the employee's activities, the stronger the effect should be of the methods applied to achieve balance. Thus, for example, risk adjustments used to counteract a materially unbalanced compensation arrangement should have a similarly material impact on the incentive compensation paid under the arrangement. Further, improvements in the quality and reliability of performance measures themselves, for example improving the reliability and accuracy of estimates of revenues and profits upon which performance measures depend, can significantly improve the degree of balance in risk-taking incentives.

Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, strong policies and procedures, internal controls, and ex post monitoring of incentive compensation payments relative to actual risk outcomes are particularly important to help ensure that the arrangements as implemented are balanced and do not encourage imprudent risk-taking. For example, if a banking organization relies to a significant degree on the judgment of one or more managers to ensure that the incentive compensation awards to employees are appropriately risk-adjusted, the organization should have policies and procedures that describe how managers are expected to exercise that judgment to achieve balance and that provide for the manager(s) to receive appropriate available information about the employee's risk-taking activities to make informed judgments.

Large banking organizations. Methods and practices for making compensation sensitive to risk are likely to evolve rapidly during the next few years, driven in part by the efforts of supervisors and other stakeholders. LBOs should actively monitor developments in the field and should incorporate into their incentive compensation systems new or emerging methods or practices that are likely to improve the organization's long-term financial well-being and safety and soundness.

• The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.

Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. For example, activities, risks, and incentive compensation practices may differ materially among banking organizations based on, among other things, the scope or complexity of activities conducted and the business strategies pursued by the organizations. These differences mean that methods for achieving balanced compensation arrangements at one organization may not be effective in restraining incentives to engage in imprudent risk-taking at another organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization.

Moreover, the risks associated with the activities of one group of non-executive employees (*e.g.*, loan originators) within a banking organization may differ significantly from those of another group of non-executive employees (*e.g.*, spot foreign exchange traders) within the organization. In addition, reliable quantitative measures of risk and risk outcomes are unlikely to be available for a banking organization as a whole, particularly a large, complex organization. This factor can make it difficult for banking organizations to achieve balanced compensation arrangements for senior executives who have responsibility for managing risks on an organization-wide basis solely through use of the risk-adjustment-of-award method.

Furthermore, the payment of deferred incentive compensation in equity (such as restricted stock of the organization) or equity-based instruments (such as options to acquire the organization's stock) may be helpful in restraining the risk-taking incentives of senior executives and other covered employees whose activities may have a material effect on the overall financial performance of the organization. However, equity-related deferred compensation may not be as effective in restraining the incentives of lower-level covered employees (particularly at large organizations) to take risks because such

Sarbanes-Oxley Act of 2002 (15 U.S.C. 7243), which applies to chief executive officers and chief financial officers of public banking organizations, is an example of this more specific type of "clawback" requirement.

[14] Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above the target or may provide that awards will be granted only if a target is met or exceeded. Employees may be particularly motivated to take imprudent risk in order to reach performance targets that are aggressive, but potentially achievable.

employees are unlikely to believe that their actions will materially affect the organization's stock price.

Banking organizations should take account of these differences when constructing balanced compensation arrangements. For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to result in arrangements that are unbalanced at least with respect to some employees.[15]

Large banking organizations. Incentive compensation arrangements for senior executives at LBOs are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance, substantial use of multi-year performance periods, or both. Similarly, the compensation arrangements for senior executives at LBOs are likely to be better balanced if a significant portion of the incentive compensation of these executives is paid in the form of equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the organization during the deferral period.

The portion of the incentive compensation of other covered employees that is deferred or paid in the form of equity-based instruments should appropriately take into account the level, nature, and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the organization and its stock price. Deferral of a substantial portion of an employee's incentive compensation may not be workable for employees at lower pay scales because of their more limited financial resources. This may require increased reliance on other measures in the incentive compensation arrangements for these employees to achieve balance.

• Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.

Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes can provide the employee significant incentives to expose the organization to undue risk. For example, an arrangement that provides an employee with a guaranteed payout upon departure from an organization, regardless of performance, may neutralize the effect of any balancing features included in the arrangement to help prevent imprudent risk-taking.

Banking organizations should carefully review any such existing or proposed arrangements (sometimes called "golden parachutes") and the potential impact of such arrangements on the organization's safety and soundness. In appropriate circumstances an organization should consider including balancing features—such as risk adjustment or deferral requirements that extend past the employee's departure—in the arrangements to mitigate the potential for the arrangements to encourage imprudent risk-taking. In all cases, a banking organization should ensure that the structure and terms of any golden parachute arrangement entered into by the organization do not encourage imprudent risk-taking in light of the other features of the employee's incentive compensation arrangements.

Large banking organizations. Provisions that require a departing employee to forfeit deferred incentive compensation payments may weaken the effectiveness of the deferral arrangement if the departing employee is able to negotiate a "golden handshake" arrangement with the new employer.[16] This weakening effect can be particularly significant for senior executives or other skilled employees at LBOs whose services are in high demand within the market.

Golden handshake arrangements present special issues for LBOs and supervisors. For example, while a banking organization could adjust its deferral arrangements so that departing employees will continue to receive any accrued deferred compensation after departure (subject to any clawback or malus[17]), these changes could reduce the employee's incentive to remain at the organization and, thus, weaken an organization's ability to retain qualified talent, which is an important goal of compensation, and create conflicts of interest. Moreover, actions of the hiring organization (which may or may not be a supervised banking organization) ultimately may defeat these or other risk-balancing aspects of a banking organization's deferral arrangements. LBOs should monitor whether golden handshake arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees. The Agencies will continue to work with banking organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

• Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.

In order for the risk-sensitive provisions of incentive compensation arrangements to affect employee risk-taking behavior, the organization's employees need to understand that the amount of incentive compensation that they may receive will vary based on the risk associated with their activities. Accordingly, banking organizations should ensure that employees covered by an incentive compensation arrangement are informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid. Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk outcomes. An organization's communications should be tailored appropriately to reflect the sophistication of the relevant audience(s).

Principle 2: Compatibility With Effective Controls and Risk-management

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

[15] For example, spreading payouts of incentive compensation awards over a standard three-year period may not appropriately reflect the differences in the type and time horizon of risk associated with the activities of different groups of employees, and may not be sufficient by itself to balance the compensation arrangements of employees who may expose the organization to substantial longer-term risks.

[16] Golden handshakes are arrangements that compensate an employee for some or all of the estimated, non-adjusted value of deferred incentive compensation that would have been forfeited upon departure from the employee's previous employment.

[17] A malus arrangement permits the employer to prevent vesting of all or part of the amount of a deferred remuneration award. Malus provisions are invoked when risk outcomes are worse than expected or when the information upon which the award was based turns out to have been incorrect. Loss of unvested compensation due to the employee voluntarily leaving the firm is not an example of malus as the term is used in this guidance.

In order to increase their own compensation, employees may seek to evade the processes established by a banking organization to achieve balanced compensation arrangements. Similarly, an employee covered by an incentive compensation arrangement may seek to influence, in ways designed to increase the employee's pay, the risk measures or other information or judgments that are used to make the employee's pay sensitive to risk.

Such actions may significantly weaken the effectiveness of an organization's incentive compensation arrangements in restricting imprudent risk-taking. These actions can have a particularly damaging effect on the safety and soundness of the organization if they result in the weakening of risk measures, information, or judgments that the organization uses for other risk-management, internal control, or financial purposes. In such cases, the employee's actions may weaken not only the balance of the organization's incentive compensation arrangements, but also the risk-management, internal controls, and other functions that are supposed to act as a separate check on risk-taking. For this reason, traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced. Rather, a banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

• Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk-management and other functions.

To help prevent damage from occurring, a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. Banking organizations should create and maintain sufficient documentation to permit an audit of the effectiveness of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements. Smaller banking organizations should incorporate reviews of these processes into their overall framework for compliance monitoring (including internal audit).

Large banking organizations. LBOs should have and maintain policies and procedures that (i) identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements; (ii) identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and (iii) identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements.

An LBO also should conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed. Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An LBO's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements. The results should be reported to appropriate levels of management and, where appropriate, the organization's board of directors.

• Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.

Developing incentive compensation arrangements that provide balanced risk-taking incentives and monitoring arrangements to ensure they achieve balance over time requires an understanding of the risks (including compliance risks) and potential risk outcomes associated with the activities of the relevant employees. Accordingly, banking organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining imprudent risk-taking.[18] Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to, (i) reviewing the types of risks associated with the activities of covered employees; (ii) approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and (iii) analyzing risk-taking and risk outcomes relative to incentive compensation payments.

Other functions within an organization, such as its control, human resources, or finance functions, also play an important role in helping ensure that incentive compensation arrangements are balanced. For example, these functions may contribute to the design and review of performance measures used in compensation arrangements or may supply data used as part of these measures.

• Compensation for employees in risk-management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.

The risk-management and control personnel involved in the design, oversight, and operation of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles. These skills and experiences should be sufficient to equip the personnel to remain effective in the face of challenges by covered employees seeking to increase their incentive compensation in ways that are inconsistent with sound risk-management or internal controls. The compensation arrangements for employees in risk-management and control functions thus should be sufficient to attract and retain qualified personnel with experience and expertise in these fields that is appropriate in light of the size, activities, and complexity of the organization.

In addition, to help preserve the independence of their perspectives, the incentive compensation received by risk-management and control personnel staff should not be based substantially on the financial performance of the business units that they review. Rather, the performance measures used in the incentive compensation arrangements for these personnel should be based primarily on the achievement of the objectives of their functions (*e.g.*, adherence to internal controls).

• Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.

Banking organizations should monitor incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether

[18] Involvement of risk-management personnel in the design and monitoring of these arrangements also should help ensure that the organization's risk-management functions can properly understand and address the full range of risks facing the organization.

incentive compensation payments to employees are reduced to reflect adverse risk outcomes or high levels of risk taken. Results should be reported to appropriate levels of management, including the board of directors where warranted and consistent with Principle 3 below. The monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation. Thus, for example, a small, noncomplex organization that uses incentive compensation only to a limited extent may find that it can appropriately monitor its arrangements through normal management processes.

A banking organization should take the results of such monitoring into account in establishing or modifying incentive compensation arrangements and in overseeing associated controls. If, over time, incentive compensation paid by a banking organization does not appropriately reflect risk outcomes, the organization should review and revise its incentive compensation arrangements and related controls to ensure that the arrangements, as designed and implemented, are balanced and do not provide employees incentives to take imprudent risks.

Principle 3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors of a banking organization should directly approve the incentive compensation arrangements for senior executives.[19] The board also should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and should carefully consider and monitor the effects of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization.

The board of directors of an organization also is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all covered employees are appropriately balanced and do not jeopardize the safety and soundness of the organization. The involvement of the board of directors in oversight of the organization's overall incentive compensation program should be scaled appropriately to the scope and prevalence of the organization's incentive compensation arrangements.

Large banking organizations and organizations that are significant users of incentive compensation. The board of directors of an LBO or other banking organization that uses incentive compensation to a significant extent should actively oversee the development and operation of the organization's incentive compensation policies, systems, and related control processes. The board of directors of such an organization should review and approve the overall goals and purposes of the organization's incentive compensation system. In addition, the board should provide clear direction to management to ensure that the goals and policies it establishes are carried out in a manner that achieves balance and is consistent with safety and soundness.

The board of directors of such an organization also should ensure that steps are taken so that the incentive compensation system—including performance measures and targets—is designed and operated in a manner that will achieve balance.

• The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.

To allow for informed reviews, the board should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. These reviews and reports should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the prevalence and scope of its incentive compensation arrangements.

The board of directors of a banking organization should closely monitor incentive compensation payments to senior executives and the sensitivity of those payments to risk outcomes. In addition, if the compensation arrangement for a senior executive includes a clawback provision, then the review should include sufficient information to determine if the provision has been triggered and executed as planned.

The board of directors of a banking organization should seek to stay abreast of significant emerging changes in compensation plan mechanisms and incentives in the marketplace as well as developments in academic research and regulatory advice regarding incentive compensation policies. However, the board should recognize that organizations, activities, and practices within the industry are not identical. Incentive compensation arrangements at one organization may not be suitable for use at another organization because of differences in the risks, controls, structure, and management among organizations. The board of directors of each organization is responsible for ensuring that the incentive compensation arrangements for its organization do not encourage employees to take risks that are beyond the organization's ability to manage effectively, regardless of the practices employed by other organizations.

Large banking organizations and organizations that are significant users of incentive compensation. The board of an LBO or other organization that uses incentive compensation to a significant extent should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness. These reports should include an evaluation of whether or how incentive compensation practices may increase the potential for imprudent risk-taking.

The board of such an organization also should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting imprudent risk-taking. Boards of directors of these organizations also should consider periodically obtaining and reviewing simulation analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risks taken.

[19] As used in this guidance, the term "board of directors" is used to refer to the members of the board of directors who have primary responsibility for overseeing the incentive compensation system. Depending on the manner in which the board is organized, the term may refer to the entire board of directors, a compensation committee of the board, or another committee of the board that has primary responsibility for overseeing the incentive compensation system. In the case of FBOs, the term refers to the relevant oversight body for the firm's U.S. operations, consistent with the FBO's overall corporate and management structure.

• The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.

The board of directors of a banking organization should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities. This level of expertise may be present collectively among the members of the board, may come from formal training or from experience in addressing these issues, including as a director, or may be obtained through advice received from outside counsel, consultants, or other experts with expertise in incentive compensation and risk-management. The board of directors of an organization with less complex and extensive incentive compensation arrangements may not find it necessary or appropriate to require special board expertise or to retain and use outside experts in this area.

In selecting and using outside parties, the board of directors should give due attention to potential conflicts of interest arising from other dealings of the parties with the organization or for other reasons. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence. While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.

Large banking organizations and organizations that are significant users of incentive compensation. If a separate compensation committee is not already in place or required by other authorities,[20] the board of directors of an LBO or other banking organization that uses incentive compensation to a significant extent should consider establishing such a committee—reporting to the full board—that has primary responsibility for overseeing the organization's incentive compensation systems. A compensation committee should be composed solely or predominantly of non-executive directors. If the board does not have such a compensation committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems. The compensation committee should work closely with any board-level risk and audit committees where the substance of their actions overlap.

• A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.

If a banking organization's incentive compensation arrangements provide employees incentives to take risks that are beyond the tolerance of the organization's shareholders, these risks are likely to also present a risk to the safety and soundness of the organization.[21] To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements for executive and non-executive employees and related risk-management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take imprudent risks. Such disclosures should include information relevant to employees other than senior executives. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.[22]

• Large banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.

At banking organizations with large numbers of risk-taking employees engaged in diverse activities, an ad hoc approach to developing balanced arrangements is unlikely to be reliable. Thus, an LBO should use a systematic approach—supported by robust and formalized policies, procedures, and systems—to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. Such an approach should provide for the organization effectively to:

◦ Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include (i) senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines; (ii) individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and (iii) groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk;

◦ Identify the types and time horizons of risks to the organization from the activities of these employees;

◦ Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take imprudent risks;

◦ Include balancing elements, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities;

◦ Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and

◦ Monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

III. Conclusion

Banking organizations are responsible for ensuring that their incentive compensation arrangements do not encourage imprudent risk-taking behavior and are consistent with the safety and soundness of the organization. The Agencies expect banking organizations to take prompt action to address deficiencies in their incentive compensation arrangements or related risk-management, control, and governance processes.

The Agencies intend to actively monitor the actions taken by banking organizations in this area and will promote further advances in designing and implementing balanced incentive compensation arrangements. Where appropriate, the Agencies will take supervisory or enforcement action to ensure that material deficiencies that pose a threat to the safety and soundness of the organization are promptly addressed. The Agencies also

[20] *See*, New York Stock Exchange Listed Company Manual Section 303A.05(a); Nasdaq Listing Rule 5605(d); Internal Revenue Code section 162(m) (26 U.S.C. 162(m)).

[21] On the other hand, as noted previously, compensation arrangements that are in the interests of the shareholders of a banking organization are not necessarily consistent with safety and soundness.

[22] A banking organization also should comply with the incentive compensation disclosure requirements of the Federal securities law and other laws as applicable. *See, e.g.*, Proxy Disclosure Enhancements, SEC Release Nos. 33–9089, 34–61175, 74 FR 68334 (Dec. 23, 2009) (to be codified at 17 CFR pts. 229 and 249).

will update this guidance as appropriate to incorporate best practices as they develop over time.

This concludes the text of the Guidance on Sound Incentive Compensation Policies.

Dated: June 17, 2010.

John C. Dugan,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, June 21, 2010.

Robert deV. Frierson,

Deputy Secretary of the Board.

Dated: June 21, 2010.

Valerie J. Best,

Assistant Executive Secretary, Federal Deposit Insurance Corporation.

Dated: June 10, 2010.

By the Office of Thrift Supervision.

John E. Bowman,

Acting Director.

[FR Doc. 2010–15435 Filed 6–24–10; 8:45 am]

BILLING CODE 6210–01–P 4810–33–P 6714–01–P 6720–01–P

GENERAL SERVICES ADMINISTRATION

[Docket 2010–009; Sequence 3]

Federal Travel Regulation (FTR); Directions for Reporting Other Than Coach-Class Accommodations for Employees on Official Travel

AGENCY: Office of Governmentwide Policy, General Services Administration (GSA).

ACTION: Notice of GSA Bulletin FTR 10–05.

SUMMARY: The General Services Administration (GSA), in conjunction with the Government Accountability Office (GAO) report, *Premium Class Travel: Internal Control Weaknesses Governmentwide Led to Improper and Abusive Use of Premium Class Travel* (GAO–07–1268), has issued GSA Bulletin FTR 10–05. This bulletin provides directions to Federal Agencies for reporting other than coach-class accommodations for employees on official travel. GSA Bulletin FTR 10–05 may be found at *http://www.gsa.gov/federaltravelregulation.*

DATES: The provisions in this Bulletin are effective June 9, 2010.

FOR FURTHER INFORMATION CONTACT: Mr. Patrick O'Grady, Office of Governmentwide Policy (M), Office of Travel, Transportation, and Asset Management (MT), General Services Administration at (202) 208–4493 or via e-mail at *patrick.ogrady@gsa.gov.* Please cite GSA Bulletin FTR 10–05.

Dated: June 16, 2010.

Becky Rhodes,

Associate Administrator, Office of Travel, Transportation, and Asset Management.

[FR Doc. 2010–15433 Filed 6–24–10; 8:45 am]

BILLING CODE 6820–14–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Indian Health Service

American Indians Into Psychology; Notice of Competitive Grant Applications for American Indians Into Psychology Program

Announcement Type: New.

Funding Opportunity Number: HHS–IHS–2010–INPSY–0001.

CFDA Number: 93.970.

Key Dates

Application Deadline: July 23, 2010.

Review Date: July 29, 2010.

Earliest Anticipated Start Date: September 1, 2010.

I. Funding Opportunity Description

The Indian Health Service (IHS) is accepting competitive grant applications for the American Indians into Psychology Program. This program is authorized under the authority of "25 U.S.C. 1621p(a–d).", Indian Health Care Improvement Act, Public Law 94–437, as amended by Public Law 102–573 and Public Law 111–148.

Purpose

The purpose of the Indians into Psychology Program is to develop and maintain Indian psychology career recruitment programs as a means of encouraging Indians to enter the behavioral health field. This program is described at 93.970 in the Catalog of Federal Domestic Assistance. Costs will be determined in accordance with applicable Office of Management and Budget Circulars. The Public Health Service (PHS) is committed to achieving the health promotion and disease prevention objectives of Healthy People 2010, a PHS-led activity for setting priority areas. This program announcement is related to the priority area of Educational and Community-based programs. Potential applicants may obtain a copy of Healthy People 2010, summary report in print, Stock No. 017–001–00547–9, or via CD–ROM, Stock No. 107–001–00549–5, through the Superintendent of Documents, Government Printing Office, P.O. Box 371954, Pittsburgh, PA 15250–7945, (202) 512–1800. You may also access this information via the Internet at the following Web site: *http://www.health.gov/healthypeople.*

The PHS strongly encourages all grant and contract recipients to provide a smoke-free workplace and promote the non-use of all tobacco products. In addition, Public Law 103–227, the Pro-Children Act of 1994, prohibits smoking in certain facilities (or in some cases, any portion of the facility) in which regular or routine education, library, day care, health care, or early childhood development services are provided to children. This is consistent with the PHS mission to protect and advance the physical and mental health of the American people.

II. Award Information

Type of Awards: Grant.

Estimated Funds Available: The total amount identified for Fiscal Year 2010 is $757,386. The award is for 12 months in duration and the average award is approximately $252,462. Awards under this announcement are subject to the availability of funds. In the absence of funding, the agency is under no obligation to make awards funded under this announcement.

Anticipated Number of Awards: An estimated two awards will be made under the program. If funding becomes available, additional awards may be made.

Project Period: 4 years.

Award Amount: $252,462, per year.

III. Eligibility Information

1. Eligible Applicants

Public and nonprofit private colleges and universities that offer a Ph.D. in clinical programs accredited by the American Psychological Association will be eligible to apply for a grant under this announcement. However, only one grant will be awarded and funded to a college or university per funding cycle.

2. Cost Sharing/Matching

This announcement does not require matching funds or cost sharing.

3. Other Requirements

Required Affiliations—The grant applicant must submit official documentation indicating a Tribe's cooperation with and support of the program within the schools on its reservation and its willingness to have a Tribal representative serving on the program advisory board. Documentation must be in the form prescribed by the Tribe's governing body, *i.e.*, letter of support or Tribal resolution. Documentation must be submitted from every Tribe involved in the grant program. If application budgets exceed

Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations

October 2011

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Contents

Executive Summary

Risk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007. To address such practices, the Federal Reserve first proposed guidance on incentive compensation in 2009 that was adopted by all of the federal banking agencies in June 2010.

To foster implementation of improved practices, in late 2009 the Federal Reserve initiated a multidisciplinary, horizontal review of incentive compensation practices at 25 large, complex banking organizations.[1] One goal of this horizontal review was to help fill out our understanding of the range of incentive compensation practices across firms and categories of employees within firms. The second, more important goal was to guide each firm in implementing the interagency guidance.

Given the variety of activities at these complex firms, and the number and range of employees who are in a position to assume significant risk, our approach has been to require each firm to develop, under our supervision, its own practices and governance mechanisms to ensure risk-appropriate incentive compensation that accords with the interagency guidance throughout the organization. Supervisors assessed areas of weakness at the firms, in response to which the firms have developed comprehensive plans outlining how those weaknesses will be addressed. These plans, as modified based on comments from supervisors, will be the basis for further progress and evaluation.

As explained in more detail in this report, every firm in the review has made progress during the review in developing practices and procedures that will internalize the principles in the interagency guidance into the management systems in each firm. Many of these changes are already evident in the actual compensation arrangements of firms. For example, senior executives now have more than 60 percent of their incentive compensation deferred on average, higher than illustrative international guidelines agreed by the Financial Stability Board, and some of the most senior executives have more than 80 percent deferred with additional stock retention requirements after deferred stock vests. Moreover, firms are now attentive to risk-taking incentives for large numbers of employees below the executive level—at many firms thousands or tens of thousands of employees—which was not the case before the beginning of the horizontal review, when most firms paid little attention to risk-taking incentives, or were attentive only for the top employees.

Yet every firm also needs to do more. As oversight of incentive compensation moves into the regular supervisory process, the Federal Reserve will continue to work to ensure progress continues both in the implementation of the firms' plans and in the risk-appropriate character of actual compensation practices.

Steps Taken by Firms

With the oversight of the Federal Reserve and other banking agencies, the firms in the horizontal review have implemented new practices to make employees' incentive compensation sensitive to risk. The following is a brief progress report on four key areas of the review. More details can be found in the report:

[1] The financial institutions in the Incentive Compensation Horizontal Review are Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; Capital One Financial Corporation; Citigroup Inc.; Discover Financial Services; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; Northern Trust Corporation; The PNC Financial Services Group, Inc.; State Street Corporation; SunTrust Banks, Inc.; U.S. Bancorp; and Wells Fargo & Company; and the U.S. operations of Barclays plc, BNP Paribas, Credit Suisse Group AG, Deutsche Bank AG, HSBC Holdings plc, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Societe Generale, and UBS AG.

- **Effective Incentive Compensation Design.** All firms in the horizontal review have implemented new practices to balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks. The most widely used methods for doing so are risk adjustment of awards and deferral of payments.

  —*Risk adjustments* make the amount of an incentive compensation award for an employee take into account the risk the employee's activities may pose to the organization. At the beginning of the horizontal review, no firm had a well-developed strategy to use risk adjustments and many had no effective risk adjustments. Every firm has made progress in developing appropriate risk adjustments, but most have more work to do to ensure the full range of risks are appropriately balanced. An example of a leading-edge practice that is now used by a few firms is including in internal profit measures used in incentive compensation awards a charge for liquidity risk that takes into account stressed conditions. This reduces incentives to take imprudent liquidity risk. An example of a challenge for many firms is development of policies and procedures to guide judgmental adjustments of incentive compensation awards. Such internal guidelines help promote consistency and effectiveness in incentive compensation decisionmaking.

  —*Deferring payout* of a portion of incentive compensation awards can help promote prudent incentives if done in a way that takes into account risk taking, especially bad outcomes. Deferring payouts was fairly common before the crisis, especially for senior executives and highly paid employees. However, pre-crisis deferral arrangements typically were not structured to fully take account of risk or actual outcomes. Almost all firms now use vehicles for some employees that adjust downward the amount of deferred incentive compensation that is paid if losses are large. However, most firms still have work to do to implement such arrangements for a larger set of employees and to more closely link such reductions to individual employees' actions, particularly for employees below the senior executive level.

- **Progress in Identifying Key Employees.** At most large banking organizations, thousands or tens of thousands of employees have a hand in risk taking. Yet, before the crisis, the conventional wisdom at most firms was that risk-based incentives were important only for a small number of senior or highly paid employees and no firm systematically identified the relevant employees who could, either individually or as a group, influence risk. All firms in the horizontal review have made progress in identifying the employees for whom incentive compensation arrangements may, if not properly structured, pose a threat to the organization's safety and soundness. All firms in the horizontal review now recognize the importance of establishing sound incentive compensation programs that do not encourage imprudent risk taking for those who can individually affect the risk profile of the firm. In addition, slightly more than half of the firms have identified groups of similarly compensated employees whose combined actions may expose the organization to material amounts of risk. However, some firms are still working to identify a complete set of mid- and lower-level employees and to fully assess the risks associated with their activities.

- **Changing Risk-Management Processes and Controls.** Because firms did not consider risk in the design of incentive compensation arrangements before the crisis, firms rarely involved risk-management and control personnel when considering and carrying out incentive compensation arrangements. All firms in the horizontal review have changed risk-management processes and internal controls to reinforce and support the development and maintenance of balanced incentive compensation arrangements. Risk-management and control personnel are engaged in the design and operation of incentive compensation arrangements of other employees to ensure that risk is properly considered. Some firms have further work to do to provide sufficiently active and robust engagement by risk management and control staff.

- **Progress in Altering Corporate Governance Frameworks.** At the outset of the horizontal review, the boards of directors of most firms had begun to consider the relationship between incentive compensation and risk, though many were focused exclusively on the incentive compensation of their firm's most senior executives. Since then, all firms in the horizontal review have made progress in altering their corporate governance frameworks to be attentive to risk-taking incentives created by the incentive compensation process for employees throughout the firm. The role of boards of directors in incentive compensation has expanded, as has the amount of risk information provided to boards related to incentive compensation. The appropriateness of the degree of engagement of the boards will be evaluated after a few years of experience.

Scope and Status of Reform Effort

Supervisors in the horizontal review gathered confidential supervisory information from all firms and found important differences in practices across business lines and banking organizations. Additionally, practices are changing rapidly in response to the Federal Reserve's efforts and industry developments. Therefore, a moment-in-time, comparative analysis of individual firms from the horizontal review is not possible and could be misleading. That said, the Federal Reserve is working to foster market discipline in the area of incentive compensation. On this front, the Federal Reserve intends to implement the Basel Committee's recent "Pillar 3 disclosure requirements for remuneration," issued in July 2011,[2] which will provide more complete information about risk-related elements of incentive compensation practices of individual institutions.

In part spurred by the horizontal review, incentive compensation practices at banking organizations are continuing to evolve and develop. We expect this evolution to continue. The Federal Reserve will continue to work with these firms through the supervisory process to ensure improvement and progress are sustained.

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2 See "Pillar 3 disclosure requirements on remuneration issued by the Basel Committee," *Bank for International Settlements*, (www.bis.org/press/p110701.htm).

Introduction

Risk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007. To address such practices, the Federal Reserve first proposed guidance on incentive compensation in 2009 that was adopted by all of the federal banking agencies in June 2010. In 2009, the Federal Reserve announced a horizontal review of incentive compensation practices at a group of large, complex banking organizations. (See "Principles of the Interagency Guidance and Supervisory Expectations" on page 9 and "Incentive Compensation Horizontal Review" on page 11.)

Pre-Crisis Conditions and Response

As discussed in the interagency guidance, the activities of employees may create a wide range of risks for a banking organization, such as credit, market, liquidity, operational, legal, compliance, and reputational risks, as well as other risks to the viability or operation of the organization. Some of these risks may be realized in the short term, while others may become apparent only over the long term. For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities. In addition, some risks—or combinations of risky strategies and positions—may have a low probability of being realized but would have highly adverse effects on the organization if they were to be realized ("bad tail risks"). While shareholders may have less incentive to guard against bad tail risks because of the infrequency of their realization and the existence of the federal safety net, these risks warrant special attention for safety-and-soundness reasons given the threat they pose to the organization's solvency and the federal safety net.

Before the crisis, large banking organizations did not pay adequate attention to risk when designing and operating their incentive compensation systems, and some employees were provided incentives to take imprudent risks. For example, an employee who made a high-risk loan may have generated more revenue in the short run than one who made a low-risk loan. Incentive compensation arrangements based solely on the level of short-term revenue paid more to the employee taking more risk, thereby incentivizing employees to take more, sometimes imprudent, risk. Led by supervisors in the horizontal review, over the past two years banking organizations have improved their incentive compensation arrangements to take appropriate account of risk. The two most common ways to do so—risk adjustments and deferral— make use of risk information that becomes available at different points in time.

Risk-Based Adjustments to Compensation

Information about risks taken that is known before incentive compensation is awarded can be used to make risk adjustments to those awards. For example, if an employee in a lending unit makes many high-risk loans during a year, the estimated profit from the loans can be adjusted when designing the employee's incentive compensation package, using either quantitative or qualitative information. In all cases, risk adjustments should consider likely losses under stressed conditions, and not merely business-as-usual, so that larger, but lower-probability, loss outcomes can be taken into account.

Both quantitative and qualitative risk information can be used in making such adjustments. They can be applied either through use of a formula or through the exercise of judgment and may play a role in setting amounts of incentive compensation pools (bonus pools), in allocating pools to individuals' incentive compensation, or both. The effectiveness of the different types of adjustments varies with the situation of the employee and the banking organization, as well as the thoroughness of their implementation. Banking organizations in the horizontal review have made significant progress in improving their risk adjustments, but most still have work to do. The first topic in "Balancing Incentives at Large Banking Organizations" on page 13 describes the main types of risk adjustments and some areas in which further work is needed.[3]

Deferred incentive compensation can contribute to prudent incentives because risk taking and risk outcomes often become clearer over time. If payout of a portion of incentive compensation awards is deferred for a period of time after the award date, late-arriving information about risk taking and outcomes of such risk taking can be used to alter the payouts in ways that will improve the balance of risk-taking incentives. Banking organizations in the horizontal review have made progress in improving deferral practices, but many still have work to do on performance conditions for vesting. Deferral practices are described in the second topic in "Balancing Incentives at Large Banking Organizations" on page 15.

Risk adjustments and deferral are not the only ways of improving the balance of risk-taking incentives. Some alternatives, such as the use of longer performance periods when evaluating employees' performance and awards and reducing the sensitivity of awards to measures of short-term performance are briefly described in the third topic in "Balancing Incentives at Large Banking Organizations" on page 17.

At the beginning of the horizontal review, the conventional wisdom at most firms was that risk-taking incentives were important only for a small number of senior or highly paid employees. Though the decisions and incentives of senior executives are indeed very important, the combined risk taking by a group of similarly compensated employees can also be material to the firm's risk profile. Thus, identifying the set of employees, who may individually or collectively expose the firm to material amounts of risk, is a key element of practice. The interagency guidance notes that such "covered employees" should include not only those who can individually affect the risk profile of the firm, but also groups of similarly compensated employees whose actions when taken together can affect the risk profile. Examples of such groups may include many types of traders and loan originators. Most firms in the horizontal review have made progress in identifying covered employees, but some still have work to do. The fourth topic in "Balancing Incentives at Large Banking Organizations" on page 18 discusses covered employees and progress in identifying them.

As described in the interagency guidance, establishment of prudent risk-taking incentives should be critically supported by risk-management and control personnel. In addition, practices to promote improvements in the reliability and effectiveness of incentive compensation systems over time can usefully support development of prudent risk-taking incentives on a sustained basis. These elements are described in "Risk Management, Controls, and Corporate Governance" on page 21, which notes progress in most areas.

Some observers have been particularly interested in comparing progress of incentive compensation practices of firms headquartered in different jurisdictions. Approximately one-third of the large banking organizations included in the horizontal review are headquartered outside the United States (foreign banking organizations, or FBOs). In general, progress in conforming to the interagency guidance is similar at the U.S. banking organizations and at the FBOs in the horizontal review, and progress in conforming to the Financial Stability Board's (FSB) *Principles for Sound Compensation Practices* (Principles) and the related *Implementation Standards*,[4] which are somewhat less demanding than the interagency guidance, is also similar, as described in "International Context" on page 25.

As the horizontal review of incentive compensation practices draws to a close, further work on incentive compensation will continue through the normal supervisory process. Much supervisory work is already focused on risk management and control systems. Risk-taking incentives are a complementary focus for supervisors. However, incentive compensation practices are likely to evolve rapidly over the next several years, so both firms and supervisors must continue to adapt and improve. The Federal Reserve also intends to implement the Basel Committee's recent "Pillar 3 disclosure requirements for remuneration," issued in July 2011. Increased public disclosure about risk-related incentive compensation practices at major firms may improve market disci-

[3] Employees sometimes take risk in pursuit of goals other than short-term financial performance. In such cases, risk adjustments may also contribute to balanced risk-taking incentives.

[4] The FSB issued the *Principles* in April 2009 and the *Implementation Standards* in September 2009. These FSB documents are available at www.financialstabilityboard.org/list/fsb_publications/tid_123/index.htm.

pline of such practices. Finally, the Federal Reserve is working with other banking and financial regulatory agencies to develop an interagency rule on incentive compensation practices, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Principles of the Interagency Guidance and Supervisory Expectations

The interagency guidance is anchored by three principles:

1. **Balance between risks and results.** Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks;
2. **Processes and controls that reinforce balance.** A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements; and
3. **Effective corporate governance.** Banking organizations should have strong and effective corporate governance to help ensure sound incentive compensation practices, including active and effective oversight by the board of directors.

The interagency guidance is consistent with both the FSB *Principles* and *Implementation Standards* adopted in 2009.[5]

Affected Bank Personnel: Executive and Non-Executive Employees

Incentive compensation arrangements for executive and non-executive employees able to control or influence risk taking at a banking organization may pose safety-and-soundness risks if not properly structured. Accordingly, the interagency guidance applies to senior executives as well as other employees who, either individually or as part of a group of similarly compensated employees, have the ability to expose the banking organization to material amounts of risk. In identifying employees covered by the interagency guidance, banking organizations are directed to consider the full range of inherent risks associated with an employee's work activities, rather than just the level or type of risk that may remain after application of the organization's internal controls for managing risk ("residual risk").

Four Methods for Linking Compensation and Risk

The interagency guidance discusses four methods that banking organizations often use to make incentive compensation more sensitive to risk: (1) risk-adjusting incentive compensation awards based on measurements of risk; (2) deferring payment of awards using mechanisms that allow for actual award payouts to be adjusted as risks are realized or become better known; (3) using longer performance periods (for example, more than one year) when evaluating employees' performance and granting awards; and (4) reducing the sensitivity of awards to measures of short-term performance.[6] Each method has advantages and disadvantages.

A key premise of the interagency guidance is that the methods used to achieve appropriately risk-sensitive incentive compensation arrangements likely will differ across and within firms. Employees' activities and the risks associated with those activities vary significantly across banking organizations and potentially across employees within a particular banking organization. Differences across firms may be based on their principal chosen lines of business and the char-

[5] On April 14, 2011, as mandated by the Dodd-Frank Act, the Federal Reserve, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the former Office of Thrift Supervision, the National Credit Union Administration, the Securities and Exchange Commission, and the Federal Housing Finance Agency, issued for comment a proposed rule on incentive compensation practices. The proposed rule builds off the interagency guidance. This report focuses on the observations from the horizontal review, which was conducted in the context of the interagency guidance and does not discuss the proposed rule. The proposed rule is available at www.gpo.gov/fdsys/pkg/FR-2011-04-14/pdf/2011-7937.pdf.

[6] As noted in the interagency guidance, this list of methods is not intended to be exhaustive—other methods may exist or be developed.

acteristics of the markets in which they operate, among other factors, affecting both the types of risk faced by the firm and the time horizon of those risks. Even within firms, employees' activities and the attendant risks can depend on many different variables, including the specific sales targets or business strategies and the nature and degree of control or influence that different employees may have over risk taking. These differences naturally create different opportunities and different potential incentives, broadly speaking, for employees to take or influence risk. Thus, the use of any single, formulaic approach to incentive compensation by banking organizations or supervisors is unlikely to be effective at addressing all incentives to take imprudent risks.

Avoiding "One-Size-Fits-All" Limits or Formulas

The interagency guidance helps to avoid the potential hazards or unintended consequences that would be associated with rigid, one-size-fits-all supervisory limits or formulas. Subject to supervisory oversight, each organization is responsible for ensuring that its incentive compensation arrangements are consistent with its safety and soundness. Methods for achieving balanced incentive compensation arrangements at one organization may not be effective at another organization, in part because of the importance of integrating incentive compensation arrangements with the firm's own risk-management systems and business model. Similarly, the effectiveness of methods is likely to differ across business lines and units within a large banking organization. In general, large banking organizations are likely to need multiple methods to ensure that incentive compensation arrangements do not encourage imprudent risk taking.

Well-Designed Management and Control Functions

The interagency guidance also places great emphasis on the role of risk-management and internal control functions in providing for balanced risk-taking incentives. Poorly designed or implemented incentive compensation arrangements can themselves be a source of risk to banking organizations and undermine existing controls. For example, unbalanced incentive compensation arrangements can place substantial strain on the risk-management and internal control functions of even well-managed organizations. Therefore, risk-management and internal control functions should be involved in designing, implementing, and evaluating incentive compensation arrangements to ensure that the arrangements properly take risk into account.

The interagency guidance recognizes that large banking organizations tend to be significant users of incentive compensation arrangements, and that flawed approaches to incentive compensation at these institutions are more likely to have adverse effects on the broader financial system. Accordingly, the interagency guidance elaborates with greater specificity certain supervisory expectations for large banking organizations.[7]

Timelines for Adoption

In adopting the interagency guidance, the banking agencies recognized that achieving conformance with its terms and principles would likely require significant changes and enhancements to firm practices and that fully implementing such changes would require some time. For the large banking organizations in the horizontal review, we communicated our expectation that each firm should demonstrate significant progress toward consistency with the interagency guidance in 2010, should achieve substantial conformance with the interagency guidance by the end of 2011 (affecting the award of incentive compensation awards for the 2011 performance year), and should fully conform thereafter.

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[7] For example, the interagency guidance states that large banking organizations should have a systematic approach to incentive compensation supported by formalized and well-developed policies, procedures, and systems to ensure that incentive compensation arrangements are appropriately balanced and consistent with safety and soundness. Such institutions should also have robust procedures for collecting information about the effects of their incentive compensation programs on employee risk taking, as well as systems and processes for using this information to adjust compensation arrangements to eliminate or reduce unintended incentives for risk taking. Similarly, the interagency guidance urges large banking organizations to actively monitor industry, academic, and regulatory developments in incentive compensation practices and theory and be prepared to incorporate into their incentive compensation systems new or emerging methods that are likely to improve the organization's long-term financial well-being and safety and soundness.

Incentive Compensation Horizontal Review

In late 2009, in conjunction with its initial proposal of principles-based guidance on incentive compensation, the Federal Reserve launched a special simultaneous, horizontal review of incentive compensation practices and related risk management, internal controls, and corporate governance practices at a group of large complex banking organizations. These firms were chosen because flawed approaches to incentive compensation at these institutions are more likely to have adverse effects on the broader financial system and because of their extensive use of incentive compensation practices. The special work associated with the horizontal review is now nearing completion, but supervisory work on incentive compensation will continue through the ongoing supervisory process.

The Federal Reserve has communicated to the firms our assessment of their practices and our expectations for remediation in areas where improvements are needed. The firms, with the oversight and input of the Federal Reserve, have each developed remediation plans. These remediation plans, along with updates and discussion around them, have been a key mechanism for bringing clarity about needed changes.

Scope of the Horizontal Review and Feedback Provided

To carry out this major supervisory initiative, the Federal Reserve made a substantial commitment of staff resources and senior management attention. More than 150 individuals from the Federal Reserve and the other banking agencies have been involved in the horizontal review. In addition to senior supervisory staff, these included a multidisciplinary group of professionals, including supervisors, economists and lawyers, several specially constituted incentive compensation on-site review teams, and the permanent supervisory teams assigned to each of the involved banking organizations. Federal Reserve staff has coordinated with other banking regulators in conducting the horizontal review and communicating with the firms.

To perform the supervisory assessments of conformance with the interagency guidance, we gathered extensive information from the firms on their incentive compensation arrangements and associated processes, policies, and procedures. We reviewed internal documents governing existing incentive compensation practices as well as self-assessments of incentive compensation practices relative to the interagency guidance. We conducted many face-to-face meetings with senior executive officers and members of boards of directors' compensation committees. To supplement this information and to evaluate specifically how incentive compensation programs were implemented at the line-of-business level, the Federal Reserve conducted focused examinations of incentive compensation practices in trading and mortgage-origination business lines at a number of the organizations involved in the horizontal review.

The Federal Reserve has continued to provide individualized feedback to each of the firms as additional information and updates of remediation plans have been received. All of the firms have made progress toward achieving consistency with the interagency guidance. The nature and extent of remaining work varies across organizations and sometimes within organizations. Achieving conformance with the interagency guidance depends on the successful build-out of systems and processes, achievement of intermediate implementation milestones, and successful completion of remediation plans. Even then, in many cases, it will be important for the firms to keep in mind that new systems and practices have not been fully tested by experience, so ongoing monitoring of these new systems and practices will be important.

With regard to FBOs with activities in the United States, we have acknowledged the particular challenges that arise as they seek to conform their U.S. operations with the details of their home-country consolidated regulator's expectations and those of the interagency guidance. As noted, the interagency guidance is consistent with international regulatory efforts on incentive compensation practices, including the FSB *Principles* and *Implementation Standards*. We have indicated our intent to follow the complementary principles of effective consolidated supervision and national treatment of banking organizations operating in the United States.[8]

[8] For observations regarding incentive compensation practices at FBOs, see "International Context" on page 25.

Balancing Incentives at Large Banking Organizations

This section describes methods firms use to provide employees with prudent risk-taking incentives, as well as identifies the relevant set of employees. It is mostly related to the first of the three principles in the interagency guidance.

Incentive compensation arrangements achieve balance between risk and financial reward when the amount of money ultimately received by an employee depends not only on the employee's performance, but also on the risks taken in achieving this performance. Firms often determine the dollar amount of incentive compensation awards for a performance year immediately after the end of the year. Part of the award may be paid immediately and part may be deferred. Risk adjustments (see Topic 1 below) are features of incentive compensation arrangements that incorporate information about risks taken into decisions about the total amount of awards. Deferred payouts can also be adjusted for risk using information that becomes available during the deferral period, as described under Topic 2. Topic 3 focuses on other balancing methods, and Topic 4 on identification of covered employees (those employees for whom prudent risk-taking incentives are particularly important).

Topic 1: Risk Adjustment and Performance Measures

At the beginning of the horizontal review, no firm had a well-developed strategy to use risk adjustments and many had no effective risk adjustments. Currently, all firms in the horizontal review employ some sort of risk adjustment for at least some subset of employees, but the role of risk adjustments in the overall mix of balancing strategies varies across firms and across businesses within firms. Some adjustments rely on quantitative measures of risk, while others are based on perceptions of risks taken by employees or business units. Quantitative measures of risk may be applied mechanically (although this is relatively unusual) or as an element in judgment-based decisions. Risk adjustments may play a role in setting amounts of bonus pools, in allocating pools to individuals' incentive compensation, or both. In all cases, risk adjustments should consider likely losses under stressed conditions, and not merely business-as-usual, so that larger, but lower-probability loss outcomes can influence incentives to take risk.

Every firm has made progress in developing and implementing appropriate risk adjustments, but the progress is uneven, not only across firms, but within firms. Substantial work remains to be done to achieve consistency and effectiveness of such adjustments in providing balanced risk-taking incentives. Because most incentive compensation decisions involve some judgment, a key element of that work is improved written policies and procedures and improved monitoring practices.

Disciplined, Judgment-Based Decisionmaking

Judgment is an element of decisionmaking at every firm and at nearly every step in the design and operation of incentive compensation arrangements.[9] This poses two challenges: (1) ensuring that decisions based on judgment are made consistently can be difficult and (2) risk adjustments may be only one of many inputs into decisionmaking about incentive compensation awards. Without appropriate restraint, judgments about other aspects of an employee's performance, such as achieving a certain level of market share, could be made in a way that would undermine the desired incentive effects of the risk adjustments. To promote consistency and effectiveness of the impact of judgment on balanced risk-taking incentives, the interagency guidance notes that firms are expected to have robust policies and procedures to guide the consistent use of judgment, and that decisions should be documented so that firms can review

[9] An exception is formulaic compensation plans, such as commission sales plans, which sometimes specify amounts of incentive compensation according to a specific formula set at the beginning of the year.

whether policies and procedures are being followed and can assess the effectiveness of the policies and procedures over time.[10]

At the beginning of the horizontal review, most firms lacked written policies and procedures to guide managers in making risk adjustments, and policies and procedures for incentive compensation decisionmaking often did not clearly identify the weight to be given to risks taken during the performance year. Such policies and procedures, along with training for managers and *ex post* review of decisions, are important to achieving consistent application of *risk* adjustments. Some firms have made progress in developing written policies and procedures and related processes, but others are still in the process of completing this work.[11]

Quantitative and Qualitative Risk Measures

In cases where risk adjustments are applied based on a formula, incentive compensation decisions are made using measures of financial performance that are net of a risk charge based on a quantitative measure of risk. Such adjustments balance incentives to take risk to the extent that such charges offset increases in financial performance (or reductions in costs) that are associated with increased risk taking. The use of mechanical risk adjustments is possible when suitable quantitative risk measures are available, and the effectiveness of this type of risk adjustment depends on the quality of the risk measure. One leading edge practice, observed at some firms, is to assess a charge against internal profit measures for liquidity risk that takes into account stressed conditions and to use this adjusted profit measure in determining incentive compensation awards.

Most firms in the horizontal review also used quantitative risk measures as an input to judgment-based incentive compensation decisionmaking. For example, boards of directors usually take into account available risk measures when making decisions about bonus pools for the firm or about awards for senior executives. Some risk measures can be difficult to convert into quantitative risk charges, but nevertheless convey useful information. However, as noted previously, achieving a consistent balancing impact through judgmental decisionmaking is a challenge. Firms with more well-developed policies and procedures to guide decisionmakers in judgmentally using quantitative risk information seemed more likely to achieve a consistent balancing impact. This is an area in which many firms are working to improve effectiveness.

Almost all firms in the horizontal review use nonquantitative perceptions of risk taking as a basis for some risk adjustments. Such adjustments have the potential to address hard-to-measure risks and limitations of existing data and risk-measurement methods. For example, the manager of a lending business might be aware that some employees of the business make riskier loans and others safer loans, even though the quantitative risk measures available to the manager do not show it. Based on this information, the manager could risk adjust by giving lower incentive compensation awards per unit of revenue to the employees making the riskier loans. As in other cases where incentive compensation awards are based on judgment-based decisionmaking, they are more likely to be consistently effective where firms have clear policies and procedures to guide application. Developing such policies and procedures is particularly challenging because the information about risk is qualitative and the nature of the information tends to change over time.

Risk Adjustment and Bonus Pools

Incentive compensation practices of firms differ in the process of determining the total bonus pools and the allocation of incentive compensation to individuals. In a top-down process, senior management and the board of directors determine the size of an overall amount of funding for the firm as a whole near the end of the performance year, and this bonus pool is then split into sub-pools for each business. Pools

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[10] For example, an organization should have policies and procedures that describe how managers are expected to exercise judgment to achieve balance, including a description, as warranted, of the appropriate available information about the employee's risk-taking activities to be considered in making informed judgments. Such policies and procedures need not involve a precise analysis to be followed in developing discretionary risk adjustments, but should provide enough structure and instruction that decisions can be justified and documented on a clear and consistent basis and thereby allow for *ex post* monitoring.

[11] Some firms have identified in their policies and procedures specific factors appropriate to the line of business and employee role, including reference points, to be considered by management when making discretionary risk adjustments. Some firms have introduced new management processes aimed at governing discretion-based risk adjustments and aimed at providing documentation sufficient to support review of such decisions by Internal Audit. Some firms also have assigned control-function employees to focus on compliance with enhanced policies and procedures, and on documentation processes. They have improved communication to managers and employees about how risk adjustments work, which is crucial to full impact on risk-taking decisions.

are allocated to individual employees in a manner related to their individual performance. In a bottom-up process, the firm assesses performance of each employee and assigns him or her an incentive compensation award, with the total amount of incentive compensation for the year for the firm as a whole simply being the sum of individual incentive compensation awards. Most firms' processes are a mixture of top-down and bottom-up, but the emphasis can differ markedly.[12]

Risk adjustments balance incentive compensation arrangements to the extent they affect the incentives provided to individuals. The impact on incentives may be limited in cases where a firm makes risk adjustments only when deciding amounts of pools because the award to each employee under the pool will receive the same adjustment. This is appropriate when the nature and extent of risk taking of all employees under the pool is the same, such as cases where a pool applies to a business unit in which all risk decisions are influenced in the same way by all employees. Where individual employees in a single pool can have varied levels of impact on the amount of risk, the differences will not be fully addressed by risk adjustments to the pool alone. In such cases, additional adjustments incorporated into decisions about individual incentive compensation awards would be needed to make the risk adjustment fully effective.

Next Steps

Most of the firms in the horizontal review have made significant changes to their risk adjustment practices for awards for the 2011 performance year. Still, most continue to have work to do, including development of appropriate policies and procedures to guide judgmental adjustments of incentive compensation awards. Most firms should continue to evaluate the effectiveness of the quantitative and qualitative risk adjustments they are using and whether risks are appropriately balanced. Additionally, in 2012 firms should evaluate how effective the risk adjustments used for the 2011 awards were, and make improvements as necessary. The Federal Reserve will continue to work with the firms to make sure progress continues and to evaluate best practices in this area as they evolve.

Topic 2: Deferred Incentive Compensation

Another method for balancing incentive compensation arrangements is to defer the actual payout of a portion of an award to an employee significantly beyond the end of the performance period, adjusting the payout for actual losses or other aspects of the employee's performance that are realized or become better known only during the deferral period. Such deferral arrangements make it possible for the amount ultimately paid to the employee to reflect information about risks taken that arrives during the deferral period.

The interagency guidance does not require that deferral be used for all employees; does not suggest any specific formula for deferral arrangements; and does not mandate the use of any specific vehicle for payment, such as stock. However, the interagency guidance does have some specific suggestions relating to deferral arrangements for senior executives. A substantial fraction of incentive compensation awards should be deferred for senior executives of the firm because other methods of balancing risk-taking incentives are less likely to be effective by themselves for such individuals.

Elements of Deferral Practices

The proportion of incentive compensation awards to be deferred was substantial at the firms in the horizontal review. For example, senior executives now have more than 60 percent of their incentive compensation deferred on average, higher than illustrative international guidelines agreed by the FSB, and some of the most senior executives have more than 80 percent deferred with additional stock retention requirements after deferred stock vests. Most firms assign deferral rates to employees using a fixed schedule or "cash/stock table" under which employees receiving higher incentive compensation awards generally are subject to higher deferral rates, though deferral rates for the most senior executives are often set separately and are higher than those for other employees.

Deferral periods generally range from three to five years, with three years the most common. Most organizations in the horizontal review use the same deferral period for all employees in a given incentive com-

[12] Even at firms with a bottom-up emphasis, budget constraints place a practical limit on the size of the aggregate bonus for the firm as a whole, so some top-down element is present. Similarly, top-down firms take some account of perceived performance of key individuals in setting pools.

pensation plan and often for all employees. Some firms transfer ownership of the entire deferred award to the employee at the end of the vesting period ("cliff vesting"), while others adopted a schedule under which a portion of the award vests at given intervals.

The most common vehicles for conveying deferred incentive compensation to employees are shares of the firm's stock, stock options, and performance units (an instrument with a payout value that depends on a measure of performance during the deferral period, often an accounting measure like earnings or return-on-equity). Some firms use deferred cash or debt-like instruments.

Performance-Based Deferral

At the beginning of the horizontal review, few firms adjusted payouts of deferred awards for risk outcomes or other information about risks taken that became available during the deferral period. Without such performance conditions, deferral arrangements are unlikely to contribute to balancing risk-taking incentives (for ease of reference, deferral with performance conditions is referred to as "performance-based deferral").[13]

Firms in the horizontal review have made progress in implementing performance-based deferral arrangements that promote balanced risk-taking incentives. Each firm's setup is somewhat different, but three broad styles of arrangement were observed—formulaic, judgment-based, and a hybrid of the two. In a formulaic approach, the percentage of the award that vests is directly related to a measure of performance during the deferral period. In a judgment-based arrangement, the circumstances under which less than full vesting will occur are decided judgmentally rather than being linked to fixed values of performance metrics, and the amount of incentive compensation paid out under those circumstances is also decided through a judgment-based process. In a hybrid setup, a specific trigger value of performance is set at the beginning of the deferral period, and if performance falls below that trigger value, a judgment-based process determines how much of the deferred incentive compensation will not vest.[14] To the extent that judgment plays a role in the vesting decision, firms are expected to have robust policies and procedures to guide the consistent use of judgment, and decisions should be appropriately documented so that firms can monitor whether their policies and procedures are being followed.[15] Policies and procedures need to be clear to employees, or they will not have a clear understanding when risk-taking decisions are made of which outcomes will lead to forfeiture, in which case deferral arrangements are not likely to have a significant impact on risk-taking behavior. Many firms still have work to do on their policies and procedures in this area.

Most firms in the horizontal review have clawback arrangements for at least some employees that are triggered by malfeasance, violations of the firm's policies, and material restatement of financial results.[16] Such clawback provisions can contribute to

[13] Two common issues with performance-based deferral became clear during the horizontal review. The first is related to payment of deferred incentive compensation in share-based instruments. Where vehicles are share-based, at the time shares are awarded, risk-taking actions during the performance year might have either upside or downside effects on the stock price in the future, so the net effect on incentives is not clear. Moreover, most employees below the senior executive level are not likely to believe that their own risk-taking decisions will have a material impact on the firm's stock price. For example, if the leader of a business unit knows that a particular strategy may lead to losses that are large from the standpoint of the unit, the leader may believe any such losses would be more than offset by profits from other business units. Thus, the leader would not expect the losses to affect the ultimate value of deferred pay received, and deferral would have little impact on his or her risk-taking incentives. In order for a deferral arrangement to meaningfully contribute to balance, vesting triggers should be based on measures of performance that are linked to the employee's risk-taking activities, especially those taken before the incentive compensation award.

The second common issue that became clear during the horizontal review related to the particular performance conditions (triggers) chosen by firms. Some firms have performance-based deferral arrangements that allow for a large or outsized payout when the values of triggers reflect positive performance. However, these arrangements may encourage employees to take more risk during the deferral period, in order to maximize the value of such triggers and thus may not balance risk-taking incentives. One example of a trigger that may be appropriate is one that reduces the amount of deferred compensation that is vested if the firm (or business line or unit, depending on the level of the employee) experiences negative net income in any fiscal year during the deferral period. The relevant triggers for any performance-based deferral arrangement also should be clearly explained to employees covered by those arrangements.

[14] In a common variant of the hybrid process, once the trigger is met for a particular group (e.g., a business unit), the discretionary process determines not only the percentage of incentive compensation that vests, but also which employees are subject to less than full vesting, usually based on which employees were responsible for losses or for imprudent risk taking.

[15] Concerns about the use of discretion in deferral arrangements are similar to concerns about the use of discretion in *ex ante* risk adjustment, as discussed under Topic 1 of this report.

[16] The word "clawback" is sometimes used to refer to any deferral-of-payment method. The term "clawback" also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee if certain risk outcomes occur. Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7243), which applies to

balanced risk-taking incentives by discouraging specific types of behavior. While potentially effective, they do not affect most risk-related decisions and are not triggered by most risk outcomes—the narrow focus of these arrangements mean that they are unlikely to contribute meaningfully to balance.

Progress on performance-based deferral for the 2010 performance year was most common for senior executives. Many firms are now in the process of revising arrangements to be used for the 2011 performance year and are extending performance-based deferral coverage to more employees as a mechanism to provide prudent risk-taking incentives. Some firms have implemented, or are implementing, performance-based deferral for all employees receiving deferred incentive compensation, while others are doing so mainly for employees whose authorities and influence over risk taking are such that risk adjustments might have only limited effectiveness in balancing risk-taking incentives, such as senior managers within business lines and other employees engaged in activities that involve risks over a long duration.

Next Steps

Most of the firms in the horizontal review have made significant changes to their deferral arrangements. Many firms in the horizontal review have increased the fraction of incentive compensation that is deferred for both senior executives and other employees. All firms have more work to do to improve their performance-based deferral arrangements. Firms may also fine-tune the role of deferral relative to risk adjustments as they gain experience with how the two work together. As firms develop and fine-tune deferral arrangements, firms should evaluate how well these deferral arrangements have worked and make improvements as necessary. The Federal Reserve will monitor and encourage progress and work to ensure that practices are effective.

Topic 3: Other Methods that Promote Balanced Risk-Taking Incentives

Risk adjustments and deferral with performance-sensitive features represent important mechanisms for achieving balanced incentives for taking risk. The interagency guidance also identifies the use of longer performance periods (for example, more than one year) and reduced sensitivity of awards to short-term performance as methods for achieving balance. During the horizontal review, we observed the use of both methods, though neither was universally used.

Evaluating Performance: Emphasis on Long-Term over Short-Term

Firms used longer performance periods (that is, a backward-looking multiyear assessment horizon), for example, for senior executives in some cases, and in others for non-executive employees. Measuring and evaluating performance or awards on a multiyear basis allows for a greater portion of risks and risk outcomes to be observed within the performance assessment horizon, thus garnering many of the benefits of a deferral arrangement with performance-sensitive features. One simple variation involves using risk outcomes from prior-year actions as a consideration in reducing current-year incentive compensation award decisions. To be effective, multiyear assessments should be based on policies and procedures that give appropriate weight to poor outcomes due to past decisions. Otherwise, adverse outcomes may be effectively ignored due to an emphasis on current-year performance.

Damping the sensitivity of incentives to measures of short-term performance was a choice made by some institutions to rein in incentives when, for example, concerns arose about the significance of the incentives or risks involved. For example, increasing bonus pools or individual award amounts at a lower rate when financial performance is well above target levels can limit incentives to take large risks to achieve extreme levels of performance. A cap on incentive compensation awards beyond a certain level of performance is another example. However, in the horizontal review, there were few instances where such caps and reduced sensitivity were sufficient by themselves to balance risk-taking incentives.

Next Steps

The interagency guidance urges large banking organizations to actively monitor industry, academic, and regulatory developments in incentive compensation practices and theory to identify new or emerging methods that are likely to improve the organization's long-term financial well-being and safety and sound-

chief executive officers and chief financial officers of public banking organizations, is an example of this more specific type of "clawback" requirement. Nearly all U.S.-based firms in the horizontal review are publicly traded, and therefore subject to this provision.

ness. The Federal Reserve will do the same and will encourage firms to use methods that are most appropriate for their circumstances.

Topic 4: Covered Employees

Identifying the full set of employees who may individually or collectively expose the firm to material amounts of risk is a crucial step toward managing risks associated with incentive compensation. Without identifying the relevant employees, a firm cannot be sure it has properly designed its incentive compensation arrangements to provide appropriate risk-taking incentives.

Three Categories of Covered Employees

The interagency guidance describes three categories of such employees, which together are referred to as "covered employees":

- senior executives;
- other individual employees able to take or influence material risks; and
- groups of similarly compensated individuals who, in aggregate, can take or influence material risks.

Incentive compensation arrangements for all covered employees should be appropriately balanced, regardless of whether the covered employee is a senior executive, an individual, or part of a group of similarly compensated individuals. Though the Federal Reserve has no target number or quota of covered employees for any firm, many of the largest firms have determined they have thousands or tens of thousands of covered employees.

Standard Approaches to Covered Employee Identification

Firms follow one of two general approaches to identify covered employees. One approach involves developing and following a systematic process that identifies types of risk that each employee (or group of employees) takes or influences and that assesses the materiality of the risks. Such a process should "cast a wide net" and should consider the full range of types and severities of risk. Some firms have invested in enhanced information systems to facilitate this process. Many firms in the horizontal review follow this approach.

The second approach designates a very large set of employees as covered, such as all employees receiving any incentive compensation, or all employees subject to a subset of the firm's incentive compensation plans. Although this reduces the effort required to identify covered employees, firms still need to identify the relevant types and severities of risks that are incentivized through incentive compensation arrangements to be sure incentives to take such risks are balanced.

Many firms appropriately identify at least some groups of similarly compensated employees who may collectively expose the firm to material risk. Examples include originators of mortgages, commercial lending officers, or groups of traders subject to similar incentive compensation arrangements.

Establishing Robust Processes Going Forward

Several firms have yet to establish robust processes for identifying covered employees that are consistent with the interagency guidance, especially for identifying groups of covered employees. Some firms rely heavily on mechanical materiality thresholds in their identification process. For example, only employees able to make decisions that commit at least $1 billion of the firm's economic capital might be eligible for consideration as covered employees, or only employees above a given level of total compensation. Such materiality thresholds as applied by most firms to exclude employees from being considered covered employees have three common weaknesses: (1) they often fail to capture the full extent to which an employee may expose the firm to risk, (2) they tend to exclude potential covered employees who may significantly influence risk taking but do not make final risk decisions, and (3) they often ignore groups of similarly compensated employees. In reviewing the firms' use of thresholds, we found that under some circumstances, a suitably chosen materiality threshold could appropriately play a complementary role in identifying covered employees if used to include employees as covered employees.

FBOs with U.S. operations that were part of the horizontal review face special challenges in developing procedures for identifying covered employees for purposes of the interagency guidance. Generally, home-country supervisors expect their standards to be met by the consolidated organization, and so in its

U.S. operations, an FBO must meet both home-country and U.S. regulatory expectations. Many of these firms have home-country supervisors whose regulations focus on a more limited set of employees than described in the interagency guidance.[17] As a result, these firms need to develop processes to identify both covered employees in their U.S. operations for application of the interagency guidance and those employees subject to home-country regulation. The number of covered employees for purposes of the interagency guidance in U.S. operations of an FBO may exceed the number of employees subject to home-country regulation.

Next Steps

All firms in the horizontal review now recognize the importance of establishing sound incentive compensation programs that do not encourage imprudent risk taking for those employees who can individually affect the risk profile of the firm. In addition, many firms have identified groups of similarly compensated employees whose combined actions may expose the organization to material amounts of risk. Some firms have put in place a robust process for identifying relevant individuals and groups of employees, with the flexibility to adapt to the changing business environment over time. However, some firms are still working to identify a complete set of mid- and lower-level employees, and others are working to ensure their process is sufficiently robust. The Federal Reserve will work with the firms to ensure that progress continues.

[17] Supervisors in many other jurisdictions require their firms to identify only their equivalent of individual covered employees, often using materiality standards that restrict attention to a relatively small number of individuals.

Risk Management, Controls, and Corporate Governance

Establishment of balanced risk-taking incentives should be supported by the engagement of risk-management and control personnel in the design and implementation of incentive compensation arrangements, incentive compensation for such personnel that is independent of the financial performance of the businesses they oversee (in order to limit conflicts of interest), practices to promote improvements in the reliability and effectiveness of incentive compensation systems over time, and improvements in corporate governance. These features are discussed in topics 5 through 8 below.

Topic 5: Risk-Management and Control Personnel and the Design of Incentive Arrangements

Properly identifying risks attendant to employees' activities and setting suitable balancing mechanisms are critical elements of providing balanced risk-taking incentives. The interagency guidance notes that risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements. Risk-management and control personnel (including Internal Audit) should be involved in the design, operation, and monitoring of incentive compensation arrangements because their skills and expertise provide essential perspective and support. Risk-management staff, in particular, should participate in the firm's analysis and decisionmaking regarding the identification of covered employees, the selection of any risk-sensitive performance metrics, the development of risk-adjustment methodologies and vesting triggers, and the overall effectiveness of the firm's balancing efforts.

At all firms in the horizontal review, certain functions, such as human resources and finance, traditionally were involved in incentive compensation decisions and in the design and implementation of incentive compensation arrangements. However, this role traditionally involved little or no focus on incentives to take risk or the risk associated with the employee's activities. Risk-management personnel traditionally had relatively little involvement in incentive compensation design, and their involvement in decisionmaking was often limited, for example, to only supplying information about breaches of internal policy and procedure by individual employees or units. However, a few firms did incorporate risk measures produced by risk-management personnel into financial performance measures used in incentive compensation decisionmaking before the crisis.

Increased Involvement of Risk-Management Personnel in Design and Decisionmaking

Risk-management personnel are now involved in incentive compensation system design and decisionmaking at virtually all firms in the horizontal review. However, the intensity and nature of involvement varies. For example, risk-management functions now provide significant risk-related input to the board-level decisionmaking process for individual senior executive incentive compensation at all firms and for bonus pool size decisions at firms at which pools play a role. Most firms consider some quantitative risk measures in making at least some incentive compensation decisions; and these are usually provided by the risk and finance functions. Nonetheless, at some firms, risk experts primarily play a peripheral or informal role

Control, finance, and risk-management staff members provide some input to individual employee performance reviews at many firms. For example, they report breaches of policy and procedure or rate the "risk awareness" or adherence to the firm's risk appetite of individual employees or business units. At firms that use committee structures in their incentive compensation decisionmaking process, control, finance, or risk-management personnel usually are among the members of committees. At most firms in the horizontal review, risk-management and control functions are also involved in identification of covered employees.

At firms where risk-management personnel are intensely involved in basic design decisions for the incentive compensation system, as well as in determining details of the risk-related elements of the incentive compensation process overall, progress on risk-taking incentives has tended to be faster. At firms where risk experts play a peripheral, informal role, progress has tended to be slower, primarily because other personnel tend to have less experience and expertise in designing risk identification and measurement features. Several firms remain in the latter category.

Next Steps

The main challenge going forward is to ensure that risk-management and control personnel are actively engaged with incentive compensation and that improvements in risk management and in recognition of risks the firm takes are incorporated into incentive compensation decisionmaking. The Federal Reserve will continue to work with firms to ensure that such personnel have an appropriate role.

Topic 6: Incentive Compensation Arrangements for Staff in Risk-Management and Control Roles

Improper incentive compensation arrangements can compromise the independence of staff in risk-management and control roles. For example, a conflict of interest is created if the performance measures applied to them, or the bonus pool from which their awards are drawn, depend substantially on the financial results of the lines of business or business activities that such staff oversee. Such dependence can give staff an incentive to allow or foster risk taking that is inconsistent with the firm's risk-management policies and control framework or the safety and soundness of the firm. Thus, risk-management and control personnel should be compensated in a way that makes their incentives independent of the lines of business whose risk taking and incentive compensation they monitor and control. Such staff includes not only employees assigned to firmwide risk-management or control functions, but also employees who perform similar roles while embedded within individual lines of business within the firm.

Maintaining the Independence of Risk-Management and Control Personnel

The firms in the horizontal review have completed much of the necessary work in this area. Performance measures applied to staff in risk-management and control roles are usually oriented to the performance of their oversight duties and not the performance of the line of business they oversee. Their incentive compensation may be indirectly related to financial performance, if, for example, the bonus pool is drawn from the firmwide pool, which is related to firmwide performance. In most cases, linkage to firmwide performance is likely to be too weakly linked to control and risk-management decisions to pose a significant conflict of interest.

Where more direct or substantial potential conflicts of interest have arisen, some firms achieved independence by moving risk-management and control function personnel out of line-of-business incentive compensation plans or line-of-business bonus pools, establishing separate plans or pools for them. Other firms established separate bonus pools for staff in risk-management and control roles, the sizes of which do not depend directly on the financial performance of a particular line of business or business activity.

At some firms, lower-level risk-management or control staff members who are embedded in business lines receive their incentive compensation awards from the business line bonus pool. Such practices can be acceptable if the relevant staff members perform functions that are unrelated to risk-taking decisions and if the product of their work is unrelated to incentive compensation decisionmaking.

Some firms include comments from cross-function reviews (such as 360 degree reviews) in incentive compensation decisionmaking for all staff members. This raises the possibility that business line reviews could influence incentive compensation decisions for risk-management and control staff members even if no formal link to financial performance exists. In addition, some firms have incentive compensation arrangements for staff in risk-management and control functions that are subject to adjustments based on management judgment. Clear guidance from policies and procedures, clear documentation of individual judgment-based adjustments (and decisions made under such policies and procedures), and review by internal audit help to ensure the incentive compensation awards are not swayed by business line results.

Next Steps

As part of its normal supervision of the independence of risk and control functions, the Federal Reserve will continue to be attentive to the risk-related incentives provided by the incentive compensation arrangements for their personnel.

Topic 7: Practices Promoting Reliability

Firms should regularly review whether the design and implementation of their incentive compensation systems deliver appropriate risk-taking incentives and should correct deficiencies and make improvements that are suggested by the findings. The interagency guidance mentions several practices that can contribute to the effectiveness of such activity, including internal reviews and audits of compliance with policies and procedures, monitoring of results relative to expectations, and simulation of the operation of incentive compensation arrangements before implementation.

Importance of Internal Reviews and Audits

Internal reviews and audits of compliance with policies and procedures are important to ensure that the incentive compensation system is implemented as intended by those employees involved in incentive compensation decisionmaking. For example, if procedures require that specific quantitative measures of risk are to be included in financial performance measures used in decisionmaking, but they are not, the sensitivity of decisions to risk taking probably would not be as intended. Though the internal audit function should play a key role in this activity, other functions such as risk management, finance, and human resources also should be involved.

An incentive compensation system may be implemented as intended, but it may still fail to achieve the desired relationship between risk and reward because features of its design and operation do not work out as expected. Detecting such problems requires that a firm monitor relationships among measures of short- and long-run financial performance, amounts of incentive compensation awards, measures of risk and risk outcomes, amounts of ultimate payments of deferred incentive compensation, and other factors relevant to incentive compensation decisions. Such monitoring bears some resemblance to the "backtesting" that is often done for risk-management models and systems. To be effective, such monitoring should include some quantitative analysis, but because all incentive compensation systems involve some exercise of human judgment in decisionmaking, effective monitoring is not likely to be purely quantitative or mechanical. Large banking organizations are more likely to require some use of automated systems to adequately monitor the effectiveness of incentive compensation arrangements in balancing risk-taking incentives, especially systems that support capture of relevant data in databases that support monitoring and analysis.

Next Steps

All organizations in the horizontal review have considerable work remaining to fully implement practices promoting balanced risk incentives in their incentive compensation arrangements. Few organizations performed extensive reviews and analyses related to risk-taking incentives before the crisis. In some cases internal audit reviewed other aspects of incentive compensation activities, such as incentive compensation award disbursement practices or adherence to vesting policies related to time-of-service.

Over time, as incentive compensation is awarded and paid out and risk outcomes become better known, firms and their supervisors will learn more about the reliability of methods for balancing risk-taking incentives and the effectiveness of different methods of assessing reliability. In the meantime, the Federal Reserve will work with firms as they develop the necessary systems and capabilities and will promote experimentation and innovation.

Topic 8: Strong Corporate Governance

Active and effective oversight of incentive compensation practices by the board of directors is a key element of the interagency guidance. The board of directors of a large banking organization, or its delegated committee, should actively oversee the development and operation of the organization's incentive compensation policies, systems, and related control processes. The board of directors or the delegated committees of such organizations should also monitor the effectiveness of incentive compensation arrangements in balancing the risk-taking incentives of covered employees.

Most of the firms in the horizontal review already had in place a board-level compensation committee composed of independent directors. While historically these committees have been actively engaged in decisions relating to the incentive compensation arrangements for certain senior executives, their involvement in overseeing the incentive compensation practices and arrangements relating to other covered employees (including non-executives) has increased considerably during the horizontal review. All firms in the horizontal review have enhanced the role of the board in overseeing the incentive compensation system for all covered employees and are now paying increased attention to risk-related aspects of incentive compensation. Some firms have established management committees that include representatives of risk-management and control functions to support their efforts. Notwithstanding progress made to date, firms indicated that they will continue to implement enhanced corporate governance practices and that these practices will continue to evolve.

Progress in Facilitating Effective Internal Communications

Most firms have established mechanisms to facilitate communication between the compensation committee and the risk and audit committees. Many firms have members of the compensation committee that are also members of the risk and audit committees. Other firms rely on regular meetings between the compensation and risk committees, while others have not yet enhanced their communications systems and rely on communications that are more ad hoc in nature.

The board of directors or its delegated committee should review and approve policies and procedures that appropriately address corporate standards and processes governing the design, approval, administration, and monitoring of incentive compensation arrangements for covered employees. At some firms in the horizontal review, the relevant body is not yet consistently reviewing and approving these standards.

The board of directors should regularly review the results of monitoring of incentive compensation arrangements described in the previous section and results of other activities undertaken to promote reliability of the incentive compensation system. For example, boards should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting imprudent risk taking. As noted previously, at most firms such reports are at a relatively early stage of development. While some boards undertake an annual review of the effectiveness of incentive compensation in avoiding inappropriate incentives to incur risk, many currently rely on periodic presentations by the chief risk officer or other risk-management staff to the board of directors or its compensation committee, the content of which varies considerably from firm to firm.

Next Steps

Though firms have implemented improved corporate governance practices, the effectiveness of such practices will not be known until some years of experience have been accumulated. Effectiveness will depend on the attentiveness of members of compensation committees to risk-taking incentives. The Federal Reserve will continue to work to promote effective governance of incentive compensation practices at banking organizations.

International Context

Some observers have been interested in comparing progress of firms headquartered in different jurisdictions in improving their incentive compensation practices, for example, in progress relative to the FSB *Principles* and *Implementation Standards.*

About one-third of the large banking organizations included in the horizontal review are headquartered outside the United States. Almost all of the FBOs in the horizontal review are headquartered in Europe (including the United Kingdom). We observed progress in implementing the interagency guidance, which is consistent with the FSB documents, at both U.S. banking organizations and FBOs. However, the interagency guidance, while consistent with the FSB *Principles* and *Implementation Standards*, is more detailed and demanding in many respects. Thus, satisfying the expectations implied by the FSB documents is not necessarily enough to satisfy the expectations in the interagency guidance.

Conformance with Interagency Guidance

In general, progress on conforming to the interagency guidance is similar at the U.S. banking organizations and at the FBOs in the horizontal review. Firms that are more and less far along can be found in both sets of firms. With respect to particular aspects of the guidance, the FBOs have had more difficulty in identifying covered employees in their U.S. operations (as noted previously, few foreign supervisors employ the concept of groups of covered employees, instead focusing their attention on relatively small numbers of senior and highly paid employees). Progress on conforming to the elements of the interagency guidance that focus on corporate governance and the role of risk-management and control personnel is similar at FBOs and U.S. banking organizations.

Progress on achieving balanced incentive compensation arrangements is similar on the whole across the two groups, but the balancing methods employed and the rate of innovation are different between the groups. For risk adjustments, some foreign supervisors have emphasized risk adjustments mainly at the level of firmwide or business line bonus pools. Thus, some FBOs have made progress risk adjusting such pools but have made less progress implementing risk adjustments down to the level of the individual employee.

Some observers have been particularly interested in the details of deferral practices, focusing on the share of incentive compensation awards that is deferred and the use of equity as a vehicle for deferred incentive compensation. Numerical examples of deferral fractions set out in the FSB *Principles* and *Implementation Standards* are sometimes used as a benchmark (60 percent or more for senior executives, 40 percent or more for other individual "material risk takers," which are not the same as covered employees). Deferral fractions are at or above these benchmarks at both the U.S. banking organizations and the FBOs in the horizontal review.

In some cases, substantial deferral fractions are achieved in different ways. As noted previously, most U.S. firms and some FBOs use a cash-stock table that increases the deferral rate as the amount of incentive compensation increases. As a practical matter, this results in substantial deferral rates for senior executives and for some employees. In contrast, as noted previously, some European Union (EU) supervisors prescribe some elements of pay structure for some employees at EU banking organizations. This also results in substantial deferral rates for those employees.

European Union Approach to Deferred Incentive Compensation

In many cases the pay structure under the EU regulation is somewhat different than that seen at U.S. banking organizations. Under some national implementations within the EU, the deferred portion of an incentive compensation award is required to be granted half in an equity-linked instrument and half in cash or a cash-like vehicle. The upfront portion of the incentive compensation award is required to be paid half in cash and half in stock subject to a retention requirement of six months to one year. Though the overall fraction of the incentive compensation award granted in stock is substantial in such implementations, the upfront stock subject to a retention requirement is likely to have a limited balancing impact on risk-taking incentives due to the short retention period. The impact of the deferred portion depends on performance conditions; in the absence of performance conditions, deferred cash will have only a modest balancing impact since the amount ultimately received by the employee is reduced only in the event of the firm's failure.

Overall, the net exposure of an employee to a firm's performance over time is not necessarily larger under the EU regulation than under the simpler structures often seen at U.S. firms. For example, if 60 percent of an incentive compensation award is deferred for three years, half in stock and half in cash that vests unless the firm fails, then only 30 percent of the incentive compensation award is exposed to poor performance short of failure. In contrast, suppose all deferred awards are in stock deferred for three years, as is common in the United States. If the same 60 percent of the incentive compensation award is deferred, the whole 60 percent is exposed to the variation in the value of the stock. If the stock is also subject to effective performance conditions, the whole 60 percent is exposed to the conditions. The details of vesting and other performance conditions are particularly important to the overall balancing impact.

Conclusion

Reinforced by the supervisory activities undertaken through the horizontal review, the large banking organizations in the review have made significant progress toward enhancing their incentive compensation arrangements in ways that provide appropriately balanced incentives to take risks (as outlined in the interagency guidance) and promote safety and soundness. As described in this report, however, most firms still have significant work to do to achieve full conformance with the interagency guidance.

The Federal Reserve remains committed to helping move the industry forward in developing and implementing incentive compensation practices that are consistent with prudent risk management and safety and soundness. Continued supervisory attention will be focused on further refinement and implementation and on making appropriate changes as business conditions change and business strategies evolve.

Questions for The Honorable Jerome H. Powell, Chairman, Boara o1 Governors of the Federal Reserve Bank of the United States, on behalf of Senator Robert Menendez:

In response to my question about the joint agency rulemaking required by Section 956 of Dodd-Frank, you said, "We tried -- we were not able to achieve consensus over a period of many years between the various regulatory agencies that need to sign off on that. But that didn't stop us from acting, you should know. We -- particularly, for the largest institutions, we do expect that they will have in place compensation plans that -- that do not provide incentives for excessive risk-taking. And we expect that the board of directors will make sure that that's the case. And so, it's not something that we haven't done. We've, in fact, moved ahead through supervisory practice to -- to make sure that these things are better than they were and they're substantially better than they were. You see much better compensation practices here, focusing mainly on the big firms where the problem really was."[16]

Your response suggests that the relevant agencies have ceased work on this rulemaking.

- Is that correct?
- Please provide a detailed explanation of how the Federal Reserve is either limiting or prohibiting incentive-based compensation practices that encourage excessive risk-taking through supervision.
- Please provide any guidance issued to regulated institutions or materials provided to bank examiners on incentive-based compensation practices.
- What metrics, thresholds, and standards is the Federal Reserve using to evaluate incentive-based compensation practices?
- Which institutions are subject to the Federal Reserve's supervision of incentive-based compensation practices?
- Were those institutions selected for supervision by asset size or some other factor?
- If there is no rule clearly delineating prohibited practices, how are you ensuring consistency across regulated institutions?

Many economists, including President Trump's Chair of the Council of Economic Advisers, have long advocated for less restrictive immigration policies to help grow the U.S. labor force, especially in light of an aging population and low birth rate. According to the Pew Research

[16] https://plus.cq.com/doc/congressionaltranscripts-5358712?4

Center, without a steady stream of a total of 18 million immigrants between now and 2035, the share of the U.S. working-age population could decrease to 166 million.17

- What repercussions would restrictive immigration policies have on our workforce and economy?

[17] http://www.pewresearch.org/fact-tank/2017/03/08/immigration-projected-to-drive-growth-in-u-s-working-age-population-through-at-least-2035/

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 18, 2018

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Tillis</u>:

1. Chairman Powell, I'd like to turn to S.2155 implementation. Many of us are hoping that you and Vice Chairman Quarles will be taking a robust role in crafting the rules to implement the newly enacted law. What role are you currently playing in the implementation of S. 2155?

The Federal Reserve Board (Board) is working in an expeditious manner to implement the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). The Board has a well-established governance process for implementing rulemakings and ensuring that such rulemakings are compliant with the law, including statutory deadlines set by Congress. Draft rulemakings are carefully reviewed and considered by the Board's Committee on Supervision and Regulation, which is chaired by Vice Chairman Quarles. I meet with staff on a regular basis to discuss regulatory proposals and provide direction. The Committee's proposals for amendments to the Board's regulations are finalized only after a vote by the full Board of Governors.

2. Many of your staff are the same staff that helped write the implementing rules for the Dodd-Frank Act. In some sense, the new law mandates they revise their own prior work. From experience, I would say that such a mandate will take robust oversight on your part and on our part—do you agree? Can you give us some insight into how you and Vice Chair Quarles are managing these workstreams and orchestrating the workstreams?

As I mentioned above, the Board is working in an expeditious manner to implement the recently enacted EGRRCPA. The highest priority of the Federal Reserve is to implement the laws that we have been entrusted to administer and to work to protect and enhance the safety and soundness of financial firms and the financial stability of the U.S. financial system. The Board has a well-established governance process for implementing rulemakings and ensuring that such rulemakings are compliant with the law. I meet with staff on a regular basis to discuss regulatory proposals and provide direction. Of course, Vice Chairman Quarles has a statutory obligation to develop policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other firms we supervise. He is actively involved in the development of proposals to implement EGRRCPA from the initial design through finalization.

I would also note that, in general, Board staff regularly revisits, revises, and tailors previously approved rulemakings. Through the rule implementation process, the Board receives feedback from affected banking organizations and other interested parties. The Board also learns from the experience of the on-the-ground Reserve Bank examiners. Because of this continuous dialogue, the Board may conclude that aspects of a regulation require amendment or streamlining.

3. One area where I would hope that congressional intent is followed is with respect to the SIFI threshold in Section 401 of the bill. My view is that all banks under $250 billion in assets are out of the enhanced prudential standards and that those above $250B are able to take advantage of the mandated robust tailoring so that the larger regional banks are not

treated like the money center banks and that we are taking business model and risk into account when applying enhanced regulations. Is this your view?

Section 401 of the EGRRCPA raised the threshold for automatic application of enhanced prudential standards for bank holding companies from $50 billion to $250 billion in total consolidated assets. Under this section, the Board has the discretion to apply enhanced prudential standards to bank holding companies with total consolidated assets between $100 billion and $250 billion, based on consideration of various factors, such as capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Board deems appropriate.

The core reforms put in place after the financial crisis -- stronger capital and liquidity requirements, stress testing, and resolution planning -- have made our financial system more resilient. Firms with assets of $100 billion or more can present a range of safety and soundness and financial stability concerns, depending on their risks and systemic profile. These concerns typically increase for firms with assets of $250 billion or more. Therefore, the Board has tailored, and will work to continue to appropriately tailor, our regulations to the risk profiles of the firms subject to those regulations.

The Board is carefully considering the statutory criteria under the EGRRCPA for determining which enhanced prudential standards should continue to apply to firms with $100 billion to $250 billion in total consolidated assets. The Board is also evaluating whether any changes to the enhanced prudential standards applicable to bank holding companies with more than $250 billion in total consolidated assets are appropriate.

Board staff have begun working on proposals to amend these aspects of our rules and we look forward to hearing feedback through the public notice and comment process in the coming months.

4. I also expect the agencies to take a look at all of the regulations where they used $50 billion as the asset threshold for application, including those outside of DFA Section 165, and raise the number accordingly. What are your thoughts?

As part of its implementation of EGRRCPA, the Board is considering which of its regulations require changes given the amended applicability thresholds in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), including section 165, as well as section 11 of the Federal Reserve Act. In addition, in light of EGRRCPA's amendments to section 165 and consistent with the Board's ongoing refinement and evaluation of its supervisory program, the Board is evaluating whether any other changes to the prudential standards applicable to large banking organizations are appropriate.

The Board's capital plan rule utilizes a $50 billion asset threshold and was not affected by the changes made to section 165. Per the Board's public statement on July 6, 2018, the Board will not take action to require bank holding companies with total consolidated assets greater than or equal to $50 billion but less than $100 billion to comply with the capital plan rule.

5. Chairman Powell, the Federal Reserve and the Office of Financial Research have studied systemic risk and have determined that banks under $250BB do not pose a

systemic risk and Congress passed and the President signed S. 2155 to raise the threshold to $250BB for the application of enhanced prudential standards. I believe that the FED should expeditiously follow this directive and should follow the will of Congress, and not wait 18-months. Will you commit to me that you will direct Fed staff to effectuate this new threshold and then move on to tailoring above the $250BB threshold?

As stated above, the core reforms put in place after the financial crisis -- stronger capital and liquidity requirements, stress testing, and resolution planning -- have made our financial system more resilient, and I would not want to see any material weakening of these reforms. The Board has the discretion under the EGRRCPA to apply enhanced prudential standards to firms with total consolidated assets between $100 billion and $250 billion. When doing so, the enacted legislation requires us to consider various factors, such as capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Board deems appropriate.

The Board is carefully considering the statutory criteria under the EGRRCPA and is evaluating whether any changes to the enhanced prudential standards applicable to bank holding companies with more than $250 billion in total consolidated assets are appropriate.

Board staff have begun working on proposals to amend these aspects of our rules and we look forward to hearing feedback through the public notice and comment process in the coming months.

6. The relief in S2155 is not immediate, and without prompt action, the relief will not come until Nov 24, 2018, 18 months after enactment. Do you plan to take action immediately?

There are a number of provisions in EGRRCPA that provided relief immediately upon enactment. The Board, along with the other federal banking agencies, have taken action to address the EGRRCPA changes that took effect immediately. As described in the Board's July 6, 2018, statements, the Board will not take action to enforce existing regulatory and reporting requirements in a manner inconsistent with EGRRCPA. For example, the Board will not take action to require bank holding companies with less than $100 billion in total consolidated assets to comply with certain existing regulatory requirements. These requirements include the enhanced prudential standards in the Board's Regulation YY, the liquidity coverage ratio requirements in the Board's Regulation WW, and the capital planning requirements in the Board's Regulation Y. The Board's statement and interagency statements also discuss other changes that took effect upon enactment and the interim positions that will be taken until the relevant regulations are amended to conform with EGRRCPA, including the treatment of high volatility commercial real estate exposures and certain municipal securities in the context of liquidity regulations.

EGRRCPA also raised the threshold for automatic application of enhanced prudential standards for bank holding companies from $50 billion to $250 billion in total consolidated assets. Under this section, the Board has the discretion within 18 months of enactment to apply enhanced prudential standards to bank holding companies with total consolidated assets between $100 billion and $250 billion based on consideration of various factors. The Board is carefully considering the statutory criteria under the EGRRCPA for determining which enhanced prudential standards should continue to apply to firms with $100 billion to $250 billion in total consolidated assets.

In addition, in light of EGRRCPA's amendments, and consistent with the Board's ongoing refinement and evaluation of its supervisory program, the Board is evaluating whether any changes to the enhanced prudential standards applicable to bank holding companies with more than $250 billion in total consolidated assets are appropriate.

Board staff have begun working on proposals to amend these aspects of our rules and we look forward to hearing feedback through the public notice and comment process in the coming months.

Committee on Banking, Housing, and Urban Affa
The Semiannual Monetary Policy Report to the Con
July 17, 2018

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Senator Thom Tillis:</u>

- Chairman Powell, I'd like to turn to S.2155 implementation. Many of us are hoping that you and Vice Chairman Quarles will be taking a robust role in crafting the rules to implement the newly enacted law. What role are you currently playing in the implementation of S. 2155?

- Many of your staff are the same staff that helped write the implementing rules for the Dodd-Frank Act. In some sense, the new law mandates they revise their own prior work. From experience, I would say that such a mandate will take robust oversight on your part and on our part—do you agree? Can you give us some insight into how you and Vice Chair Quarles are managing these workstreams and orchestrating the workstreams?

- One area where I would hope that congressional intent is followed is with respect to the SIFI threshold in Section 401 of the bill. My view is that all banks under $250 billion in assets are out of the enhanced prudential standards and that those above $250B are able to take advantage of the mandated robust tailoring so that the larger regional banks are not treated like the money center banks and that we are taking business model and risk into account when applying enhanced regulations. Is this your view?

- I also expect the agencies to take a look at all of the regulations where they used $50 billion as the asset threshold for application, including those outside of DFA Section 165, and raise the number accordingly. What are your thoughts?

- Chairman Powell, the Federal Reserve and the Office of Financial Research have studied systemic risk and have determined that banks under $250BB do not pose a systemic risk and Congress passed and the President signed S. 2155 to raise the threshold to $250BB for the application of enhanced prudential standards. I believe that the FED should expeditiously follow this directive and should follow the will of Congress, and not wait 18-months. Will you commit to me that you will direct Fed staff to effectuate this new threshold and then move on to tailoring above the $250BB threshold?

- The relief in S2155 is not immediate, and without prompt action, the relief will not come until Nov 24, 2018, 18 months after enactment. Do you plan to take action immediately?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 6, 2018

The Honorable Tom Cotton
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 1 that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. On August 20, 2018, I provided response to question 2. Copies of all responses have also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Cotton</u>:

1. ***International Organizations***

Background. The Federal Reserve has membership in several international standard-setting bodies. Among them are the Bank for International Settlements (BIS) and the Financial Stability Board (FSB). These standard-setting bodies provide opportunities to push U.S. interests and greater regulatory harmonization globally. The level of participation by the Federal Reserve going forward is unclear. The question is intended to give Chairman Powell an opportunity to describe his vision for the Federal Reserve's participation in these international organizations.

Chairman Powell, the Federal Reserve has traditionally played an important and active role in international standard-setting bodies such as the Bank for International Settlements (BIS) and the Financial Stability Board (FSB). This has been important for both representing the interests of the United States and promoting policies that benefit the global financial system. In the Treasury Department's first report to the President on financial regulatory reform, it advocated for robust U.S. engagement in international financial regulatory standard-setting bodies as a way to "promote financial stability, level the playing field for U.S. financial institutions, prevent unnecessary regulatory standard-setting that could stifle financial innovation, and assure the competitiveness of U.S. companies and markets...." The Treasury Department recommended in its report that U.S. regulators advocate for international regulatory standards that are aligned with U.S. interests.

a. As Chairman, what will be your top priorities when representing the United States in international standard-setting bodies such as BIS and FSB?

One of our top priorities in international standard setting bodies is to consolidate the financial reform gains we have achieved globally. These include a responsible increase in bank capital standards, introduction of liquidity standards, recovery and resolution planning for the most globally active and systematically important banks, and mandates to increase incentives for financial firms to centrally clear derivatives. As we get further from the financial crisis, it will become easier to forget the reasons for which we took actions to strengthen significantly the prudential framework for banks and global financial stability. Therefore, it is important that the United States, with its large number of globally active financial firms, continue to play a central role in re-enforcing this message at the international level.

At the same time, we believe now is an appropriate time to evaluate the reforms to ensure that they are working as efficiently and effectively as they can and do not give rise to adverse incentives. The evaluation work, already underway, may lead us to adjust various standards to achieve these objectives while maintaining the strength and resiliency of the system.

b. Can you describe the work you hope to accomplish or new initiatives you hope to pursue in BIS, FSB and other relevant international standard-setting bodies?

One priority is to finalize the bank capital framework for trading activities. Strong standards are necessary for these activities as trading activities facilitated many of the riskier bank practices that led to the crisis. At the same time, it is important to ensure that these standards are well-crafted in order to avoid adverse effects on market liquidity. The international standard-setters are also working to build up financial firms' resiliency to operational risks, including those emanating from cyber risks. These risks are some of the most important risks that financial firms face today. These international efforts are aimed at ensuring that we have common terminology to discuss these risks and have a common set of expectations for firms' resiliency in the face of operational risk incidents.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

August 20, 2018

The Honorable Tom Cotton
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 2 that you submitted following the July 17, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 25, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Cotton</u>:

2. *<u>EU</u>*

Background. Legislative bodies in Europe are considering draft revisions to the European Market Infrastructure Regulation (EMIR) that would bring U.S.-based and other third-country central counterparties (CCPs) under the regulation and supervision of the EU for the first time. The proposed changes would expand the European Securities and Markets Authority's (ESMA) and the European System of Central Banks' supervisory authority over third-country CCPs, including U.S. CCPs, that are recognized to do business in Europe. EMIR's stated purpose for making these changes is to address the potential risks that third-country CCPs could pose to the EU's financial system. These changes could also reopen a 2016 equivalence agreement for derivatives clearinghouse supervision between the CFTC and the EU authorities. CFTC Chairman Giancarlo has expressed significant concerns regarding the potential impact this proposed legislation could have on U.S. CCPs. In recent testimony before the U.S. Senate Agriculture Committee, Chairman Giancarlo stated that "regulatory and supervisory deference needs to remain the key principle underpinning cross border supervision of CCPs. Deference continues to be the right approach to ensure that oversight over these global markets is effective and robust without fragmenting markets and trading activity." The question is intended to determine how Chairman Powell's intends to address this issue and whether his views align with that of other U.S. regulators.

The European Union is considering legislation that, for the first time, would permit EU regulators, including the European Central Banks, to directly supervise systemically important U.S.-based and other third-country CCPs, including U.S. CCPs in the securities and derivatives markets. This approach itself could pose risks and potentially interfere with the Federal Reserve's ability to ensure its policies are being effectuated without interference by EU supervisors. The U.S. Congress and regulators have chosen to not take this approach and instead adhere to the long-standing principal of regulatory deference.

- **How do you plan to address this situation as Chair?**

- **The proposed legislation (EMIR 2.2) would subject U.S. CCPs to overlapping EU regulation and supervision without deferring to U.S. regulators that oversee these entities; namely, the Federal Reserve, SEC, and CFTC. Do you share CFTC Chairman Giancarlo's concerns about this proposal? If so, are you coordinated in your position and messaging to the EU?**

The U.S. central counterparties (CCPs) that may potentially fall within the scope of the proposed European Union (EU) legislation to amend the European Market Infrastructure Regulation include those designated as systemically important financial market utilities (DFMUs) by the Financial Stability Oversight Council under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Commodity Futures Trading Commission and the Securities and Exchange Commission are the supervisory agencies with primary responsibility for supervising and regulating these firms. The Federal Reserve Board (Board) plays a secondary role in the oversight of these CCPs under Title VIII of the Dodd-Frank Act. The proposed EU legislation has more direct implications for the primary supervisors of these firms, and those agencies are actively involved in a dialogue with EU authorities. To date, Board staff has worked to educate EU authorities on the legal framework created by Title VIII, explained the nature of the Board's role in the oversight of DFMUs, pointed out differences considered in the proposed EU legislation, and expressed support for cooperation among authorities.

The Board has a long-standing policy objective to foster the safety and efficiency of payment, clearing, and settlement systems and to promote financial stability, more broadly.[1] In that policy, the Board has set out its views, and related standards, regarding the management of risks that financial market infrastructures, including CCPs, present to the financial system and the Federal Reserve Banks. It has also described how it will engage cooperatively with authorities with direct responsibility for particular CCPs located outside of the United States.

As a central bank, the Federal Reserve has a particular interest in liquidity issues. As far as liquidity risks are concerned, it is immaterial whether a CCP is based in the United States or abroad so long as it clears U.S. dollar denominated assets and makes and receives U.S. dollar payments. The current EU legislative proposal outlines that the European Commission, in consultation with the European Securities and Markets Authority and the relevant EU member central bank, may determine a third country CCP to be of such systemic importance to the EU that the only way to mitigate the risks posed would be for that CCP to establish its clearing business within the EU. This aspect of the proposed legislation presents a risk of splintering central clearing by currency area, which could fragment liquidity and reduce netting opportunities. Given the extensive cross-border nature of the firms potentially covered by the proposed EU legislation, we support the EU and U.S. authorities' efforts to search for cooperative solutions to these issues that promote CCP resilience while upholding the aims of both U.S. and international authorities.

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[1] See, Federal Reserve Policy on Payment System Risk: https://www.federalreserve.gov/paymentsystems/files/psr_policy.pdf.

Committee on Banking, Housing, and Urban Aff&
The Semiannual Monetary Policy Report to the Con&
July 17, 2018

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve Bank of the United States, on behalf of Senator Tom Cotton:

1 ***International Organizations***

Background. The Federal Reserve has membership in several international standard-setting bodies. Among them are the Bank for International Settlements (BIS) and the Financial Stability Board (FSB). These standard-setting bodies provide opportunities to push U.S. interests and greater regulatory harmonization globally. The level of participation by the Federal Reserve going forward is unclear. The question is intended to give Chairman Powell an opportunity to describe his vision for the Federal Reserve's participation in these international organizations.

Chairman Powell, the Federal Reserve has traditionally played an important and active role in international standard-setting bodies such as the Bank for International Settlements (BIS) and the Financial Stability Board (FSB). This has been important for both representing the interests of the United States and promoting policies that benefit the global financial system. In the Treasury Department's first report to the President on financial regulatory reform, it advocated for robust U.S. engagement in international financial regulatory standard-setting bodies as a way to "promote financial stability, level the playing field for U.S. financial institutions, prevent unnecessary regulatory standard-setting that could stifle financial innovation, and assure the competitiveness of U.S. companies and markets...." The Treasury Department recommended in its report that U.S. regulators advocate for international regulatory standards that are aligned with U.S. interests.

a • As Chairman, what will be your top priorities when representing the United States in international standard-setting bodies such as BIS and FSB?

b • Can you describe the work you hope to accomplish or new initiatives you hope to pursue in BIS, FSB and other relevant international standard-setting bodies?

2 ***EU***

Background. Legislative bodies in Europe are considering draft revisions to the European Market Infrastructure Regulation (EMIR) that would bring U.S.-based and other third-country central counterparties (CCPs) under the regulation and supervision of the EU for the first time. The proposed changes would expand the European Securities and Markets Authority's (ESMA) and the European System of Central Banks' supervisory authority over third-country CCPs, including U.S. CCPs, that are recognized to do business in Europe. EMIR's stated purpose for making these changes is to address the potential risks that third-country CCPs could pose to the EU's financial system. These changes could also reopen a 2016 equivalence agreement for derivatives clearinghouse supervision between the CFTC and the EU authorities. CFTC Chairman Giancarlo has expressed significant concerns regarding the potential impact this proposed legislation could have on U.S. CCPs. In recent testimony before the U.S. Senate Agriculture Committee, Chairman Giancarlo stated that "regulatory and supervisory deference needs to remain the key principle underpinning cross border supervision of CCPs. Deference continues to be the right approach to ensure that oversight over these global markets is effective and robust without fragmenting markets and trading activity." The question is intended to determine how Chairman Powell's intends to address this issue and whether his views align with that of other U.S. regulators.

The European Union is considering legislation that, for the first time, would permit EU regulators, including the European Central Banks, to directly supervise systemically important U.S.-based and other third-country CCPs, including U.S. CCPs in the securities and derivatives markets. This approach itself could pose risks and potentially interfere with the Federal Reserve's ability to ensure its policies are being effectuated without interference by EU supervisors. The U.S. Congress and regulators have chosen to not take this approach and instead adhere to the long-standing principal of regulatory deference.

a
- How do you plan to address this situation as Chair?

b
- The proposed legislation (EMIR 2.2) would subject U.S. CCPs to overlapping EU regulation and supervision without deferring to U.S. regulators that oversee these entities; namely, the Federal Reserve, SEC, and CFTC. Do you share CFTC Chairman Giancarlo's concerns about this proposal? If so, are you coordinated in your position and messaging to the EU?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 5, 2018

The Honorable Bill Huizenga
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the question that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. A copy of my response has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 28, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Representative Huizenga:

1. When the GSIB surcharge was finalized in 2015, the FRB recognized that the GSIB surcharge "may be affected by economic growth that does not represent an increase in systemic risk." Accordingly, the FRB committed, "[t]o ensure changes in economic growth do not unduly affect firms' systemic risk scores, the Board will periodically review the coefficients and make adjustments as appropriate." Do you continue to believe, as you have testified, that the United States has experienced significant economic growth in recent years? Accordingly, is the FRB monitoring and prepared to update the requirement accordingly?

The Federal Reserve Board's (Board) capital rules have been designed to significantly reduce the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure were it to occur. Capital rules and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle, credit availability and economic growth. Consistent with these principles, the Board originally calibrated the GSIB surcharge so that—given the circumstances of the financial system—each GSIB would hold enough capital to lower its probability of failure so that the expected impact of its failure on the financial system would be approximately equal to that of a large non-GSIB.

The bulk of post-crisis regulation is largely complete, with the important exception of the U.S. implementation of the recently concluded Basel Committee agreement on bank capital standards. It is therefore a natural and appropriate time to step back and assess those efforts. The Board is conducting a comprehensive review of the regulations in the core areas of post-crisis reform, including capital, stress testing, liquidity, and resolution. The objective of this review is to consider the effect of those regulatory frameworks on the resiliency of the financial system, including improvements in the resolvability of banking organizations, and on credit availability and economic growth.

In general, I believe overall capital for our largest banking organizations is at about the right level. Critical elements of our capital structure for these organizations include stress testing, the stress capital buffer, and the enhanced supplementary ratio. Work is underway to finalize the calibration of these fundamental building blocks, all of which form part of the system in which the GSIB surcharge has an effect. In this regard, I would note that the GSIB surcharge rule does not take full effect until January 2019.

QUESTIONS OF REP. BILL HUIZENGA

House Financial Services Committee
Hearing on Monetary Policy and the State of the Economy
July 18, 2018

1. When the GSIB surcharge was finalized in 2015, the FRB recognized that the GSIB surcharge "may be affected by economic growth that does not represent an increase in systemic risk." Accordingly, the FRB committed, "[t]o ensure changes in economic growth do not unduly affect firms' systemic risk scores, the Board will periodically review the coefficients and make adjustments as appropriate." Do you continue to believe, as you have testified, that the United States has experienced significant economic growth in recent years? Accordingly, is the FRB monitoring and prepared to update the requirement accordingly?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

November 13, 2018

The Honorable Brad Sherman
United States House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 5, 7, and 8 of the questions that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. On September 28, 2018, I provided responses to questions 1 through 4, 6, and 9 through 11. Copies of all responses have also been forwarded to the Committee for inclusion in the hearing record. This submission constitutes the completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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[1] Questions for the record related to this hearing were received on August 28, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Representative Sherman:</u>

5. What effect do you think the President's trade policies will have on the economy?

As you know, trade policy is the responsibility of Congress and the Administration. The Federal Reserve's statutory mandate is to formulate monetary policy to achieve price stability and maximum sustainable employment.

In general, trade and access to global markets provide many benefits for businesses and the people they employ, including larger and deeper markets for their products and a wider selection of inputs for production. Consumers also benefit through a greater variety of goods and more competitive prices. That said, the benefits of trade are not shared equally by all people and all sectors of the economy. Policymakers and economists alike are increasingly cognizant of the need to design policies to support workers and families so that the benefits of trade can be more widely shared.

In pursuit of our statutory objectives, we monitor the effects of various developments, including trade policy, on the economy. Tariff increases, by both the United States and other countries, have already affected individual businesses and industries. Although the direct effects of announced measures on the overall U.S. economy are likely to be fairly modest, there is a possibility that trade tensions could disrupt supply chains and undermine business confidence. As indicated in the Federal Open Market Committee's (FOMC or Committee) minutes and the Beige Book, our business contacts increasingly report that trade policy developments are raising input costs and creating policy uncertainty, which is causing some firms to delay investments.

The Administration's current trade policy process is still ongoing. If the end result is a world with higher tariffs in many countries, then experience suggests there will be significant negative effects for the U.S. economy. On the other hand, if the end result is a world with lower trade barriers and a more level playing field, then the U.S. economy will benefit.

7. How concerned are you about the danger of a crisis in emerging market economies with their currencies losing value and with the Federal Open Market Committee raising rates? How concerned are you about risks of contagion to the United States if there is a crisis in emerging market economies?

Emerging market countries are an important part of the global economy, accounting for about half of U.S. trade and over half of global economic growth. Accordingly, developments in emerging markets matter for the U.S. economy.

The Federal Reserve adjusts its policy to achieve its congressionally mandated objectives of price stability and maximum employment in the United States. Rising U.S. interest rates largely reflect the strength of the U.S. economy, which is good news for the rest of the world, and emerging markets are no exception.

Higher U.S. interest rates and a rising dollar may exert some financial pressure on emerging markets, especially those that have borrowed considerably in U.S. dollars. Only a few emerging market economies have faced substantial financial distress this year, and those are countries with particular vulnerabilities, such as high debt, current account deficits, and inflation. Still, we continue to monitor emerging market developments, as more-widespread economic difficulties could lead to heightened volatility in global financial markets and reduce demand for U.S. exports.

The Federal Reserve strives to communicate its thinking about monetary policy as clearly and transparently as possible, which should limit the likelihood of market overreaction to its decisions. We have signaled for some time that we expect to raise interest rates only gradually as the U.S. economy strengthens. Ultimately, sustaining the economic expansion and domestic financial stability will help support prosperity and growth abroad as well.

8. How will diverging rate paths between the United States and the European Union play out? Is there anything in the data that suggests rising inflation will become a significant issue?

The Federal Reserve's monetary policy is focused on our congressionally mandated objectives of maximum employment and price stability in the United States. In pursuing those objectives, we monitor developments abroad, which can affect U.S. economic activity and inflation through a number of channels. For instance, if the path of foreign interest rates falls short of expectations, that will likely put some upward pressure on the dollar and also could weigh on U.S. long-term bond yields. With those effects offsetting each other to some extent, lower foreign interest rates should have only a marginal impact on the U.S. economy.

Economies vary in terms of their inflation performance and the degree of labor market slack. It should be expected that monetary policy will also vary across economies in response to local conditions. Currently, the U.S. labor market is very strong and U.S. inflation has moved to near 2 percent. In the euro area, the economic recovery continues to be sluggish compared to the United States, and inflation has persisted well below their 2 percent target, so the European Central Bank has only recently begun to signal a gradual reduction in monetary accommodation. The divergence between U.S. and euro-area interest rates has contributed the U.S. dollar's appreciation against the euro.

An appreciating dollar makes our exports more expensive abroad and makes imports more competitive relative to domestic production. All else equal, that circumstance would reduce net exports and be a drag on U.S. economic growth. That said, the underlying strength of demand in the United States, supported by healthy growth in consumption and investment, seems to be sufficiently robust to overcome the drag from a higher dollar.

A strong dollar, which lowers prices for U.S. imports, also tends to restrain U.S. price inflation, whereas tightening resource slack tends to push up inflation. In the United States, inflation has recently moved up to near 2 percent, but, as noted earlier, we have not seen a clear sign of an acceleration above 2 percent, and there does not seem to be an elevated risk of overheating. That said, the Committee monitors inflation developments carefully and sets monetary policy accordingly.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 28, 2018

The Honorable Brad Sherman
United States House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to questions 1 through 4, 6, and 9 through 11 that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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[1] Questions for the record related to this hearing were received on August 28, 2018.

<u>Questions for The Honorable Jerome Powell, Chairman, Board of Governors of the Federal Reserve System from Representative Sherman:</u>

1. Home price and rent growth are driving inflation. Are there measures the Federal Reserve could take to stimulate single family and apartment construction and thereby ease inflation?

The Federal Open Market Committee (FOMC or Committee) monitors the housing market carefully as it is an important sector of the economy. However, monetary policy affects the economy as a whole and cannot be used to stimulate single family and apartment construction in isolation. To the extent that there are supply constraints in the housing sector, addressing them is well beyond the responsibility of the Federal Reserve. Rather, the Federal Reserve aims to promote an economic environment with stable inflation and sustainable economic growth, which helps support investment in all sectors of the economy, including housing.

2. With low unemployment, how does the Federal Reserve plan to curb inflation?

The Federal Reserve conducts monetary policy in order to promote maximum employment and low and stable inflation at the rate of 2 percent per year. While there exists an economic relationship between slack in the labor market and inflation, this relationship appears to be much weaker than in previous decades. In the latest Summary of Economic Projections, the median projection of FOMC participants indicates that, under appropriate monetary policy, the unemployment rate will remain low and inflation will stay close to 2 percent. That said, the Committee is always monitoring inflation developments carefully and is ready to adjust the course of monetary policy to achieve its objectives.

3. To the extent the Federal Reserve decides to continue to raise interest rates to combat signs of increasing inflation, are you concerned that these steps could lead to a slower economy, or possibly a recession?

As I discussed in remarks I gave at a symposium hosted by the Federal Reserve Bank of Kansas City in Jackson Hole in August, there are two main risks confronting policymakers currently: moving too fast and needlessly shortening the expansion, versus moving too slowly and risking a destabilizing overheating. Minutes of FOMC meetings and other Federal Reserve communications inform the general public that our discussions focus keenly on the relative salience of these risks.

I see the current path of gradually raising interest rates as the FOMC's approach to taking seriously both of these risks. While the unemployment rate is below the Committee's estimate of the longer-run natural rate, estimates of this rate are quite uncertain. The same is true of estimates of the neutral interest rate. We therefore refer to many indicators when judging the degree of slack in the economy or the degree of accommodation in the current policy stance. We are also aware that, over time, inflation has become much less responsive to changes in resource utilization.

While inflation has recently moved up near 2 percent, we have seen no clear sign of an acceleration above 2 percent, and there does not seem to be an elevated risk of overheating. This is good news, and we believe that this good news results in part from the ongoing normalization process, which has moved the stance of policy gradually closer to the FOMC's rough assessment of neutral as the expansion has continued. As the most recent FOMC statement indicates, if the strong growth in income and jobs continues, further gradual increases in the target range for the federal funds rate will likely be appropriate.

My colleagues and I are carefully monitoring incoming data, and we are setting policy to do what monetary policy can do to support continued growth, a strong labor market, and inflation near 2 percent.

4. Are you concerned at all about the possibility of "stagflation"? In addition, are you concerned that with interest rates still being relatively low, you would have limited tools to combat a recession when one occurs?

"Stagflation" is typically defined as involving a combination of substandard growth or above-normal unemployment, and higher-than-desired inflation. There are many risks in the macroeconomy at any given time, and the future course of the economy is always difficult to discern. My colleagues and I are carefully monitoring incoming data, and are on alert for unforeseen developments of any kind. However, at present, the risk of stagflation appears to be quite low.

6. How concerned are you about the risks of an inverted yield curve, which historically leads to a recession? Will you let the yield curve invert?

The Federal Reserve does not control or target the Treasury yield curve. The shape of the yield curve is one of many financial and economic indicators that we consider in assessing the economic outlook and the appropriate course of monetary policy. It is normal for the yield curve to flatten over the course of an economic expansion as the FOMC scales back monetary policy accommodation. The FOMC's policies reflect the strong performance of the U.S. economy and are intended to help make sure that this trend continues. Currently, the risks to the economic outlook appear roughly balanced. In other words, when weighing a wide range of relevant information, it does not appear that there is an elevated risk of a recession. The FOMC will continue to make its monetary policy decisions to best promote its maximum employment and price stability objectives.

Based on historical data, there is a statistical relationship between an inverted yield curve and the probability of a subsequent recession. However, research is not conclusive as to whether an inverted yield curve causes recessions. Since the financial crisis, longer-term yields have been held down by many factors other than policy rate expectations, so it is uncertain whether the historical predictive relationship is still a reliable guide.

9. What is your goal for the 10-year Treasury note by the end of 2019?

The Federal Reserve does not control or target the yield on the ten-year Treasury note. To fulfill its congressional mandate of maximum employment and price stability, the FOMC adjusts the stance of monetary policy primarily by changing the target range for the federal funds rate. The yield on the ten-year Treasury note is one of many indicators that the Committee considers in its policy deliberations.

10. Do you see the economy staying strong for the next 2 years or do you see a possible recession in 2019 or 2020?

As I noted in remarks in Jackson Hole, over the course of a long recovery, the U.S. economy has strengthened substantially. The unemployment rate has declined steadily for almost nine years and, at 3.9 percent, is now near a 20-year low. Most people who want jobs can find them. Inflation has moved up and is now near the FOMC's objective of 2 percent after running generally below that level for six years. With solid household and business confidence, healthy levels of job creation, rising incomes, and fiscal stimulus arriving, there is good reason to expect that this strong performance will continue.

11. What are you going to do to keep stimulating business growth, which ultimately stimulates the economy for individuals?

To support the ongoing growth of the economy, my colleagues and I will focus intently on pursing the dual mandate given to us by the Congress -- to promote price stability and maximum employment. We strongly believe that pursuing that dual mandate is the best means available to us to set a positive backdrop for decision-making by businesses and households, consistent with their long-term wellbeing.

Congressman Brad Sherman

Questions for the Record

Financial Services Housing and Insurance Hearing "Monetary Policy and the State of the Economy"

July 18, 2018

1. Home price and rent growth are driving inflation. Are there measures the Federal Reserve could take to stimulate single family and apartment construction and thereby ease inflation?

2. With low unemployment, how does the Federal Reserve plan to curb inflation?

3. To the extent the Federal Reserve decides to continue to raise interest rates to combat signs of increasing inflation, are you concerned that these steps could lead to a slower economy, or possibly a recession?

4. Are you concerned at all about the possibility of "stagflation"? In addition, are you concerned that with interest rates still being relatively low, you would have limited tools to combat a recession when one occurs?

5. What effect do you think the President's trade policies will have on the economy?

6. How concerned are you about the risks of an inverted yield curve, which historically leads to a recession? Will you let the yield curve invert?

7. How concerned are you about the danger of a crisis in emerging market economies with their currencies losing value and with the Federal Open Market Committee raising rates? How concerned are you about risks of contagion to the United States if there is a crisis in emerging market economies?

8. How will diverging rate paths between the United States and the European Union play out? Is there anything in the data that suggests rising inflation will become a significant issue?

9. What is your goal for the 10-year Treasury note by the end of 2019?

10. Do you see the economy staying strong for the next 2 years or do you see a possible recession in 2019 or 2020?

11. What are you going to do to keep stimulating business growth, which ultimately stimulates the economy for individuals?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 5, 2018

The Honorable Josh Gottheimer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to your questions that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 28, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Representative Gottheimer:</u>

1. In the 2015 rulemaking for the risk-based capital surcharges for Global Systemically Important Bank Holding Companies (GSIBs), the Federal Reserve Board (FRB) notes the need to periodically review the coefficients to update its GSIB Method 2 in relation to economic growth. The FRB rule states, "To ensure changes in economic growth do not unduly affect firms' systemic risk scores, the Board will periodically review the coefficients and make adjustments as appropriate."

- **Are there any discussions or plans to update or re-examine the GSIB coefficients, particularly given recent economic growth?**
- **Does the FRB plan to periodically review coefficient or are there economic factors that will trigger such a review? If periodically, how frequently will the reviews be conducted?**
- **How has recent economic growth impacted scores under the GSIB methodology?**

The Federal Reserve Board's (Board) capital rules have been designed to significantly reduce the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure were it to occur. Capital rules and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle, credit availability and economic growth. Consistent with these principles, the Board originally calibrated the GSIB surcharge so that—given the circumstances of the financial system—each GSIB would hold enough capital to lower its probability of failure so that the expected impact of its failure on the financial system would be approximately equal to that of a large non-GSIB.

The bulk of post-crisis regulation is largely complete, with the important exception of the U.S. implementation of the recently concluded Basel Committee agreement on bank capital standards. It is therefore a natural and appropriate time to step back and assess those efforts. The Board is conducting a comprehensive review of the regulations in the core areas of post-crisis reform, including capital, stress testing, liquidity, and resolution. The objective of this review is to consider the effect of those regulatory frameworks on the resiliency of the financial system, including improvements in the resolvability of banking organizations, and on credit availability and economic growth.

In general, I believe overall capital for our largest banking organizations is at about the right level. Critical elements of our capital structure for these organizations include stress testing, the stress capital buffer, and the enhanced supplementary ratio. Work is underway to finalize the calibration of these fundamental building blocks, all of which form part of the system in which the GSIB surcharge has an effect. In this regard, I would note that the GSIB surcharge rule does not take full effect until January 2019.

Questions for the Record
Congressman Josh Gottheimer
Submitted: Wednesday, July 25th, 2018

Committee on Financial Service Hearing on "Monetary Policy and the State of the Economy"
Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System
Wednesday, July 18, 2018

In the 2015 rulemaking for the risk-based capital surcharges for Global Systemically Important Bank Holding Companies (GSIBs), the Federal Reserve Board (FRB) notes the need to periodically review the coefficients to update its GSIB Method 2 in relation to economic growth. The FRB rule states, "To ensure changes in economic growth do not unduly affect firms' systemic risk scores, the Board will periodically review the coefficients and make adjustments as appropriate."

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- How has recent economic growth impacted scores under the GSIB methodology?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 24, 2018

The Honorable Joyce Beatty
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the questions that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 28, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Representative Beatty:</u>

1. Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, ("Dodd-Frank") transferred to the Board of Governors of the Federal Reserve System supervisory and examination authority of savings and loan holding companies and their non-depository subsidiaries in 2011. This included supervisory and examination authority of savings and loan holding companies primarily engaged in insurance underwriting activities. According to the 104th Annual Report of the Board of Governors of the Federal Reserve System, the Fed supervised 11 insurance savings and loan holding companies in 2017, including two Ohio-based companies.

Please describe the Fed's history of regulating insurance companies.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) gave the Federal Reserve supervisory and regulatory responsibilities for insurance companies that either own a federally insured thrift as part of a savings and loan holding company (SLHC) or are designated as systemically important by the Financial Stability Oversight Council (FSOC). This responsibility extends to the functionally regulated subsidiaries of these companies. Prior to the Dodd-Frank Act, the Federal Reserve supervised insurance companies that were part of a bank holding company structure. In developing its regulatory framework for supervised insurance companies, the Federal Reserve Board (Board) has sought to adapt and tailor its overall statutory responsibility for supervised institutions and to appropriately incorporate considerations for the different material characteristics of insurance companies. While the Board has developed rules specifically for supervised insurance companies, the Federal Reserve does not regulate the business of insurance, including for its supervised institutions.

As part of the Dodd-Frank Act's authorization to develop a regulatory and supervisory framework for its supervised insurance companies, the Federal Reserve has pursued several initiatives. These initiatives include the establishment of capital requirements for supervised insurance companies and the establishment of enhanced prudential standards for institutions that have been designated as systemically important. On June 3, 2016, the Board approved and invited comment on an advance notice of proposed rulemaking (ANPR) on two tailored conceptual frameworks for capital standards for supervised insurance companies. One of the proposed frameworks was tailored for insurance companies designated as systemically important, while the other was tailored for insurance companies that own a depository institution. The Federal Reserve is continuing to develop consolidated capital requirements for supervised insurance companies. The Board also approved a proposed rule on June 3, 2016, to apply enhanced prudential standards to systemically important insurance companies designated by the FSOC. These rulemakings would apply consistent liquidity, corporate governance, and risk-management standards to these firms. In addition, the Board regularly reviews new and existing guidance and regulations to determine the appropriate applicability for insurance savings and loan holding companies (ISLHCs) while continuing to develop appropriate regulations.

2. Currently, how many insurance savings and loan holding companies does the Fed supervise?

The Federal Reserve currently supervises 11 ISLHCs.

3. Do you believe that you have the authority to tailor supervisory regulations with regards to insurance savings and loan holding companies? If so:

a. Can you provide a complete list and short description of every instance where the Fed has explicitly tailored supervisory and examination regulations, guidance or supervisory letters to insurance savings and loan holding companies since July 21, 2011?

The Home Owners' Loan Act of 1933 (via the Dodd-Frank Act) provides the Federal Reserve the flexibility to tailor appropriately its regulations and guidance for ISLHCs, to ensure each firm's safety and soundness without imposing bank-centric standards.

As part of the general supervisory process, the Federal Reserve tailors the application of supervisory letters (i.e., guidance) and regulations to ISLHCs based on the firm's size, risk profile, structure, and business model. Federal Reserve supervisors work closely with state insurance regulators and other relevant functional regulators of material business lines to ensure the Federal Reserve's supervisory expectations are appropriately aligned with each firm's business and risk profiles.

Below is a sample list and summary of significant supervisory guidance and regulations that the Federal Reserve has tailored or exempted ISLHCs from since July 21, 2011.

Exemption from Dodd-Frank Act Capital, Stress Testing, and Liquidity Requirements: The expectations in Supervision and Regulation (SR) Letter 12-7, "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets," and in the Comprehensive Capital Analysis and Review/Dodd-Frank Annual Stress Testing have not been applied to ISLHCs to date but do apply to bank holding companies that meet the same asset thresholds. In addition, the Federal Reserve did not apply Dodd-Frank Act bank liquidity requirements (e.g., liquidity coverage ratio) and Basel III regulatory capital standards to ISLHCs, as those specific capital and liquidity standards are too bank-centric.

Applicability of the Federal Reserve's Holding Company Rating System: In 2016, the Board issued a Notice for Public Comment regarding the view that the permanent application of the RFI Rating System (Risk Management, Financial Condition, and Impact) to SLHCs would not apply to ISLHCs. This notice stated the Board's intent to review "whether a modified version of the RFI rating system or some other supervisory rating system is appropriate for these firms on a permanent basis." Similarly, in a 2017 Notice of Proposed Rulemaking, the proposed Large Financial Institution (LFI) Rating System to be used at large firms supervised by the Federal Reserve would not apply to large ISLHCs. If the LFI Rating System is implemented, the Board intends to review the potential application and/or modification for ISLHCs. ISLHCs will continue to be rated under the RFI rating system on an indicative basis while the Board considers rating system options.

The Federal Reserve has tailored the application of indicative RFI ratings to ISLHCs through internal guidance, which are called Advisory Letters. Internal guidance provides Federal Reserve examiners direction on how to tailor their analysis of the financial conditions of ISLHCs to reflect the differences associated with the business of insurance. It also directs examiners to rely, to the fullest extent possible, on the work of an ISLHC's state insurance regulator(s) when assessing the risk management of insurance-specific activities at an ISLHC. Internal guidance requires Federal Reserve examiners to incorporate an ISLHC's Own Risk Solvency Assessments (ORSAs), a state insurance regulator requirement, in their evaluations and to discuss results from the ORSA with the appropriate state insurance regulator(s).

Supervisory Guidance Applicable to SLHCs prior to July 21, 2011: SR Letter 14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program," lists guidance that was applicable to SLHCs prior to the transfer of supervisory authority from the Office of Thrift Supervision to the Federal Reserve. Internal guidance issued on general supervision allows for tailoring for ISLHCs, if necessary. For example, SR Letter 12-17, "Consolidated Supervision for Large Financial Institutions," is applicable to ISLHCs with $50 billion or more in assets (now $100 billion following enactment of S. 2155), and addresses generally the supervision program for large firms. Guidance issued on specific topics addressed in SR Letter 12-17, however, will have insurance-specific tailoring.

The Board is in the process of developing guidance that outlines the Federal Reserve's supervisory framework for ISLHCs. This guidance will also discuss how supervisory guidance is applied and tailored, as well as the Federal Reserve's interagency coordination activities with state insurance regulators and other functional regulators of ISLHCs.

b. Does the Fed have any additional plans to tailor new and/or existing regulations, guidance, or supervisory letters to insurance savings and loan holding companies in the future? If so:

i. Please describe those plans with specificity to the fullest extent possible.

ii. When does the Fed expect to undertake these actions?

Board staff is currently developing guidance that provides an overview of its supervisory framework for ISLHCs. This guidance will clarify the Federal Reserve's supervisory objectives and approach; articulate the Federal Reserves's process for applying and tailoring supervisory guidance; and demonstrate how the Federal Reserve relies on, and coordinates with, the primary functional regulators (i.e., state insurance regulators, federal and state banking regulators, and any other domestic or foreign supervisors) of ISLHCs and their regulated subsidiaries. In addition, this guidance will describe the Board's process for reviewing the applicability of guidance and regulations to ISLHCs and its oversight duties of ISLHC supervisory activities. The Board expects to issue this guidance in the near future. The Board will continue to assess new guidance and regulations for applicability to ISLHCs and tailor applicable guidance, when appropriate.

Questions for the Record
Congresswoman Joyce Beatty (OH-03)
Committee on Financial Services Hearing, July 18, 2018
"Monetary Policy and the State of the Economy"

Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, ("Dodd-Frank") transferred to the Board of Governors of the Federal Reserve System supervisory and examination authority of savings and loan holding companies and their non-depository subsidiaries in 2011. This included supervisory and examination authority of savings and loan holding companies primarily engaged in insurance underwriting activities. According to the 104th Annual Report of the Board of Governors of the Federal Reserve System, the Fed supervised 11 insurance savings and loan holding companies in 2017, including two Ohio-based companies.

1. Please describe the Fed's history of regulating insurance companies.

2. Currently, how many insurance savings and loan holding companies does the Fed supervise?

3. Do you believe that you have the authority to tailor supervisory regulations with regards to insurance savings and loan holding companies? If so:

    a. Can you provide a complete list and short description of every instance where the Fed has explicitly tailored supervisory and examination regulations, guidance or supervisory letters to insurance savings and loan holding companies since July 21, 2011?

    b. Does the Fed have any additional plans to tailor new and/or existing regulations, guidance, or supervisory letters to insurance savings and loan holding companies in the future? If so:
        i. Please describe those plans with specificity to the fullest extent possible.
        ii. When does the Fed expect to undertake these actions?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

November 13, 2018

The Honorable Kyrsten Sinema
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed is my response to question 1 of the questions that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. On October 30, 2018, I provided responses to questions 2 and 3. Copies of all responses have also been forwarded to the Committee for inclusion in the hearing record. This submission constitutes the completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 28, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Representative Sinema:

1. The Arizona Chamber of Commerce notes that a trade war immediately threatens over 250 million dollars in Arizona exports and 772,800 Arizona jobs supported by global trade. Eighty-eight percent of Arizona exporters are small or medium-sized businesses, making the effects of trade war particularly acute for Arizona entrepreneurs and family-run businesses. Job-killing tariffs will target Arizona-made agricultural goods like apples and cotton, imperiling the livelihoods of Arizona family farmers. Tariffs also impose costs directly passed on to consumers, forcing Arizona families to pay more for their everyday purchases. One of the functions of the Federal Reserve System is to strengthen U.S. standing in the world economy. How do you anticipate the Administration's tariff policies affecting that work?

As you know, Congress has entrusted the Federal Reserve with the statutory dual mandate of achieving price stability and maximum employment. Trade policy is the responsibility of Congress and the Administration.

In general, trade and access to global markets provide many benefits for businesses and the people they employ, including larger and deeper markets for their products and a wider selection of inputs for production. Consumers also benefit through a greater variety of goods and more competitive prices. Because of these and other benefits, more open and globalized economies generally have been faster growing, more productive, and more dynamic. That said, the benefits of trade are not shared equally by all people and all sectors of the economy. Policymakers and economists alike are increasingly cognizant of the need to design policies to support workers and families so that the benefits of trade can be more widely shared.

Since World War II, the United States has been a global leader in building a rules-based trading system, which has resulted in, over time, the consistent lowering of tariffs and growth in trade. The Administration's current trade policy process is still ongoing. If the end result is a world with higher tariffs in many countries, then experience suggests there will be significant negative effects for the U.S. economy. On the other hand, if the end result is a world with lower trade barriers and a more level playing field, then the U.S. economy will benefit.

To date, tariff increases, both by the United States and other countries, have already affected individual businesses and industries, in particular the agricultural sector. Moreover, our business contacts increasingly report that trade developments are creating policy uncertainty, which is causing some firms to delay investments. Although the direct effects of announced measures on the overall U.S. economy are likely to be fairly modest, there is a possibility that trade tensions could disrupt supply chains and undermine business confidence. We continue to monitor trade developments and their effects on U.S. employment and inflation.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 30, 2018

The Honorable Kyrsten Sinema
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to questions 2 and 3 of the questions that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 28, 2018.

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Representative Sinema:

2. I was pleased to see economic growth in Q2 that is considerably stronger than that of Q1. Yet too many Arizona families aren't seeing wages rise in a commensurate manner. For many Arizonans, wages have stagnated or even declined when factoring in inflation. At the same time, the cost of health care and other essential goods and services continues to rise, causing many families to feel the pinch. What explanation can you offer for wages failing to trend upward with economic growth?

Although most indicators suggest that the labor market is quite strong, wage growth has remained moderate. Generalizing across various measures, average annual wage gains have picked up a little in recent years, from about 2 percent a few years ago to about 2½ to 3 percent now. Even taking into account relatively low inflation, the gains in inflation-adjusted wages have averaged less than were seen prior to the recession. And of course, those figures are averages. Some people have seen larger gains than that and unfortunately some have seen less.

One important factor for the disappointing pace of overall wage gains, in the face of a strong labor market, is that productivity has increased relatively slowly over the past several years. Over time, productivity gains are necessary to support rising living standards. Many other factors influence wages as well. There is no consensus about their relative importance, but some of the other factors cited by economists include globalization, demographic changes (e.g., the retirement of higher paid older workers) which affect measured average wage growth, hidden labor market slack (e.g., the low labor force participation rate), declines in unionization, rising employer concentration, and an increase in the use of non-compete agreements and non-poaching agreements.[1]

3. Congress passed the Volcker Rule as part of Dodd-Frank to reduce risky activities, such as high-risk proprietary trading, at banks. We share the goal of reducing systemic risk in our financial system to ensure another crisis does not happen. At the same time, we also want to help companies grow and innovate by ensuring they have sufficient access to capital. The current definition of "covered fund" in the Volcker Rule permits banks to provide capital and credit to businesses but prohibits doing so via a fund structure.

I'm incredibly proud of Arizona's public universities, which create opportunities for Arizonans to turn good ideas into great startups – creating jobs and growing the economy. These startup incubators are placed at risk if the startup structures itself as a covered fund. This is perplexing because fund structures allow banks to diversify risk, which would appear to be consistent with the goal of the Volcker Rule.

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[1] *See* Alan B. Krueger, Reflections on Dwindling Worker Bargaining Power and Monetary Policy, Luncheon Address at the Jackson Hole Economic Symposium (Aug. 24, 2018), *available at* https://www.kansascityfed.org/~/media/files/publicat/sympos/2018/papersandhandouts/824180824kruegerremarks.pdf?la=en; *see also* Ernie Tedeschi, *Unemployment Looks Like 2000 Again. But Wage Growth Doesn't*, The New York Times, Oct. 22, 2018, *available at* https://www.nytimes.com/2018/10/22/upshot/mystery-slow-wage-growth-econony.html.

What are your thoughts on this? Is there intention to address aspects of the definition of covered fund so that banks are not discouraged from diversifying risk?

The Board, along with the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission, and Securities and Exchange Commission (the "agencies") adopted regulations to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. § 1851) (the "Volcker Rule") in 2013. These regulations included a definition of "covered fund" that, in the agencies' view, was consistent with the statutory purpose of the Volcker Rule to limit certain investment activities of banking entities. Subsequently, and based on experience with the Volcker Rule regulations, the agencies identified opportunities for improvement and proposed amendments to the Volcker Rule regulations in May 2018.[2]

The proposal requests comment on how to tailor the regulations governing a banking entity's covered fund activities. For example, the proposal asks whether a different definition of "covered fund" would be appropriate. In addition, the proposal requests comment on potential exemptions for particular types of funds, or funds with particular characteristics.

Since proposing the amendments in May, the agencies have held meetings with and received comments from interested parties regarding the treatment of covered funds. The agencies expect to meet with and receive comments from interested parties throughout the comment period, and will carefully consider each comment to determine whether any changes to the covered fund regulations would be appropriate.

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[2] 83 Fed. Reg. 33,432 (July 17, 2018).

Questions for the Record

"Monetary Policy and the State of the Economy" FC Hearing
Wednesday, July 18th at 10:00am
Congresswoman Kyrsten Sinema

All questions directed to The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System and sole witness of the hearing.

1. The Arizona Chamber of Commerce notes that a trade war immediately threatens over 250 million dollars in Arizona exports and 772,800 Arizona jobs supported by global trade. Eighty-eight percent of Arizona exporters are small or medium-sized businesses, making the effects of trade war particularly acute for Arizona entrepreneurs and family-run businesses. Job-killing tariffs will target Arizona-made agricultural goods like apples and cotton, imperiling the livelihoods of Arizona family farmers. Tariffs also impose costs directly passed on to consumers, forcing Arizona families to pay more for their everyday purchases. One of the functions of the Federal Reserve System is to strengthen U.S. standing in the world economy. How do you anticipate the Administration's tariff policies affecting that work?

2. I was pleased to see economic growth in Q2 that is considerably stronger than that of Q1. Yet too many Arizona families aren't seeing wages rise in a commensurate manner. For many Arizonans, wages have stagnated or even declined when factoring in inflation. At the same time, the cost of health care and other essential goods and services continues to rise, causing many families to feel the pinch. What explanation can you offer for wages failing to trend upward with economic growth?

3. Congress passed the Volcker Rule as part of Dodd-Frank to reduce risky activities, such as high-risk proprietary trading, at banks. We share the goal of reducing systemic risk in our financial system to ensure another crisis does not happen. At the same time, we also want to help companies grow and innovate by ensuring they have sufficient access to capital. The current definition of "covered fund" in the Volcker Rule permits banks to provide capital and credit to businesses but prohibits doing so via a fund structure.

   I'm incredibly proud of Arizona's public universities, which create opportunities for Arizonans to turn good ideas into great startups – creating jobs and growing the economy. These startup incubators are placed at risk if the startup structures itself as a covered fund. This is perplexing because fund structures allow banks to diversify risk, which would appear to be consistent with the goal of the Volcker Rule.

   What are your thoughts on this? Is there intention to address aspects of the definition of covered fund so that banks are not discouraged from diversifying risk?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 5, 2018

The Honorable Luke Messer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the question that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. A copy of my response has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 28, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Representative Messer:</u>

1. Chairman Powell, thank you for testifying before the House Financial Services Committee on July 18, 2018. On May 24, 2018, President Trump signed S. 2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act, into law. I am concerned about the implementation of Section 403 of the Act, which is entitled "Treatment of Certain Municipal Obligations." Specifically, subsection (b) of that section states:

> **Not later than 90 days after the date of the enactment of this Act, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Comptroller of the Currency shall amend the final rule entitled "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards" (79 Fed. Reg. 61439 (October 10, 2014)) and the final rule entitled "Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets" (81 Fed. Reg. 21223 (April 11, 2016)) to implement the amendments made by this section.**

Can you detail the steps the Federal Reserve has taken to work with the FDIC and OCC to amend the relevant rules relating to the Liquidity Coverage Ratio to meet the August 22, 2018, deadline as established by the Act?

Following the enactment of S. 2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), staff from the Federal Reserve, FDIC, and OCC (the agencies) took action to comply with the requirements of the statute. Section 403 of the EGRRCPA required the agencies, within 90 days of enactment, to treat municipal obligations as high-quality liquid assets (HQLA) under their liquidity coverage ratio (LCR) rules if the municipal obligations are investment grade and considered liquid and readily marketable.

On August 22, 2018, the agencies jointly issued an interim final rule (IFR) to treat eligible municipal obligations as HQLA. The IFR took effect upon publication in the Federal Register on August 31, 2018, and public comments on the IFR were accepted by the agencies until October 1, 2018.

House Committee on Financial Services
Full Committee Hearing: Monetary Policy & the State of the Economy
Honorable Jerome Powell, Chairman, Board of Governors of the Federal Reserve System
Congressman Luke Messer (R-IN)
July 18, 2018

QUESTIONS FOR THE RECORD

Chairman Powell, thank you for testifying before the House Financial Services Committee on July 18, 2018. On May 24, 2018, President Trump signed S. 2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act, into law. I am concerned about the implementation of Section 403 of the Act, which is entitled "Treatment of Certain Municipal Obligations." Specifically, subsection (b) of that section states:

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 5, 2018

The Honorable Steve Stivers
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to your question that you submitted following the July 18, 2018,[1] hearing before the Committee on Financial Services. A copy of my response has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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[1] Questions for the record related to this hearing were received on August 28, 2018.

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Representative Stivers:</u>

1. Chairman Powell: As you know, the U.S. Method 2 G-SIB framework created fixed coefficients that apply to each indicator used in the surcharge calculation. This incentivizes firms to reduce their risk. However, despite recognizing the need to update these rules to account for normal economic growth, these coefficients have remained unchanged since the finalization of the U.S. G-SIB rule in 2015. Since that time, the U.S. economy has experienced significant economic growth. Does the Fed monitor the impact of economic growth on the GSIB coefficients? Additionally, when will the FRB update the coefficients to address the economic growth?

The Federal Reserve Board's (Board) capital rules have been designed to significantly reduce the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure were it to occur. Capital rules and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle, credit availability and economic growth. Consistent with these principles, the Board originally calibrated the GSIB surcharge so that—given the circumstances of the financial system—each GSIB would hold enough capital to lower its probability of failure so that the expected impact of its failure on the financial system would be approximately equal to that of a large non-GSIB.

The bulk of post-crisis regulation is largely complete, with the important exception of the U.S. implementation of the recently concluded Basel Committee agreement on bank capital standards. It is therefore a natural and appropriate time to step back and assess those efforts. The Board is conducting a comprehensive review of the regulations in the core areas of post-crisis reform, including capital, stress testing, liquidity, and resolution. The objective of this review is to consider the effect of those regulatory frameworks on the resiliency of the financial system, including improvements in the resolvability of banking organizations, and on credit availability and economic growth.

In general, I believe overall capital for our largest banking organizations is at about the right level. Critical elements of our capital structure for these organizations include stress testing, the stress capital buffer, and the enhanced supplementary ratio. Work is underway to finalize the calibration of these fundamental building blocks, all of which form part of the system in which the GSIB surcharge has an effect. In this regard, I would note that the GSIB surcharge rule does not take full effect until January 2019.

Representative Steve Stivers
Hearing entitled "Monetary Policy and the State of the Economy"
July 18, 2018

Chairman Powell: As you know, the U.S. Method 2 G-SIB framework created fixed coefficients that apply to each indicator used in the surcharge calculation. This incentivizes firms to reduce their risk. However, despite recognizing the need to update these rules to account for normal economic growth, these coefficients have remained unchanged since the finalization of the U.S. G-SIB rule in 2015. Since that time, the U.S. economy has experienced significant economic growth. Does the Fed monitor the impact of economic growth on the GSIB coefficients? Additionally, when will the FRB update the coefficients to address the economic growth?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

January 11, 2019

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. I was the Attorney General of Nevada during the financial crisis and saw first-hand how big banks targeted vulnerable people and communities of color. This is exactly why it was so important that the CFPB required more data collection and more oversight over lending activities. The law signed by President Trump earlier this year eliminated some of the data we need to preserve this progress. Despite the loss of public HMDA data, each of your agencies still has a requirement to ensure that Latinos, African Americans, women and other people are not rejected for loans due to their gender or ethnicity.

(a) How many lenders supervised by your agency will not publically report the additional data that was to be required this year? This data includes loan characteristics like credit score, fees, points and interest rates.

With respect to Home Mortgage Disclosure Act (HMDA), the Federal Reserve supervises approximately 800 state member banks. Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) exempts certain institutions from reporting the additional HMDA data fields required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2] However, institutions exempted by EGRRCPA that meet HMDA's data reporting threshold[3] must continue to report the HMDA data fields that are not the additional fields required by the Dodd-Frank Act. Based on previous HMDA reporting, approximately 350 of the Federal Reserve's supervised institutions will not be required to report the additional HMDA data fields.

(b) Would it have been easier to spot fair lending violations with transparent data reporting, rather than relying on your bank examiners to go bank by bank, loan by loan to root out discrimination?

The Federal Reserve's fair lending supervisory program reflects our commitment to promoting financial inclusion and ensuring that the financial institutions under our jurisdiction fully comply with applicable federal consumer protection laws and regulations. For all state member banks, we enforce the Fair Housing Act, which means we can review all Federal Reserve-regulated institutions for potential discrimination in mortgages, including potential redlining, pricing, and underwriting discrimination. For state member banks of $10 billion or less in assets, we also enforce the Equal Credit Opportunity Act, which means we review these state member banks for potential discrimination in any credit product. Together, these laws prohibit discrimination on the basis of race, color, national origin, sex, religion, marital status, familial status, age, disability, receipt of public assistance, and the good faith exercise of rights under the Consumer Credit Protection Act (collectively, the "prohibited basis").

[2] *See* EGRRCPA, § 104(a), Pub. L. No. 115-174, 132 Stat. 1296 (2018).

[3] In general, if a financial institution has assets exceeding $45 million and originated at least 25 closed-end mortgage loans in each of the two preceding calendar years, or originated at least 500 open-end lines of credit in each of the two preceding calendar years, it must meet the HMDA reporting requirements for its asset size. *See* A Guide To HMDA Reporting: Getting it Right!, Federal Financial Institutions Examination Council (Eff. Jan. 1, 2018), https://www.ffiec.gov/Hmda/pdf/2018guide.pdf.

We evaluate fair lending risk at every consumer compliance exam based on the risk factors set forth in the 2009 Interagency Fair Lending Examination Procedures (Procedures).[4] The Procedures set forth risk factors for several types of potential fair lending issues. For example, a risk factor for potential discrimination in pricing is the presence of a financial incentive for loan officers or brokers to charge higher prices for loans. Provisions in EGRRCPA related to HMDA data collection requirements for certain institutions will not affect the Federal Reserve's ability to fully evaluate the risk of mortgage pricing or underwriting discrimination. If warranted by risk factors, the Federal Reserve will request any data related to relevant pricing and underwriting criteria, such as the interest rate and credit score. These data can be requested from any Federal Reserve-supervised institution, including the institutions that were exempted from reporting additional HMDA data by EGRRCPA. The Federal Reserve's analysis then incorporates the additional data to determine whether applicants with similar characteristics received different pricing or underwriting outcomes on a prohibited basis (for example, on the basis of race), or whether legitimate pricing or underwriting criteria can explain the differences.

(c) Without the expanded HMDA data reporting slated to begin this year, what information will your agency's examiners have to trigger a review of potential discrimination?

As previously noted, the Federal Reserve is committed to promoting financial inclusion and a fair and transparent financial service market place. We take seriously our responsibilities to ensure that the financial institutions under our jurisdiction comply with applicable federal consumer protection laws and regulations and evaluate fair lending risk at every consumer compliance exam based on the risk factors set forth in the Procedures.[5] With respect to potential discrimination in the pricing or underwriting of mortgages, if warranted by risk factors, the Federal Reserve will request data beyond the public HMDA data, including any data related to relevant pricing or underwriting criteria, such as applicant interest rates and credit scores. As noted in response to the subpart above, the Federal Reserve's practice of requesting data relevant to pricing and underwriting criteria, where warranted by risk factors, pre-dates EGRRCPA's enactment, and the practice will continue.

As noted in the prior response, exemptions of HMDA data reporting under EGRRCPA will not affect the Federal Reserve's ability to fully evaluate the risk of mortgage pricing or underwriting discrimination at these institutions, as data can be requested from any Board-supervised institution, including the institutions that were exempted from reporting additional HMDA data by EGRRCPA. Such additional data inform analysis that helps to determine whether applicants with similar characteristics received different pricing or underwriting outcomes on a prohibited basis (for example, on the basis of race), or whether legitimate pricing or underwriting criteria can explain the differences.

Community Reinvestment Act

2. We have a massive affordable rental housing crisis in Nevada: 119,854 families pay more than half their income for rent.

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[4] *See* Interagency Fair Lending Examination Procedures (August 2009), available at: https://www.ffiec.gov/pd/fairlend.pdf.

[5] *Id.*

One of the few resources we have is the Low Income Housing Tax Credit. The new tax law is already making it harder to finance low-income housing because the cost of the credit has fallen.

(a) Will you commit to ensure that any changes you consider to the Community Reinvestment Act make federal tools like the Low Income Housing Tax Credit and New Market Tax Credit work better in communities?

The Federal Reserve is committed to supporting efforts to facilitate credit flows to support creditworthy consumers and businesses in all communities, including in low- and moderate-income areas, to further economic development. We recognize the important role that tax credit programs have played in bringing private capital to lower-income communities for the financing of housing and other community projects. A bank can receive credit under its performance evaluation under Community Reinvestment Act (CRA) when the investments primarily benefit low-and moderate-income populations or communities.

Given that the Low Income Housing Tax Credit and the New Market Tax Credit programs provide important investment vehicles to support affordable housing and community economic development, our objective in modernizing the CRA regulations will be to ensure that they will continue to receive CRA consideration.

(b) Non-banks provide more than half of all mortgages in this country. Six of the 10 largest mortgage lenders are not banks. Do you think non-bank mortgage lenders should be covered by the Community Reinvestment Act?

We recognize that the financial services marketplace is highly competitive and has many more non-bank participants than there were when the CRA was enacted, which has resulted in more retail lending activity taking place outside insured depository institutions. An expansion of coverage of the CRA would require congressional action. The Federal Reserve stands ready to implement any statutory changes that Congress may deem appropriate.

Section 108: Escrow Requirements

3. For generations, lenders understood that they should require property taxes and homeowners insurance be placed in escrow, so that those obligations are always paid in time. But in the run-up to the foreclosure crisis, lenders cut corners so that they could misrepresent monthly payments to homeowners and put them into obligations they couldn't afford.

(a) How will your agencies monitor the implementation of the escrow exemption? Will your examiners monitor foreclosure activities resulting from unpaid property taxes and/or property insurance?

Section 108 of the EGRRCPA directs the Bureau of Consumer Financial Protection ("Bureau") to issue rules to adjust the threshold below which an institution is exempt from escrow requirements related to higher-priced mortgage loans. The Bureau has indicated in its Fall 2018 Unified Agenda that it is currently in a pre-rulemaking phase with respect to this provision.

Once the Bureau engages in the rulemaking process, the Board will fulfill our consultative role as required by the Dodd-Frank Act.

The Federal Reserve monitors conditions in the residential real estate market, including mortgage performance trends associated with foreclosures. We remain committed to supervising for safety and soundness and enforcing applicable consumer protection laws. We also expect the financial institutions we supervise to underwrite residential mortgage loans in a prudent fashion and to address key risk areas in their residential mortgage lending programs, including borrower payment obligations.

(b) How will you communicate any findings or concerns from the elimination of the escrow requirement to us in Congress?

As you know, supervisory findings of examinations at individual banks are confidential. To the extent that the Board identifies areas for supervisory risk or concern at a broader level, we note such issues in various mediums, including our Annual Report, recently-published Supervision and Regulation Report, Consumer Compliance Supervision Bulletin, as well as the Semi-Annual Supervision testimony and webinars such as "Ask the Fed" and "Outlook Live" to inform the industry, policymakers, and the public of such concerns.

Questions for The Honorable Randal K. Quarles, Vice Chairman of Supervision, Board of Governors of the Federal Reserve System, from Senator Catherine Cortez Masto:

I was the Attorney General of Nevada during the financial crisis and saw first-hand how big banks targeted vulnerable people and communities of color. This is exactly why it was so important that the CFPB required more data collection and more oversight over lending activities. The law signed by President Trump earlier this year eliminated some of the data we need to preserve this progress. Despite the loss of public HMDA data, each of your agencies still has a requirement to ensure that Latinos, African Americans, women and other people are not rejected for loans due to their gender or ethnicity.

- How many lenders supervised by your agency will not publically report the additional data that was to be required this year? This data includes loan characteristics like credit score, fees, points and interest rates.

- Would it have been easier to spot fair lending violations with transparent data reporting, rather than relying on your bank examiners to go bank by bank, loan by loan to root out discrimination?

- Without the expanded HMDA data reporting slated to begin this year, what information will your agency's examiners have to trigger a review of potential discrimination?

Community Reinvestment Act

We have a massive affordable rental housing crisis in Nevada: 119,854 families pay more than half their income for rent.

One of the few resources we have is the Low Income Housing Tax Credit. The new tax law is already making it harder to finance low-income housing because the cost of the credit has fallen.

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Committee on Banking, Housing, and Urban Affairs
Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act
October 2, 2018

- How will your agencies monitor the implementation of the escrow exemption? Will your examiners monitor foreclosure activities resulting from unpaid property taxes and/or property insurance?

- How will you communicate any findings or concerns from the elimination of the escrow requirement to us in Congress?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

November 13, 2018

The Honorable David Perdue
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. *Section 401 Regulations*

Vice-Chair Quarles, when Congress wrote Section 401 of S.2155, it amended Section 165 of Dodd-Frank to raise the SIFI threshold up from $50 billion to $250 billion, but granted the Board of Governors of the Federal Reserve the right to promulgate rules for bank holding companies between $100 billion and $250 billion under certain circumstances. I would suggest that this is a forward looking provision that should serve as a safety valve should one of the firms become systemic. This is the logical course in light of the fact that you regulate these firms now and have repeatedly determined that they are not systemic to the financial system.

(a) **Since the Board has determined that there must be rules for bank holding companies between $100 and $250 billion to mitigate risks to U.S financial stability and promote safety and soundness, would you be sharing with us the empirical data that demonstrates that there is sufficient risk to the financial system poised by individual institutions between $100 and $250 billion?**

Section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) increased the minimum threshold for automatic application of enhanced prudential standards (EPS) from $50 billion to $250 billion. With respect to a bank holding company with total consolidated assets of between $100 billion and $250 billion, section 401 provides the Federal Reserve Board (Board) with discretion to apply EPS to a bank holding company if the Board determines the application of the standard or standards is necessary to prevent or mitigate risks to financial stability or promote safety and soundness, and taking into consideration size, complexity, and other risk-related factors. Consistent with these legislative changes and building on the Board's prior tailoring of its regulations, the Board is seeking comment on two proposals, one with the other federal banking agencies, which would establish four categories of prudential standards for large U.S. banking organizations. The proposed categories would set forth a framework for determining the application of prudential standards to firms with total consolidated assets of $100 billion or more but less than $250 billion, and for differentiating the standards that apply to all firms subject to prudential standards based on their risk profile. The proposal would also implement section 401(e) of EGRRCPA, which requires the Board to conduct periodic supervisory stress tests for bank holding companies with $100 billion or more, but less than $250 billion, in total consolidated assets.

The failure of a bank holding company with total consolidated assets of $100 billion or more but less than $250 billion could have a more significant negative effect on economic growth and employment relative to the failure or distress of smaller firms. In addition, the standards that would be applied to institutions of this size under the proposal would help promote the safety and soundness of these institutions and address weaknesses observed during the financial crisis. For example, the liquidity risk management and buffer requirements help to ensure that a large banking organization is equipped to manage its liquidity risk and to withstand disruptions in funding sources. These requirements address weaknesses observed during the financial crisis, when many banking organizations did not have adequate risk management practices to take into account the liquidity stresses of individual products or business lines, had not adequately accounted for draws from off-balance sheet exposures, or had not adequately planned for a disruption in funding sources.

b. Under the proposed rule, is it the Board's intention to apply a tailored version of the enhanced prudential standard on every institution between $100 and $250 billion or will the Board conduct an activity based risk analysis on each institution and impose a tailored enhanced prudential standard on institutions deemed too risky?

Please see the response to question 1(a).

2. *Recalibration of Thresholds*

Vice-Chair Quarles, S.2155 raised the SIFI threshold under Section 165 of Dodd-Frank from $50 billion to $250 billion.

Do you believe that S.2155 gives the Board the impetus to reevaluate whether or not it should readjust all other regulations where the Board relied upon Section 165's $50 billion threshold figure?

On October 31, 2018, the Board issued two notices of proposed rulemakings, one jointly with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), seeking comment on a framework for determining the prudential standards that apply to large U.S. banking organizations, based on the risk profiles of these firms. The proposals would build on the Board's existing tailoring of its rules and account for changes made by section 401 of EGRRCPA regarding enhanced prudential standards for these firms. In particular, the proposals would modify the enhanced prudential standards applicable to large banking organizations, including domestic and foreign banking organizations with more than $250 billion in total consolidated assets, based on the risk profile of these firms. In addition, the proposals would modify the thresholds for application of other requirements that rely on a $50 billion asset threshold, but which were not affected by EGRRCPA, such as the capital plan rule.

3. *FBO Treatment*

Vice-Chair Quarles, I understand from your testimony that the Board will continue to use the global consolidated assets for foreign banking organizations. FBO operations in the U.S cover a wide spectrum of activities that encompasses consumer and commercial banking, wealth management, and capital markets.

(a) Will the Board tailor treatment for FBOs to differentiate based upon their active footprint in the U.S for example will there be different treatment

between an entirely depository IHC and one that is heavily invested in the capital markets?

As noted in the previous answer, on October 31, 2018, the Board issued two notices of proposed rulemaking, one together with the OCC and FDIC, seeking comment on a framework for determining the prudential standards that apply to large U.S. banking organizations, based on the risk profiles of these firms. As noted in the proposals, the Board is considering the appropriate application of the categories of prudential standards described in the proposal to the U.S. operations of foreign banking organizations, in light of the special structures through which these firms conduct business in the United States. The Board plans to issue a separate proposal for public comment regarding foreign banking organizations that would reflect the principles of national treatment and equality of competitive opportunity.

(b) After the Board released the US IHC rules in 2014 that required foreign banks to hold additional capital and liquidity in the U.S. Brussels retaliated in 2016 with reciprocal standards that eventually forced both sides to hold additional capital and liquidity. Does geographic ring fencing make the international banking system safer?

The prepositioning of capital and liquidity in local jurisdictions can minimize the temptation of host jurisdictions to restrict the transfer of assets ("ring fencing") held locally of internationally active banking groups during a time of stress. Ring fencing of assets during stress can further exacerbate a stress event and destabilize a group. The Federal Reserve recognizes that an appropriate balance between centrally managed resources at the home country level and prepositioned capital and liquidity in host jurisdictions is the key to effective cooperation among home and host supervisors to resolve troubled banking groups.

(c) Is there a better solution than creating additional capital trapped on both sides of the Atlantic?

Across the globe supervisors recognize the benefits of efficient cross-border banking and efficient movement of capital and liquidity but are focused on minimizing the costs of cross-border resolutions given the experience with the recent financial crisis. The single-point-of-entry resolutions and bail-in concepts hold promise for minimizing resolution costs, but cooperation between home and host country supervisors is critical to achieving success. The Federal Reserve continues to be open to considering adjustments that would improve transparency and efficiency and will continue to reassess its regime relating to cross-border resolution.

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

Section 401 Regulations

Vice-Chair Quarles, when Congress wrote Section 401 of S.2155, it amended Section 165 of Dodd-Frank to raise the SIFI threshold up from \$50 billion to \$250 billion, but granted the Board of Governors of the Federal Reserve the right to promulgate rules for bank holding companies between \$100 billion and \$250 billion under certain circumstances. I would suggest that this is a forward looking provision that should serve as a safety valve should one of the firms become systemic. This is the logical course in light of the fact that you regulate these firms now and have repeatedly determined that they are not systemic to the financial system.

- Since the Board has determined that there must be rules for bank holding companies between \$100 and \$250 billion to mitigate risks to U.S financial stability and promote safety and soundness, would you be sharing with us the empirical data that demonstrates that there is sufficient risk to the financial system poised by individual institutions between \$100 and \$250 billion?

- Under the proposed rule, is it the Board's intention to apply a tailored version of the enhanced prudential standard on every institution between \$100 and \$250 billion or will the Board conduct an activity based risk analysis on each institution and impose a tailored enhanced prudential standard on institutions deemed too risky?

Recalibration of Thresholds

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- Is there a better solution than creating additional capital trapped on both sides of the Atlantic?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

November 13, 2018

The Honorable Dean Heller
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. Your agencies have been working on regulations to implement the Biggert-Waters Flood Insurance Reform Act of 2012 for the last six years. The rule regarding acceptance of private flood insurance has been proposed in draft form twice, the last time on January 6, 2017. Nearly all comments submitted on the two drafts expressed serious concerns over the proposals, and the unintended consequences that would result.

What steps are each of your agencies taking to address the concerns expressed during the comment period?

As you are aware, the National Flood Insurance Act (NFIA) makes the purchase of flood insurance mandatory in connection with loans made by a federally-regulated lending institution, including a state member bank, and secured by improved real estate or mobile homes in an area designated by Federal Emergency Management Agency (FEMA) as a Special Flood Hazard Area (SFHA). Currently, most of the flood insurance policies purchased to comply with NFIA are issued under FEMA's National Flood Insurance Program (NFIP).

The Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Farm Credit Administration (FCA), and the National Credit Union Administration (NCUA) (the Agencies), which are responsible for writing federal flood insurance rules, issued proposed rules in October 2013 and in November 2016 to implement the private flood insurance provisions of the Biggert-Waters Act (Act), but have not issued a final rule. The proposals incorporated the mandatory acceptance of private flood insurance policies that meet the criteria identified in the Act and clarified the applicable legal standards related to private flood insurance. Based on feedback from commenters, the Agencies re-proposed a rule in November 2016 that included "discretionary private flood insurance" criteria, which would permit lenders to accept private flood insurance that met some, but not all, of the criteria provided for by the Act to satisfy the statutory mandatory purchase requirement.

The comment period on the November 2016 proposal closed on January 6, 2017. Agency staff have carefully analyzed the written comments received in connection with both proposals and have also conducted further outreach with stakeholders to further understand concerns raised in the comments. Agency staff are working to publish a final rule in early 2019, balancing commenters' concerns with the requirements of the statute and principles of safety and soundness and consumer protection.

2. By law the Federal Reserve and Treasury Department are supposed to submit a report and testify to Congress on efforts to increase transparency at the International Association of Insurance Supervisors within 180 days.

Can you give an update on the progress of this mandated report and other requirements outlined in Section 212 of Public Law 115-174?

As a member of the International Association of Insurance Supervisors (IAIS), the Federal Reserve continues to work collaboratively in partnership with the National Association of Insurance Commissioners (NAIC) and the Federal Insurance Office (FIO), and remains committed to pursuing an engaged dialogue to achieve outcomes that are appropriate for the United States.

The Federal Reserve supports transparency in the development of international insurance standards at the IAIS. With regard to the report on the efforts of the Board and U.S. Treasury to increase transparency at IAIS meetings, we remain committed to producing this report, and expect to do so in a timely manner. The other reports required of the Board under Section 211 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)—namely, the annual report "with respect to global insurance regulatory or supervisory forums" and a joint report with the FIO required "before supporting or consenting to the adoption of any final international insurance capital standard"—also remain high priorities for timely and accurate completion in accordance with EGRRCPA.

Also, with regard to the EGRRCPA, we appreciate the opportunity to develop and engage with an Insurance Policy Advisory Committee on international capital standards and other issues, which we believe will be helpful in providing relevant information to both the domestic and international policy process. We are in the process of setting up that committee, in accordance with relevant federal laws.

It is important to recall that the IAIS has no ability to impose requirements on any national jurisdiction, and any standards developed through this forum is not self-executing or binding upon the U.S. unless adopted by the appropriate U.S. lawmakers or regulators in accordance with applicable domestic laws and rulemaking procedures.

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

Your agencies have been working on regulations to implement the Biggert-Waters Flood Insurance Reform Act of 2012 for the last six years. The rule regarding acceptance of private flood insurance has been proposed in draft form twice, the last time on January 6, 2017. Nearly all comments submitted on the two drafts expressed serious concerns over the proposals, and the unintended consequences that would result.

- What steps are each of your agencies taking to address the concerns expressed during the comment period?

By law the Federal Reserve and Treasury Department are supposed to submit a report and testify to Congress on efforts to increase transparency at the International Association of Insurance Supervisors within 180 days.

- Can you give an update on the progress of this mandated report and other requirements outlined in Section 212 of Public Law 115-174?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

November 13, 2018

The Honorable Mark Warner
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

<u>Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, from Senators Warner, Tillis, Jones, and Cotton</u>:

1. Comptroller Otting has testified before that "the process for complying with current BSA/AML laws and regulations has become inefficient and costly." In talking with banks/credit unions it is clear that they do not object to the principle of complying with AML regulations, it is that they feel that much of the time, effort, and money spent on compliance is ineffective, and therefore, a waste of time. Banks/credit unions fill out forms invented in the 1970s and have little insight into whether it is doing any good. And we've heard from banks/credit unions that they believe AML examinations are done without respect to the riskiness of the institution or its activities.

(a) What improvements can be made so we have a cheaper & faster system that is better at catching criminals?

The Federal Reserve supports efforts to review the efficiency and effectiveness of the Bank Secrecy Act (BSA) and anti-money laundering (AML) compliance framework for the banking organizations we supervise. To that end, the Federal Reserve is participating in a Treasury-led working group that will examine the BSA/AML framework, including the risk-focused approach to the examination process, and potential innovative ways in which financial institutions identify, detect, and report financial crime while still meeting the requirements of the statute and supporting law enforcement. Furthermore, in 2017, the Federal Reserve and other federal banking agencies completed a review of regulations prescribed by the agencies to identify outdated, unnecessary, or overly burdensome regulations, consistent with the statutory mandate under the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). As part of this review, several commenters suggested changes to the reporting requirements imposed under the regulations issued by Treasury's Financial Crimes Enforcement Network (FinCEN). The federal banking agencies have referred these EGRPRA comments to FinCEN as the agency with the responsibility and authority to amend the reporting obligations for banks under the BSA.

(b) Is there a place in a new AML regime for new technology, like artificial intelligence or machine learning?

The Federal Reserve recognizes that innovation by the private sector, including new ways of using existing tools and adopting new technologies, has the potential to improve the efficiency and effectiveness of a regulated institution's BSA/AML compliance program. While the Federal Reserve supports efforts by the banks we supervise to innovate, banks should also be prudent in evaluating the risks associated with any new technology and address information security issues, third-party risk management, and compliance with other applicable laws and regulations, including those related to customer notifications and privacy.

(c) What do you, as a regulator, think that it means to have a risk-based AML program?

A BSA/AML compliance program begins with a well-developed and documented risk assessment that identifies and limits the banking organization's risk exposure through its products, services, customers, and geographic locations. The Federal Reserve expects banking organizations to structure their BSA/AML compliance programs to adequately address their risk profiles, as identified by the risk assessment. Banking organizations should understand their BSA/AML risk exposure and develop the appropriate policies, procedures, and processes to monitor and control BSA/AML risks. It is essential that banking organizations make a judgment with respect to the level of risk customers pose. For example, the bank monitoring systems to identify, research, and report suspicious activity should be risk-based, with particular emphasis on higher-risk products, services, customers, entities, and geographic locations as identified by each bank's BSA/AML risk assessment.

(d) How do you implement the risk-based AML program requirement through examinations?

The Federal Reserve's BSA/AML examinations are risk-focused, so that supervisors apply the appropriate level of scrutiny to higher-risk business lines. To ensure consistent design and execution of our BSA/AML examinations, the Federal Reserve uses procedures developed jointly with the Federal Financial Institutions Examination Council (FFIEC),[5] FinCEN, and the Department of Treasury's Office of Foreign Assets Control (OFAC). The findings of the Federal Reserve's BSA/AML reviews are taken into account in determining examination ratings. The scoping and planning of an exam, such as the number of examiners and the length of the exam, is informed by the money laundering and terrorist financing risk profile of the supervised entity.

The Federal Reserve reinforces its supervisory program by conducting targeted examinations of financial institutions vulnerable to illicit financing. Banks are selected for such examinations based on a variety of factors including our analysis of the institution's payments activity, suspicious activity reports (SARs), currency transaction reports, and law enforcement activity.

2. One common criticism of the current AML regime is the lack of feedback given to banks/credit unions after they file their SARs. The current system is extremely segmented, and as a consequence, it is not the "fault" of any one entity that there is little feedback given. But without a system to provide feedback, the quality of SARs suffer. A system that doesn't focus on the quality of reports being filed is one that is not optimized to catch criminals. Many banks/credit unions wish that they had an idea of what FinCEN is really trying to find, because then their cooperation and input might be more helpful and effective.

(a) How often does your agency meet with FinCEN and with the DOJ/FBI to discuss the usefulness of suspicious activity reports that are being filed?

As you know, the Federal Reserve does not have the authority to conduct criminal investigations or to prosecute criminal cases. Rather, the Federal Reserve and other federal banking agencies ensure that suspected criminal activity is referred to the appropriate criminal authorities for prosecution, and the BSA rules are intended to achieve this purpose. Accordingly, the

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[5] The FFIEC is an interagency body made up of the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau, and the National Credit Union Administration, as well as a state liaison committee comprised of state supervisors.

Federal Reserve relies on the Justice Department, other law enforcement agencies, and FinCEN as the primary liaison for law enforcement, to communicate whether the reporting obligations of banks are furthering law enforcement's objectives. Indeed, communication among law enforcement, FinCEN, and the banking industry is important to maintaining a high degree of usefulness in SAR reporting.

The Federal Reserve has regular contact with the agencies that have responsibility for the administration and enforcement of the BSA, including through participation in the FFIEC. The FFIEC has a BSA working group that meets monthly to discuss relevant issues and that includes representatives from FinCEN. In addition, the Federal Reserve participates in the Bank Secrecy Act Advisory Group (BSAAG), a public-private partnership established by Congress for the purpose of soliciting advice on the administration of the BSA, which facilitates sharing of information on regulatory policies and initiatives, industry developments, and emerging money laundering threats. As part of these ongoing initiatives, as well as other collaborations between FinCEN and the federal banking agencies, the Federal Reserve has encouraged FinCEN to further consider ways to facilitate appropriate information sharing between the agencies and supervised institutions related to suspicious activity reporting.

(b) When a bank/credit union files a SAR, or a regulator is examining a financial institution, how much feedback is there across the system about whether or not the SARs they filed were found to be useful, informative, or effective?

The Federal Reserve examines, on a regular basis, institutions for which we have been granted supervisory authority from Congress and, through that activity, we provide feedback to institutions regarding their BSA/AML programs and their policies and procedures for monitoring, identifying and reporting suspicious activity to law enforcement. Federal Reserve examiners routinely discuss with management any supervisory concerns that arise during the examination with respect to the institution's BSA/AML program. These types of less formal communications are well-suited to address any deficiencies or violations of law that can be addressed while examiners are still on site. Problems that cannot be easily corrected are formally reported to the institution in an examination report or supervisory letter as a matter requiring management's attention. Supervision staff will subsequently follow up on management's actions and engage in additional dialogue with the institution as needed to address our concerns. Importantly, the Justice Department is the agency with the authority to prosecute any suspected criminal activity identified and reported by the institutions we supervise. Accordingly, Federal Reserve examiners are not in a position to discuss with management the value of any information the institution has presented as part of a SAR.

(c) What are the legal hurdles that prevent more effective and more regular feedback within the federal government and between the federal government and financial institutions?

As described above, the Federal Reserve has exercised the authority provided by Congress to examine the BSA/AML compliance programs of the institutions we supervise and to provide feedback at appropriate points during the examination process. Notwithstanding our supervisory role, the Federal Reserve, like other federal banking agencies, does not have unrestricted access to the information obtained by law enforcement officials during a criminal investigation that results from the filing a SAR, nor does it have the authority to interpret the policies and regulations that govern the protection and release of information that Justice Department officials obtain in the course of these investigations.

(d) Will you pledge to institutionalize feedback mechanisms wherein banks/credit unions both get and can give feedback on how to constantly improve the process?

The Federal Reserve will continue to carry out its mandate from Congress to examine the BSA/AML programs of the institutions we supervise, and to provide feedback at appropriate points during the supervisory process. As noted above, the Federal Reserve relies on the Justice Department, other law enforcement agencies, and FinCEN to communicate whether the reporting obligations of banks are furthering law enforcement's objectives. We also support efforts by these agencies to share information with the financial institutions as appropriate.

3. We hear from banks that they feel pressured to file SARs even when they believe the underlying transaction or activity does not rise to a level of suspiciousness that merits a filing. They say they do this because they are afraid of being second-guessed by examiners after the fact, and because there is no government penalty for over-filing SARs—only a penalty for not filing a SAR. But banks bear the significant cost of filing unnecessary SARs.

What can be done to realign incentives so that banks/credit unions don't feel pressured to file SARs that they don't feel reflects activity warranting a filing?

When conducting a BSA/AML examination, the Federal Reserve utilizes procedures contained in the interagency examination manual that was developed jointly between the Federal Reserve and the other members of the FFIEC in consultation with FinCEN. The FFIEC manual describes the regulatory expectations for suspicious activity reporting requirements and explains how examinations will be performed. The interagency examination manual recognizes that the decision to file a SAR under the reporting requirement is an inherently subjective judgment. The manual directs examiners to focus on whether the institution has an effective SAR decision-making process, not individual SAR decisions. The Federal Reserve, along with the other federal banking agencies, provides ongoing training opportunities to its examiners regarding BSA topics and various aspects of the BSA examination process.

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

4. Banks/credit unions commonly use "rules-based" software to screen transactions and alert AML compliance teams to suspicious activities. While these rules-based systems can be effective, we have concerns that they might not be the most effective tool available to us

given advances in data science and machine learning, and further, that there may be opportunities for criminals to manipulate these rules-based systems.

(a) We have heard concerns that many criminals have access to the exact same products that are used by financial institutions—is this true?

Some financial institutions have implemented commercially available suspicious activity monitoring systems that use rules to identify suspicious activity, based on certain thresholds, geographies, and other factors. These rules may be common among multiple financial institutions or developed from publicly available lists of red flags, high-risk jurisdictions and other data. That does not, however, mean that these systems are not effective in monitoring for suspicious activity. Many systems have overlapping and complementary rules that are designed to resist manipulation. Moreover, financial institutions are periodically required to independently test the effectiveness of their suspicious activity monitoring systems.

(b) If criminals have access to similar products, or can easily come to understand the rules-based system, how easy is it to manipulate these detection systems?

Please see answer to 4(a) above.

(c) If there was a proven model of using a "learning," algorithmic system to flag potentially suspicious transactions, would this be an improvement on the current system? What are the hurdles to financial institutions adopting such systems?

As stated above, the Federal Reserve recognizes that innovation has the potential to augment aspects of banks' BSA/AML compliance programs, such as risk identification, transaction monitoring, and suspicious activity reporting. As with all applications and technologies that firms employ, the Federal Reserve expects financial institutions to innovate in a responsible manner and to consider and address information security issues, third-party risk management, and compliance with other applicable laws and regulations, including those related to customer notifications and privacy.

(d) In what ways is a bank's/credit union's "safety and soundness" implicated by its AML system?

A review of an institution's compliance with the BSA has been part of the Federal Reserve's supervision of banks for many years, and is integrally related to our assessment of an institution's safety and soundness. The Federal Reserve expects the institutions we supervise to identify, measure, monitor, and control the risks of an institution's activities. The inability to properly manage legal and compliance risk, for example, can compromise a bank's safety and soundness by reducing the confidence of its customers and counterparties and result in loss of capital, lower earnings, and weakened financial condition. For these reasons, Congress amended the Federal Deposit Insurance Act in 1986 to require the Federal Reserve and other federal banking agencies to review the BSA/AML compliance program of the banks we supervise at each examination.

Under current interagency ratings guidance, the capability of the board of directors and management to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in the management or "M" component rating of banking agencies' CAMELS supervisory rating system. The Federal Reserve has established procedures to ensure that BSA/AML deficiencies are fully considered as part of an institution's management rating. Moreover, we direct our examiners to view serious deficiencies in a bank's BSA/AML compliance area, including program violations, as presumptively adversely affecting a bank's management component rating.

Questions for The Honorable Randal K. Quarles, Vice Chairman of Supervision, Board of Governors of the Federal Reserve System, from Senator Mark Warner, Senator Thom Tillis, Senator Doug Jones, and Senator Tom Cotton:

Comptroller Otting has testified before that "the process for complying with current BSA/AML laws and regulations has become inefficient and costly." In talking with banks/credit unions it is clear that they do not object to the principle of complying with AML regulations, it is that they feel that much of the time, effort, and money spent on compliance is ineffective, and therefore, a waste of time. Banks/credit unions fill out forms invented in the 1970s and have little insight into whether it is doing any good. And we've heard from banks/credit unions that they believe AML examinations are done without respect to the riskiness of the institution or its activities.

- What improvements can be made so we have a cheaper & faster system that is better at catching criminals?
- Is there a place in a new AML regime for new technology, like artificial intelligence or machine learning?
- What do you, as a regulator, think that it means to have a risk-based AML program?
- How do you implement the risk-based AML program requirement through examinations?

One common criticism of the current AML regime is the lack of feedback given to banks/credit unions after they file their SARs. The current system is extremely segmented, and as a consequence, it is not the "fault" of any one entity that there is little feedback given. But without a system to provide feedback, the quality of SARs suffer. A system that doesn't focus on the quality of reports being filed is one that is not optimized to catch criminals. Many banks/credit unions wish that they had an idea of what FinCEN is really trying to find, because then their cooperation and input might be more helpful and effective.

- How often does your agency meet with FinCEN and with the DOJ/FBI to discuss the usefulness of suspicious activity reports that are being filed?
- When a bank/credit union files a SAR, or a regulator is examining a financial institution, how much feedback is there across the system about whether or not the SARs they filed were found to be useful, informative, or effective?
- What are the legal hurdles that prevent more effective and more regular feedback within the federal government and between the federal government and financial institutions?
- Will you pledge to institutionalize feedback mechanisms wherein banks/credit unions both get and can give feedback on how to constantly improve the process?

We hear from banks that they feel pressured to file SARs even when they believe the underlying transaction or activity does not rise to a level of suspiciousness that merits a filing. They say they do this because they are afraid of being second-guessed by examiners after the fact, and because there is no government penalty for over-filing SARs—only a penalty for not filing a SAR. But banks bear the significant cost of filing unnecessary SARs.

- What can be done to realign incentives so that banks/credit unions don't feel pressured to file SARs that they don't feel reflects activity warranting a filing?

Banks/credit unions commonly use "rules-based" software to screen transactions and alert AML compliance teams to suspicious activities. While these rules-based systems can be effective, we have concerns that they might not be the most effective tool available to us given advances in data science and machine learning, and further, that there may be opportunities for criminals to manipulate these rules-based systems.

- We have heard concerns that many criminals have access to the exact same products that are used by financial institutions–is this true?

- If criminals have access to similar products, or can easily come to understand the rules-based system, how easy is it to manipulate these detection systems?

- If there was a proven model of using a "learning," algorithmic system to flag potentially suspicious transactions, would this be an improvement on the current system? What are the hurdles to financial institutions adopting such systems?

- In what ways is a bank's/credit union's "safety and soundness" implicated by its AML system?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

February 4, 2019

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are my responses to the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. Some provisions of S. 2155 may be implemented through guidance or other policy statements that do not go through formal notice and comment rulemaking. The Congressional Review Act requires agencies to submit, with certain minor exceptions, all rules to Congress for review. Under the Congressional Review Act, a rule, by definition, is "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency." This definition is very broad. In order to ensure Congress can engage in its proper oversight role, I encourage the regulators to follow the Congressional Review Act and submit all rules to Congress, even if they have not gone through formal notice and comment rulemaking.

Can you commit to following the law by submitting all rulemakings and guidance documents to Congress as required by the Congressional Review Act?

The Federal Reserve Board (Board) submits rules to Congress in accordance with the Congressional Review Act. As you know, the Board, along with other federal financial agencies, recently issued an interagency statement clarifying the role of supervisory guidance. The statement explains that, unlike a law or regulation, supervisory guidance does not have the force and effect of law and that the agencies should not and will not take enforcement actions based on supervisory guidance. The Board will continue its practice of submitting all binding rules to Congress as required under the Congressional Review Act and will be clear internally and externally that our guidance documents are not binding rules.

2. On July 6, 2018, the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency issued an interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act.[2] It is my understanding that the interagency statement would qualify as a rule under the Congressional Review Act.

Have the agencies submitted the interagency statement to Congress as required by the Congressional Review Act? If not, can you commit to submitting the interagency statement to Congress?

The July 6, 2018, interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) did not modify any existing rule of the Board. Rather, the interagency statement indicated that the Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) would not enforce certain regulations that were affected by EGRRCPA. As noted above, the Board will continue its practice of submitting all binding rules to Congress as required under the Congressional Review Act.

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[2] *See* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf.

3. Section 165 of Dodd-Frank established a $50 billion, and in some cases a $10 billion, threshold in total consolidated assets for the application of enhanced prudential standards. Such thresholds have been applied in rulemakings and guidance documents consistent with Dodd-Frank's requirements. As an example in 2012, regulators issued jointly supervisory guidance on company-run stress testing for banks with more than $10 billion in assets. The regulators have also applied numerous other standards using either the $10 billion or $50 billion asset threshold to be consistent with Section 165 of Dodd-Frank. For example, banks with $50 billion or more in total assets have historically been subject to CCAR, a supervisory test not required by statute.

Can you commit to reviewing all rules and guidance documents referencing thresholds consistent with Section 165 of Dodd-Frank, and revise such thresholds to be consistent with S. 2155?

On October 31, 2018, the Board issued two notices of proposed rulemaking, one together with the OCC and the FDIC, seeking comment on a framework for determining the prudential standards that apply to large U.S. banking organizations, based on the risk profiles of these firms. The proposals account for changes made by section 401 of EGRRCPA regarding enhanced prudential standards for these firms. As you suggest in this question, the Board also is evaluating changes to the prudential standards applicable to other large banking organizations, including rules that rely on a $50 billion total consolidated asset threshold but that were not affected by EGRRCPA. In addition, the Board is reviewing all guidance documents related to the statutory changes made by EGRRCPA.

United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510-6075

October 10, 2018

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

Dear Vice Chairman Quarles:

Thank you for testifying before the Committee on Banking, Housing, and Urban Affairs on October 2, 2018 at our hearing entitled, "*Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act.*" In order to complete the hearing record, we would appreciate your answers to the enclosed questions as soon as possible. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Ms. Dawn L. Ratliff, the Committee's Chief Clerk and Mr. Cameron D. Ricker, the Committee's Deputy Clerk. They will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Dawn_Ratliff@banking.senate.gov and Cameron_Ricker@banking.senate.gov.

If you have any questions about this letter, please contact Ms. Ratliff at (202) 224-3043.

Sincerely,

Mike Crapo

Mike Crapo
Chairman

MC/dr

Committee on Banking, Housing, and Urban Affairs
Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act
October 2, 2018

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

Some provisions of S. 2155 may be implemented through guidance or other policy statements that do not go through formal notice and comment rulemaking. The Congressional Review Act requires agencies to submit, with certain minor exceptions, all rules to Congress for review. Under the Congressional Review Act, a rule, by definition, is "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency." This definition is very broad. In order to ensure Congress can engage in its proper oversight role, I encourage the regulators to follow the Congressional Review Act and submit all rules to Congress, even if they have not gone through formal notice and comment rulemaking.

- Can you commit to following the law by submitting all rulemakings and guidance documents to Congress as required by the Congressional Review Act?

On July 6, 2018, the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency issued an interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act.[1] It is my understanding that the interagency statement would qualify as a rule under the Congressional Review Act.

- Have the agencies submitted the interagency statement to Congress as required by the Congressional Review Act?

- If not, can you commit to submitting the interagency statement to Congress?

Section 165 of Dodd-Frank established a $50 billion, and in some cases a $10 billion, threshold in total consolidated assets for the application of enhanced prudential standards. Such thresholds have been applied in rulemakings and guidance documents consistent with Dodd-Frank's requirements. As an example in 2012, regulators issued jointly supervisory guidance on company-run stress testing for banks with more than $10 billion in assets. The regulators have also applied numerous other standards using either the $10 billion or $50 billion asset threshold to be consistent with Section 165 of Dodd-Frank. For example, banks with $50 billion or more in total assets have historically been subject to CCAR, a supervisory test not required by statute.

- Can you commit to reviewing all rules and guidance documents referencing thresholds consistent with Section 165 of Dodd-Frank, and revise such thresholds to be consistent with S. 2155?

[1] *See* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

November 19, 2018

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. Thank you for the dialogue during our recent hearing and for clarifying that the G-SIB surcharge will be a part of the Federal Reserve's larger regulatory review. As the sponsor of S. 366, the TAILOR Act, which would require federal regulatory authorities to tailor regulations to the operational risk of a financial institution, I agree with you that reducing duplicative rules and regulatory inefficiencies is important.

This past January when you were speaking before the American Bar Association you mentioned that you would be working towards simplifying the framework regarding loss absorbency requirements, including the G-SIB surcharge, and that the 24 total loss absorbency requirements you counted in the existing regulatory framework "is too many." I appreciate your commitment and the commitment of Chairman Powell to engaging in a holistic review of these requirements and to examining the level of transparency in our regulatory process.

As the Federal Reserve undertakes its review of existing regulations, will you commit to instilling a greater degree of transparency in regulations, including by requests for public comment on the Federal Reserve's analysis?

Transparency is central to the Federal Reserve's mission and is key to ensuring that the Federal Reserve remains accountable to the public. In the rulemaking process, the Federal Reserve is committed to using public notice and comment procedures to ensure that its policymaking decisions are open to public scrutiny and participation. In addition, a transparent approach to rulemaking has the practical benefit of allowing the Federal Reserve to improve its proposals based on public input. Accordingly, the Federal Reserve will remain committed to the use of public notice and comment procedures to ensure a high degree of transparency in the development of regulations.

2. As you are aware, Section 201 of S. 2155 requires federal regulators to develop a Community Bank Leverage Ratio. If a community bank meets that ratio then they would automatically be considered to be in compliance with leverage capital requirements, risk-based capital requirements, and any other capital or leverage requirements to which that particular bank is subject to. This relief is critical for small institutions that are burdened by Dodd-Frank's regulatory overreach and have a more difficult time complying with regulations than do their larger counterparts.

When does the Federal Reserve intend to begin implementation of this section of the legislation?

As you indicate, the recent Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) requires the appropriate federal banking agency to create a simple leverage ratio framework for community banks with less than $10 billion in total consolidated assets. The Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) are working to issue a joint notice of proposed rulemaking that would seek feedback from community banks, consumers, and the broader public. The Agencies expect to issue the proposed joint rulemaking for public comment in the near future.

3. Last spring the Federal Reserve proposed changes to the regulatory capital framework that were designed to simplify capital management and increase transparency. An important part of that proposal were changes to certain CCAR assumptions the Federal Reserve has previously made. Many of the proposed CCAR changes are improvements on the existing regulatory process and would be more accurate reflections of how companies and markets react during periods of economic stress.

It would therefore seem to be unnecessary to delay making these improvements only because similar proposals made by the Federal Reserve like the stress capital buffer need additional improvements.

Because the next iteration of the CCAR process is due to begin soon, will you commit to finalizing the CCAR changes that the Federal Reserve proposed and incorporate them into the 2019 CCAR exercise?

The changes associated with the stress capital buffer proposal would simplify the Federal Reserve's capital rules for large banks, while preserving strong capital levels that would maintain their ability to lend to households and businesses under stressful conditions. The Federal Reserve Board (Board) is carefully reviewing comments received on the stress capital buffer proposal, including on the proposed modifications of several assumptions in the Comprehensive Capital Analysis and Review (CCAR) process to better align them with a firm's expected actions under stress. The Board is working to complete its review in a timely manner.

4. On July 12, 2018, I sent you written questions following the April 19th hearing before the Committee. The question related to how you were going to help farmers, ranchers and manufacturers in South Dakota that use derivatives markets to manage their risk. Specifically, I asked if you plan to recognize margin contributed by clients for cleared derivatives as offsetting under the leverage ratio.

In response, you said you would look closely at adjusting the treatment of initial margin under the leverage ratio and that the Basel Committee on Banking Supervision is reviewing this issue to understand the impact of the leverage ratio on incentives to clear over the counter derivatives.

The Financial Stability Board, the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions jointly considered incentives to clear derivatives. On behalf of the United States, the Federal Reserve and CFTC contributed to this effort. A follow-up report that was released on August 7th of this year found that the current regulatory treatment disincentivized client clearing.

Europe has already proposed an offset of initial margin under the leverage ratio.

Now that the issue has been studied, can you provide an update on the Federal Reserve's plan to provide an offset of initial client margin for cleared derivatives under the leverage ratio?

The Board is committed to domestic and international policy initiatives that support the use of well-regulated and well-managed central counterparties to clear derivative contracts. On October 30, 2018, the Agencies approved a joint proposal that would implement a new standardized approach for calculating the exposure amount of derivative contracts in the Agencies' risk-based and leverage capital rules. As part of that proposal, the Agencies are inviting comment on the recognition of initial margin provided by clearing member clients for purposes of the supplementary leverage ratio, and asking for comment on the recent Basel Committee on Banking Supervision proposal regarding the recognition of client collateral in the leverage ratio.[1] The proposal allows for a sixty-day comment period, and the Board will review comments on the proposal after the comment period ends.

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[1] See https://www.bis.org/bcbs/publ/d451.pdf.

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

Thank you for the dialogue during our recent hearing and for clarifying that the G-SIB surcharge will be a part of the Federal Reserve's larger regulatory review. As the sponsor of S. 366, the TAILOR Act, which would require federal regulatory authorities to tailor regulations to the operational risk of a financial institution, I agree with you that reducing duplicative rules and regulatory inefficiencies is important.

This past January when you were speaking before the American Bar Association you mentioned that you would be working towards simplifying the framework regarding loss absorbency requirements, including the G-SIB surcharge, and that the 24 total loss absorbency requirements you counted in the existing regulatory framework "is too many." I appreciate your commitment and the commitment of Chairman Powell to engaging in a holistic review of these requirements and to examining the level of transparency in our regulatory process.

- As the Federal Reserve undertakes its review of existing regulations, will you commit to instilling a greater degree of transparency in regulations, including by requests for public comment on the Federal Reserve's analysis?

As you are aware, Section 201 of S. 2155 requires federal regulators to develop a Community Bank Leverage Ratio. If a community bank meets that ratio then they would automatically be considered to be in compliance with leverage capital requirements, risk-based capital requirements, and any other capital or leverage requirements to which that particular bank is subject to. This relief is critical for small institutions that are burdened by Dodd-Frank's regulatory overreach and have a more difficult time complying with regulations than do their larger counterparts.

- When does the Federal Reserve intend to begin implementation of this section of the legislation?

Last spring the Federal Reserve proposed changes to the regulatory capital framework that were designed to simplify capital management and increase transparency. An important part of that proposal were changes to certain CCAR assumptions the Federal Reserve has previously made. Many of the proposed CCAR changes are improvements on the existing regulatory process and would be more accurate reflections of how companies and markets react during periods of economic stress.

It would therefore seem to be unnecessary to delay making these improvements only because similar proposals made by the Federal Reserve like the stress capital buffer need additional improvements.

- Because the next iteration of the CCAR process is due to begin soon, will you commit to finalizing the CCAR changes that the Federal Reserve proposed and incorporate them into the 2019 CCAR exercise?

Committee on Banking, Housing, and Urban Affairs
Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act
October 2, 2018

On July 12, 2018, I sent you written questions following the April 19th hearing before the Committee. The question related to how you were going to help farmers, ranchers and manufacturers in South Dakota that use derivatives markets to manage their risk. Specifically, I asked if you plan to recognize margin contributed by clients for cleared derivatives as offsetting under the leverage ratio.

In response, you said you would look closely at adjusting the treatment of initial margin under the leverage ratio and that the Basel Committee on Banking Supervision is reviewing this issue to understand the impact of the leverage ratio on incentives to clear over the counter derivatives.

The Financial Stability Board, the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions jointly considered incentives to clear derivatives. On behalf of the United States, the Federal Reserve and CFTC contributed to this effort. A follow-up report that was released on August 7th of this year found that the current regulatory treatment disincentivized client clearing.

Europe has already proposed an offset of initial margin under the leverage ratio.

- Now that the issue has been studied, can you provide an update on the Federal Reserve's plan to provide an offset of initial client margin for cleared derivatives under the leverage ratio?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

November 15, 2018

The Honorable Pat Toomey
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. As I stated during the hearing, I greatly appreciated the recent Interagency Statement Clarifying the Role of Supervisory Guidance.

(a) Could you describe what, if any, additional steps you have taken to ensure that the content of the statement is understood and observed by your examination staff?

We have taken a number of steps to reaffirm the role of supervisory guidance in our communications to examiners and to supervised institutions. First, on October 4, 2018, we conducted an internal, mandatory training session for all our supervisory staff to reinforce the distinctions between laws and regulations versus guidance and to clarify the use of guidance in the supervisory process. Second, we are helping examiners with outreach to supervised institutions in answering questions about the policy statement. Third, we are reviewing the templates examiners use when they refer to supervisory guidance in their communications with supervised institutions. Fourth, we will continue to review supervisory findings to confirm that our examiners are referring to guidance appropriately. Finally, we regularly solicit the views of the firms we supervise on our supervisory process to include their views on our use of guidance in supervisory communications.

(b) Additionally, have past supervisory actions been reviewed to confirm that they are consistent with the statement? If so, have any problems been identified?

In connection with our ongoing scrutiny of supervisory practices, of which our clarification of the role of supervisory guidance forms a part, we look at existing supervisory actions to ensure that they are in line with developments in policy. At this point we have not found many instances where guidance has been used inappropriately in light of our clarifying statement, but in cases where we do discover that a reference to guidance in a supervisory action is inconsistent with our policy, we will address the error promptly.

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

As I stated during the hearing, I greatly appreciated the recent Interagency Statement Clarifying the Role of Supervisory Guidance.

- Could you describe what, if any, additional steps you have taken to ensure that the content of the statement is understood and observed by your examination staff?

- Additionally, have past supervisory actions been reviewed to confirm that they are consistent with the statement?

    - If so, have any problems been identified?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

November 29, 2018

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. *Sales practices*

The Wells Fargo fraudulent account scandal exposed how abusive sales practices and incentive compensation place consumers at risk of harm. In the two years since the first Wells Fargo scandal, we've watched as bank executives blamed low-paid employees for sales practices gone wrong, but in reality, these scandals reflect a failure of risk management and bank culture that comes from the top. A new report by the National Employment Law Project found that 90 percent of bank employees surveyed stated that failure to meet sales quotas still results in bullying, disciplinary action or possible termination.

Are your agencies incorporating reviews of sales practices and compensation programs into your supervision?

If so, does that include any input or feedback from frontline employees?

If not, how are you monitoring possible misconduct related to sales practices?

One of the Federal Reserve's fundamental goals is to promote a financial system that is strong, resilient and able to serve a healthy and growing economy. We work to ensure the safety and soundness of the firms we supervise, as well as their compliance with applicable consumer protection laws, so that such firms may, even when faced with stressful financial conditions, continue serving consumers, businesses, and communities.

The Federal Reserve applies high standards for risk management, internal controls, and consumer protection to organizations under its responsibility. To that end, we review compliance risk management and board oversight of bank holding companies and state member banks. We are focused on the compliance environment with respect to sales practices, and seek to ensure that internal controls, senior management oversight, and involvement of the board of directors are appropriately tailored to limit these risks according to each firm and the banking system as a whole.

Recently, the Federal Reserve assessed our existing guidance related to sales practices, incentive compensation, and fraud, and we determined that the existing guidance is sufficient to cover supervisory expectations for large and regional banks.[2] In addition, the Federal Reserve coordinated with other financial regulatory agencies to conduct a review of sales practices,

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[2] Supervision and Regulation (SR) Letter 12-17/CA 12-14, Consolidated Supervision Framework for Large Financial Institutions (Dec. 17, 2012); Interagency Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. 36,395 (June 25, 2010); SR Letter 08-09/CA 08-12, Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations (Oct. 16, 2008); SR Letter 08-08/CA 08-11, Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles (Oct. 16, 2008).

incentive compensation, and fraud at some of the largest banking organizations under our supervision, which included reviewing audit reports related to sales practices, both internal and external as applicable, as well as interviews conducted with frontline employees.

The Federal Reserve's review noted that some banks needed to strengthen policies and procedures, management information systems reporting to all levels of management, and training. More specifically, a few banks had inadequate programs for oversight escalation and investigations of unethical behavior, and complaints were not always adequately captured for resolution. Any matters detected at these banks are being reviewed through active continuous monitoring or through specific follow-up examinations being conducted by the Federal Reserve.

2. *Bank of America*

Last week, I sent a letter to the CEO of Bank of America regarding recent customer reports that the bank has asked existing account holders for their citizenship status, and in some cases the bank has frozen accounts when customers fail to respond.

Have any of your agencies directed or suggested to banks under your supervision to ask existing account holders for their citizenship status? Please provide any information about whether any institutions may have been asked or encouraged to collect citizenship information on existing customers.

The Federal Reserve is not aware of instances in which an institution we supervise has been directed by our examiners to request the citizenship status of an existing account holder. As you may know, banks are generally required under the Bank Secrecy Act (BSA) to have risk-based procedures to identify their customers at account opening and to conduct appropriate customer due diligence (CDD) throughout the lifespan of the account relationship. For example, under the Customer Identification Program (CIP) regulations adopted by the Federal Reserve and the Financial Crimes Enforcement Network (FinCEN), banks are required to obtain, at a minimum, the customer's name, date of birth, address, and identification number, and to verify the customer's identity using documentary or non-documentary means. For a U.S. person, the identification number is their taxpayer identification number. For a non-U.S. person, the identification number may be a passport number, alien identification card, or any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

In addition, under the CDD regulations adopted by FinCEN, banks are required to collect customer information commensurate with the customer's risk profile. Indeed, the level and type of customer information gathered under the CDD rule may vary from customer to customer. Although citizenship information is not expressly required by the CIP or CDD regulations, banks may choose to collect additional customer information in accordance with their own policies and procedures. The Federal Reserve's supervisory expectation is that banks can offer account services to law-abiding customers, including those who are not U.S. citizens, by applying risk-based policies, procedures, and processes as required under the BSA.

3. In April, you said that the Section 956 incentive-based compensation rulemaking "had not fallen behind the refrigerator."[3] In July, Chair Powell said that regulators had effectively ceased work on this rulemaking. He recently clarified in response to questions for the record that the agencies are continuing to consider the comments to the proposed rule.

Can you provide an update on this joint rulemaking? When can we expect to see a final rule?

The Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities Exchange Commission, National Credit Union Association, and the Federal Housing Finance Agency (the agencies), jointly published and requested comment on the revised proposed rule in June 2016. The agencies received over one hundred comments and many raised important and complicated questions. The agencies continue to consider the complex issues raised in comments and do not have a projected date for completion of this rulemaking.

[3] https://plus.cq.com/doc/congressionaltranscripts-5302844?3.

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

Sales practices

The Wells Fargo fraudulent account scandal exposed how abusive sales practices and incentive compensation place consumers at risk of harm. In the two years since the first Wells Fargo scandal, we've watched as bank executives blamed low-paid employees for sales practices gone wrong, but in reality, these scandals reflect a failure of risk management and bank culture that comes from the top. A new report by the National Employment Law Project found that 90 percent of bank employees surveyed stated that failure to meet sales quotas still results in bullying, disciplinary action or possible termination.

- Are your agencies incorporating reviews of sales practices and compensation programs into your supervision?

- If so, does that include any input or feedback from frontline employees?

- If not, how are you monitoring possible misconduct related to sales practices?

Bank of America

Last week, I sent a letter to the CEO of Bank of America regarding recent customer reports that the bank has asked existing account holders for their citizenship status, and in some cases the bank has frozen accounts when customers fail to respond.

- Have any of your agencies directed or suggested to banks under your supervision to ask existing account holders for their citizenship status? Please provide any information about whether any institutions may have been asked or encouraged to collect citizenship information on existing customers.

In April, you said that the Section 956 incentive-based compensation rulemaking "had not fallen behind the refrigerator."6 In July, Chair Powell said that regulators had effectively ceased work on this rulemaking. He recently clarified in response to questions for the record that the agencies are continuing to consider the comments to the proposed rule.

- Can you provide an update on this joint rulemaking? When can we expect to see a final rule?

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[6] https://plus.cq.com/doc/congressionaltranscripts-5302844?3

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

March 18, 2019

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2, 3(a), and 3(b) that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On December 21, 2018, I provided responses to questions 1 and 4 through 9. A copy has also been forwarded to the Committee for inclusion in the hearing record. This constitutes the completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

2. Recently, former Fed Chair Yellen said in an interview that "regulators should sound the alarm," with regard to risks posed by leveraged corporate lending.[1] Chair Yellen noted that regulators "should make it clear to the public and the Congress there are things they are concerned about and they don't have the tools to fix it."[2]

Do you agree with this statement from Chair Yellen on the risks posed by growing leverage in corporate lending?

We continue to monitor and assess leveraged loan risk closely in the banks we supervise. The Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (the Agencies) believe that supervised banks can continue to participate in leveraged lending activities and provide credit to this market segment, provided such activities, as with all lending activities, are conducted in a prudent manner, consistent with safety and soundness standards.

Even when the direct risks posed to the banking sector are limited – principally because most leveraged loans originated by banks are promptly sold to other investors – indirect risks could arise if banks were separately exposed to those purchasers. The principal purchasers of leveraged loans from banks are collateralized loan obligation (CLO) vehicles, which are usually structured to reduce their susceptibility to runs by ensuring that the duration of their liabilities exceeds those of their assets. We monitor banks' exposures to such structures and take appropriate supervisory steps to reduce the risk that such exposures could rise to a level that might undermine confidence in a bank if the value of that bank's CLO holdings were to decline precipitously. At the same time, the Financial Stability Board under my chairmanship has begun analyzing the global distribution of exposure to CLOs, to understand whether such risks are arising elsewhere in the financial system.

3. When Chairman Powell was a Fed governor in 2015, he noted that the Fed's leveraged lending guidance from 2013 would "stand in the way of a return to pre-crisis conditions."[3]

(a) Do you agree? If so, why has the Fed lessened the supervisory consequences for banks not in conformance with that guidance?

The Agencies issued the 2013 Interagency Leveraged Lending Guidance (2013 Guidance)[4] to provide banks with principles that are particularly relevant when we evaluate leveraged loan risk management and prudent underwriting. As discussed in the 2013 Guidance, and consistent with

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[1] https://www.bloomberg.com/news/articles/2018-09-27/wall-street-s-riskiest-loans-flash-dangers-as-watchdogs-muzzled?srnd=premium.

[2] *Id.*

[3] https://www.federalreserve.gov/newsevents/speech/powell20150218a.htm.

[4] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, "Interagency Guidance on Leveraged Lending," March 21, 2013, https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf.

banks' obligations to operate in a safe and sound manner,[5] the Agencies continue to believe that banks engaged in leveraged lending activities should have underwriting standards that reflect the bank's risk appetite, and that consider covenant protections for expected financial performance, reporting requirements, and compliance monitoring. When assessing banks' practices, examiners focus on any weaknesses that could affect safety and soundness, taking into account each bank's individual circumstances.

As supervisory guidance, the 2013 Guidance does not have the force and effect of law, and the Agencies do not take enforcement actions based on supervisory guidance. Examiners may refer to the principles outlined in the 2013 Guidance when they assess any impact on safety and soundness posed by leveraged lending activities. If a bank has deficient practices relating to safety and soundness, the Agencies may take supervisory or enforcement actions, as appropriate, so that the institution addresses those deficiencies.

(b) How is the Fed protecting the banking sector from the risks of leveraged corporate lending? As a member of the Financial Stability Oversight Council, what is the Fed doing to protect against emerging risks among nonbank lenders?

The Agencies expect supervised banks to have prudent credit underwriting practices and commensurate risk management processes, as well as appropriate controls, transparency, and communication to senior management and the board of directors about leveraged lending risks. Deficient policies, procedures, or practices that relate to safety and soundness may result in supervisory actions.

In addition, the Agencies will continue to perform semi-annual interagency Shared National Credit (SNC) reviews. For some time, SNC reviews have been heavily weighted towards leveraged loans, and results are used by examiners when assessing credit quality and risk management practices at individual banks.

The Agencies also evaluate the results of various stress tests performed by the banks we supervise. Leveraged loans are one of several asset classes stressed under different scenarios to assess whether capital levels are appropriate. Examiners will take supervisory action if adverse findings are revealed.

The Financial Stability Oversight Council (FSOC) is able to analyze financial stability issues it may identify, as appropriate, including any related to leveraged lending markets. The FSOC has noted leveraged lending in some of its previous annual reports, including the most recent report.

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[5] Section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p-1) requires each of the Agencies to prescribe bank standards relating to internal controls, information systems, and internal audit systems; loan documentation; credit underwriting; interest rate exposure; asset growth; compensation, fees, and benefits; and such other operational and managerial standards as it determines to be appropriate.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

December 21, 2018

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1 and 4 through 9 that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question is forthcoming

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. While S.2155 does not require the Fed to change the domestic asset threshold for the establishment of an intermediate holding company for a foreign banking organization, does the Fed have any plans to alter the current $50 billion U.S. non-branch asset threshold?

As you note in this question, S. 2155 does not require the Federal Reserve Board (Board) to change the U.S. asset threshold for the establishment of an intermediate holding company (IHC), which is currently at $50 billion in U.S. non-branch assets. Foreign banking organizations are subject to Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) based on total global consolidated assets. In applying section 165 to foreign banks, the Board previously has tailored the enhanced prudential standards based, in part, on the size and nature of a foreign bank's activities in the United States. The IHC requirement and $50 billion U.S. non-branch asset IHC threshold are examples of tailored standards based on the size and nature of a foreign bank's activities in the United States. Consistent with section 165, as amended by the Economic Growth, Regulatory Reform, and Consumer Protection Act (EGRRCPA), and the Board's longstanding policy objectives, the Board's enhanced prudential standards generally treat the U.S. operations of a foreign banking organization similarly to a domestic banking organization of the same size and business model. As a general matter, the Board routinely evaluates whether changes to certain standards would be appropriate, and the Board anticipates that it will continue this practice, taking into account the structures through which foreign banking organizations operate in the United States.

4. Fed officials, including yourself, have said the economy is performing robustly – for example, banks are more profitable than ever. Wall Street Reform required that bank capital requirements should increase in "times of economic expansion," but Chairman Powell has said now is not the time to activate the countercyclical capital buffer.

If not now, then when? Would increasing the capital buffer now give the Fed more room to lower it in the future, and soften the impact of the next downturn?

The countercyclical capital buffer (CCyB) is designed to increase the resilience of large banking organizations when there is an elevated risk of above-normal losses. The Federal Reserve finalized its policy statement on the CCyB in 2016, which spelled out a comprehensive framework for setting its level. The framework centers on the Board's assessment of the overall vulnerability of the financial system. It incorporates the Board's judgement of not only asset valuations and risk appetite, but also the level of three other key financial vulnerabilities that tend to vary with the economic cycle—financial leverage, nonfinancial leverage, and maturity and liquidity transformation—and how all four of those vulnerabilities interact.

Within that framework, asset valuations continue to be elevated, despite recent declines in the forward price-to-earnings ratio of equities and the prices of corporate bonds. In the private nonfinancial sector, borrowing among highly-levered and lower-rated businesses remains elevated, although the ratio of household debt to disposable income continues to be moderate.

However, the financial system is substantially stronger than at similar points in previous cycles. Bank capital ratios and liquidity buffers are now substantially higher than they were a decade ago. The stress tests ensure that the largest banks can continue to support economic activity even in the face of a severe recession – importantly, one characterized by extreme declines in asset prices. Following our scenario design framework for the stress tests, the scenarios used this year were the most severe since the start of the CCAR program in 2011, reflecting the framework's countercyclical elements. Outside the banking system, financial leverage does not appear to have risen to elevated levels, and the risks associated with maturity transformation by money-market mutual funds are much reduced from the levels seen a decade ago.

Thus, I believe that the financial system is quite resilient, with the institutions at the core of the system well capitalized and less risky. Central clearing of derivatives limits the amount of contagion from the distress of an institution.

The CCyB is an important mechanism to build resilience among the largest banks should it become appropriate to do so, and we are carefully assessing relevant developments. If asset valuation pressures were to continue to build, especially if they were accompanied by increased leverage or increased maturity and liquidity transformation, activation of the CCyB could promote additional resilience among the largest U.S. banks, and then its later reduction during a downturn could support lending in that period.

5. Some of the sponsors of S.2155 and Chairman Powell have said that they do not intend for S.2155 to benefit large foreign banks operating in the U.S. But you've given speeches saying that the Fed should take a look at reducing the regulatory burden on these banks, saying that the Fed should "reconsider its calibration" of foreign bank rules.

As you run to head the Financial Stability Board – a crucial position leading international bank regulators – don't you think it's important for the United States to offer a united perspective that we must maintain the post-crisis regulatory framework for all large banks?

Post-financial crisis reforms have resulted in substantial gains in the resiliency of banking organizations and the financial system as a whole. We undoubtedly have a stronger and more resilient financial system due in significant part to the gains from those core reforms.

In undertaking a review of the post-crisis body of regulations, however, in addition to ensuring that we are satisfied with the effectiveness of these regulations, we have an opportunity to evaluate whether we can improve the efficiency, transparency, and simplicity of regulation. If we can achieve the same outcome with more efficient regulations, that is a benefit for the entire financial system.

The Board recognizes the important role that foreign banking organizations play in the U.S. financial sector and remains committed to the principles of national treatment and equality of competitive opportunity between the U.S. operations of foreign banking organizations and U.S. banking organizations. Consistent with section 165 of the Dodd-Frank Act, as amended by

EGRRCPA, and the Board's longstanding policy objectives, the Board's enhanced prudential standards generally treat the U.S. operations of a foreign banking organization similarly to a domestic banking organization of the same size and business model. As a general matter, the Board anticipates that it would continue this practice, while taking into account the structures through which foreign banking organizations operate in the United States.

6. At the hearing, you noted in response to a question regarding the GSIB surcharge that the Fed will reconsider it, in part, "to insure that we have a level playing field internationally not as a way of trying to seek a benefit for our firms, but because when you have an international system that has an unlevel playing field, over time pathologies will develop as activity moves to different areas of that global system not on the basis of - or driven by incentives other than purely economic incentives - incentives by the cost of capital." Currently, the GSIB surcharge in the U.S. is higher than the surcharge mandated by the Basel Committee on Banking Supervision.

Has this, to date, caused any pathologies to develop or caused activity to move out of U.S. banks and to other banks in the global system?

The Board's capital rules have been designed to significantly reduce the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure were it to occur. Thus, the capital surcharge applied to U.S. global systemically important banking organizations (GSIBs) was calibrated so that each GSIB would hold enough capital to lower its probability of failure so that the expected impact of its failure would be approximately equal to that of a non-GSIB. In particular, the Board's "method 2" GSIB surcharge methodology takes into account the risks of short-term wholesale funding, and results in a higher surcharge than the international surcharge methodology designed by the Basel Committee on Banking Supervision (BCBS). Reliance on short-term wholesale funding is indicative of interconnectedness and makes firms vulnerable to large-scale funding runs.

The Board has noted unintended consequences related to the leverage ratio requirements applied to U.S. GSIBs, which may encourage them to reduce their activity in certain low-risk, but capital intensive, activities. For example, the Board is aware that the enhanced supplementary leverage ratio standards for U.S. GSIBs may increase the costs for low-risk and low-margin activities, such as custodial services. In direct response to the regulatory requirements, certain U.S. GSIBs indicate that they have pursued a strategy of restricting the availability of their custodial services and passing along higher costs to customers.

The bulk of post-crisis regulation largely complete, with the important exception of the U.S. implementation of the recently concluded BCBS agreement on bank capital standards. It is therefore a natural and appropriate time to step back and assess those efforts. The Board is conducting a comprehensive review of the regulations in the core areas of post-crisis reform, including capital, stress testing, liquidity, and resolution. The objective of this review is to consider the effect of those regulatory frameworks on the resiliency of the financial system, including improvements in the resolvability of banking organizations, and on credit availability and economic growth.

In general, I believe overall loss-absorbing capacity for our largest banking organizations is at about the right level. Critical elements of our capital structure for these organizations include stress testing, the stress capital buffer, and the enhanced supplementary ratio. Work is underway to finalize the calibration of these fundamental building blocks, all of which form part of the system in which the GSIB surcharge has an effect.

7. Former Fed Governor Tarullo recently stated, "there is still some legitimate question among people as to whether if one of [the largest U.S. banks] got into significant trouble — and if one does the others will probably be at least under some stress — whether there still wouldn't be a view that they are too big to fail and that the government should take extraordinary measures."[1]

Do you agree with this statement?

U.S. regulators have made a great deal of progress in our work to address the too-big-to-fail phenomenon. Notably, the statutory framework established by Congress and the efforts of financial regulators have made the largest banking firms more resilient and have significantly improved their resolvability. In particular, for the largest, most systemically important firms, the Federal Reserve has increased the quantity and quality of capital that they maintain, have established capital surcharges that are scaled to each firm's systemic risk footprint, have required them to have more stable liquidity risk profiles, and have required them to carry long-term debt that can be converted to equity as part of a resolution.

In this regard, I believe it is much more likely that the failure of one of our most systemically important financial institutions could be resolved without critically undermining the financial stability of the United States. Moreover, more of the losses from such a failure would fall on the firm's shareholders and bondholders, not the Deposit Insurance Fund or taxpayers. Investors have recognized this progress as well. For example, the major rating agencies have removed the ratings benefit associated with the perceived government support that they once ascribed to the largest bank holding companies. That said, financial institutions and markets are always evolving, and therefore it is important to remain vigilant regarding changing systemic risks.

8. The federal financial agencies often take intermediate steps to address problems in the financial institutions they regulate before formal enforcement actions are taken. For example, we know that the OCC had taken supervisory actions related to concerns about Wells Fargo's sales practices before the 2016 enforcement action.

Please describe the process for how your agency determines what type of supervisory action to take when it finds a problem at a financial institution it regulates, how it expects the financial institution to address the problem, how much time a financial institution is given to address the problem, how the agency follows up with the financial institution on the problem, and how the agency makes a determination that a problem has not been addressed and warrants escalated action.

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[1] https://www.politico.com/story/2018/09/26/wall-street-too-big-to-fail-podcast-842587.

The Federal Reserve's supervisory program is designed to focus on both individual firms and portfolio-wide risks in order to mitigate threats to a firm's safety and soundness and financial stability. Supervisors engage in continuous monitoring of firms and routinely meet with the firm's staff to discuss the operations of the firm, new issues, and remediation plans for previously identified weaknesses. Supervisors also conduct horizontal and firm specific examinations. The type of supervisory action taken is based on individual facts and circumstances and depends upon the number of violations, materiality to the safety and soundness of the firm, repeat nature of the deficiencies, and the ability of current management to correct the issues.

Prior to a formal enforcement action, supervisors have a range of tools available to address identified problems at a firm. Informal enforcement actions that may be taken include issuing supervisory findings or entering into a memorandum of understanding. Supervisors consider the type of action to take based upon the severity, complexity, and impact of the weaknesses identified. A frequently used method is to issue supervisory findings to a firm after an examination. These include recommendations for follow-up action on the part of the organization's management. These "matters requiring attention" (MRA) call for action to address weaknesses in processes or controls that could lead to deterioration in a banking organization's soundness, may result in harm to consumers, or could lead to noncompliance with laws and regulations. When weaknesses are acute or protracted, Federal Reserve examiners may recommend that management take action more quickly by issuing a "matter requiring immediate attention" (MRIA). A high volume of these may prompt an examiner to assign a less than satisfactory annual composite rating to a holding company.

Supervisory actions generally require that the institution submit a remediation plan that details how it expects to remediate issues identified by supervisors. Once a remediation plan is submitted, the Federal Reserve will notify the firm if the remediation plan is approved or whether changes are needed. Once agreement is reached on a remediation plan, the firm will implement the plan in accordance with designated timelines. Generally, after the firm believes that remediation is complete, the firm's internal audit function will validate implementation of the remediation plan. After internal audit validation, examiners also will confirm that implementation of remediation actions has taken place. If supervisors believe that a firm is not adequately addressing noted deficiencies, then the matter may be escalated and stronger supervisory actions imposed. These actions may include formal enforcement actions and, in some cases, fines. Occasionally, if the deficiencies result in the firm being in an unsafe or unsound condition or there is a violation of law or regulation, a formal or informal enforcement action may be pursued in the absence of previously communicated MRAs or MRIAs.

9. As you know, financial institution misconduct often continues for many years, and it raises concerns that the current supervisory process is ineffective in addressing problems.

Given that the details about supervisory actions including "matters requiring attention" or "MRAs" are considered confidential supervisory information, please provide the committee for each year starting in 2005 the aggregate number of outstanding MRAs from the Fed for the U.S. GIBs, and the aggregate number of MRAs that were satisfactorily addressed and are no longer outstanding.

On November 9, 2018, the Board released a *Supervision and Regulation Report* that provides data related to outstanding and addressed supervisory findings, including MRAs and MRIAs, since 2013.[2]

[2] The Supervision and Regulation Report uses data since 2013 given systems availability. In addition, data after this date is most relevant for large financial institutions, given the changes in the supervisory program following the crisis. *See* SR letter 12-17/CA letter 12-14.

Committee on Banking, Housing, and Urban Afl
Implementation of the Economic Growth, Regulatory Relief, and Co
October 2, 2018

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

- While S.2155 does not require the Fed to change the domestic asset threshold for the establishment of an intermediate holding company for a foreign banking organization, does the Fed have any plans to alter the current $50 billion U.S. non-branch asset threshold?

Recently, former Fed Chair Yellen said in an interview that "regulators should sound the alarm," with regard to risks posed by leveraged corporate lending. 2 Chair Yellen noted that regulators "should make it clear to the public and the Congress there are things they are concerned about and they don't have the tools to fix it.''3

- Do you agree with this statement from Chair Yellen on the risks posed by growing leverage in corporate lending?

When Chairman Powell was a Fed governor in 2015, he noted that the Fed's leveraged lending guidance from 2013 would "stand in the way of a return to pre-crisis conditions."4

- Do you agree?
    - If so, why has the Fed lessened the supervisory consequences for banks not in conformance with that guidance?

- How is the Fed protecting the banking sector from the risks of leveraged corporate lending? As a member of the Financial Stability Oversight Council, what is the Fed doing to protect against emerging risks among nonbank lenders?

Fed officials, including yourself, have said the economy is performing robustly – for example, banks are more profitable than ever. Wall Street Reform required that bank capital requirements should increase in "times of economic expansion," but Chairman Powell has said now is not the time to activate the countercyclical capital buffer.

- If not now, then when? Would increasing the capital buffer now give the Fed more room to lower it in the future, and soften the impact of the next downturn?

Some of the sponsors of S.2155 and Chairman Powell have said that they do not intend for S.2155 to benefit large foreign banks operating in the U.S. But you've given speeches saying that the Fed should take a look at reducing the regulatory burden on these banks, saying that the Fed should "reconsider its calibration" of foreign bank rules.

[2] https://www.bloomberg.com/news/articles/2018-09-27/wall-street-s-riskiest-loans-flash-dangers-as-watchdogs-muzzled?srnd=premium
[3] Id
[4] https://www.federalreserve.gov/newsevents/speech/powell20150218a.htm

- As you run to head the Financial Stability Board – a crucial position leading international bank regulators – don't you think it's important for the United States to offer a united perspective that we must maintain the post-crisis regulatory framework for all large banks?

At the hearing, you noted in response to a question regarding the GSIB surcharge that the Fed will reconsider it, in part, "to insure that we have a level playing field internationally not as a way of trying to seek a benefit for our firms, but because when you have an international system that has an unlevel playing field, over time pathologies will develop as activity moves to different areas of that global system not on the basis of - or driven by incentives other than purely economic incentives - incentives by the cost of capital." Currently, the GSIB surcharge in the U.S. is higher than the surcharge mandated by the Basel Committee on Banking Supervision.

- Has this, to date, caused any pathologies to develop or caused activity to move out of U.S. banks and to other banks in the global system?

Former Fed Governor Tarullo recently stated, "there is still some legitimate question among people as to whether if one of [the largest U.S. banks] got into significant trouble — and if one does the others will probably be at least under some stress — whether there still wouldn't be a view that they are too big to fail and that the government should take extraordinary measures."5

- Do you agree with this statement?

The federal financial agencies often take intermediate steps to address problems in the financial institutions they regulate before formal enforcement actions are taken. For example, we know that the OCC had taken supervisory actions related to concerns about Wells Fargo's sales practices before the 2016 enforcement action.

- Please describe the process for how your agency determines what type of supervisory action to take when it finds a problem at a financial institution it regulates, how it expects the financial institution to address the problem, how much time a financial institution is given to address the problem, how the agency follows up with the financial institution on the problem, and how the agency makes a determination that a problem has not been addressed and warrants escalated action.

As you know, financial institution misconduct often continues for many years, and it raises concerns that the current supervisory process is ineffective in addressing problems.

- Given that the details about supervisory actions including "matters requiring attention" or "MRAs" are considered confidential supervisory information, please provide the committee for each year starting in 2005 the aggregate number of outstanding MRAs

[5] https://www.politico.com/story/2018/09/26/wall-street-too-big-to-fail-podcast-842587

from the Fed for the U.S. GIBs, and the aggregate number of MRAs that were satisfactorily addressed and are no longer outstanding.

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

Under the agencies' proposal to simplify and tailor the regulations implementing the Volcker Rule, the proposed "accounting prong" would cover all purchases or sales of financial instruments that are recorded at fair value on a recurring basis under applicable accounting standards, which would subject a significantly higher number of financial activities to the rule.

- Given the agencies' policy goals of simplification and tailoring, how do you intend to revise the proposal to remain faithful to these goals?

- The proposed amendments to the Volcker Rule would also introduce new metrics that could result in a nearly 50 percent increase in metrics reporting. How do you intend to revise the proposal to ensure that covered institutions are not subject to additional compliance burdens?

Your comments in both the hearing and your speech to the Utah Bankers Association seem to imply that banks between $100-$250bn in size will be subject to tailoring of the Section 165 Enhanced Prudential Standards (EPS). Tailoring, as you are aware, only applies to institutions subject to a given rule. As one of those involved in the drafting of S.2155, my intent and that of my colleagues was that banks in that asset class be released from EPS application, hence the raising of the threshold to $250bn. Therefore, tailoring would not need to apply to those institutions and was envisioned for those banks over the threshold that have substantially similar business models as those below the new $250bn line.

- Why do you continue to use the term tailoring for institutions that are mandated to be carved out of EPS application?

- Is it your view that the legislation begins with the presumption that those banks remain subject to EPS? Or, as the legislation clearly spells out, is it your understanding that those banks are out and that only through an empirically demonstrated determination can they be put back in?

After NASDAQ became an exchange in 2006, the Federal Reserve has not undertaken any effort to update its rules to provide a pathway to margin eligibility for companies traded over-the-counter (OTC). Margin eligibility of OTC-traded stocks can be an important part of the growth of small and emerging companies, as it helps to improve the market quality of those securities, impact an investor's willingness to purchase those securities, and as a result have a direct impact on capital formation.

- Will you commit the Federal Reserve to take action to revive the margin list for certain OTC securities?

Committee on Banking, Housing, and Urban Affairs
Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act
October 2, 2018

Recently the "Interagency Statement Clarifying the Role of Supervisory Guidance" was issued. I think this directive is a very important step in ensuring that the regulation and supervision of financial institutions is conducted pursuant to legal standards. Each of you is the leader of an organization that has thousands of employees and examiners and are responsible for its implementation.

- How are you making sure examiners on the ground are following this statement?

- Have you considered a formal rulemaking so that staff take this important statement seriously?

- How will you independently verify that this statement is followed? (audits, surveys from supervised entities, other independent verification)

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

February 28, 2019

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2(a) and 2(b) of the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On December 21, 2018, I provided responses to questions 1 and 4. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question is forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

2. Your comments in both the hearing and your speech to the Utah Bankers Association seem to imply that banks between $100-$250bn in size will be subject to tailoring of the Section 165 Enhanced Prudential Standards (EPS). Tailoring, as you are aware, only applies to institutions subject to a given rule. As one of those involved in the drafting of S.2155, my intent and that of my colleagues was that banks in that asset class be released from EPS application, hence the raising of the threshold to $250bn. Therefore, tailoring would not need to apply to those institutions and was envisioned for those banks over the threshold that have substantially similar business models as those below the new $250bn line.

(a) Why do you continue to use the term tailoring for institutions that are mandated to be carved out of EPS application?

When speaking of Federal Reserve regulatory policy, I often use the word "tailoring" to refer to the general concept of ensuring that the nature and stringency of regulation is appropriate to the nature and risk factors of the firms being regulated. Our objective should be that simpler and less risky firms are not subject to the regulatory burden of complying with measures more appropriate to larger and more complex firms. Section 165(a)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act refers to this concept in requiring the Federal Reserve Board (Board) to tailor the application of enhanced prudential standards (EPS), but in my view this is a specific instance of the tailoring concept rather than the entire definition of it. Accordingly, my use of the word tailoring with regard to the treatment under the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) of institutions with assets between $100 billion and $250 billion is not intended to suggest that those firms should necessarily remain subject to some form of modified or "tailored" EPS, but rather that their treatment under EGRRCPA is an example of the tailoring concept, as is the framework we have proposed for determining when EPS would apply.

Section 401 of EGRRCPA made a number of changes to the scope of application of EPS. For example, as you observe, section 401 increased from $50 billion to $250 billion the threshold for automatic application of EPS to bank holding companies. With respect to a bank holding company with total assets of between $100 billion and $250 billion, section 401 provides the Board with discretion to apply EPS to a bank holding company if the Board determines that application of the standard or standards is necessary to prevent or mitigate risks to financial stability or promote safety and soundness, taking into consideration size, complexity, and other risk-related factors. Under section 401(e) of EGRRCPA, the Board is required to conduct periodic supervisory stress tests of bank holding companies with $100 billion or more, but less than $250 billion, in total consolidated assets.

In light of these amendments, and consistent with the Board's ongoing refinement and evaluation of its regulations and supervisory program, the Board is seeking comment on a proposal that would establish four categories of prudential standards for large U.S. banking organizations. The proposed framework would determine the application of prudential standards to firms with total consolidated assets of $100 billion or more but less than $250 billion, and would differentiate the standards that apply to all firms subject to prudential standards based on their size, complexity, and other risk-based factors.

(b) Is it your view that the legislation begins with the presumption that those banks remain subject to EPS? Or, as the legislation clearly spells out, is it your understanding that those banks are out and that only through an empirically demonstrated determination can they be put back in?

As noted in my response to Question 2(a), section 401 of EGRRCPA increased the threshold for automatic application of EPS from \$50 billion to \$250 billion. With respect to a bank holding company with total consolidated assets of between \$100 billion and \$250 billion, section 401 provides the Board with discretion to apply EPS to a bank holding company if the Board determines the application of the standard or standards is necessary to prevent or mitigate risks to financial stability or promote safety and soundness, and taking into consideration size, complexity, and other risk-related factors. Consistent with these statutory changes, the Board is seeking comment on a proposed framework to determine the application of prudential standards for large U.S. banking organizations—those with \$100 billion or more in total assets—based on their risk profiles. Specifically, the proposed framework would take into consideration the risk profile of a large banking organization based on the following risk indicators: size, cross-jurisdictional activity, weighted short-term wholesale funding, off-balance sheet exposure, and nonbank assets. By taking into consideration the relative importance of each risk factor, the proposal would provide a basis for assessing a banking organization's financial stability and safety and soundness risks. The proposal also would implement section 401(e) of EGRRCPA, which requires the Board to conduct periodic supervisory stress tests of bank holding companies with \$100 billion or more, but less than \$250 billion, in total consolidated assets.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

December 21, 2018

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1 and 4 of the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question is forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. Under the agencies' proposal to simplify and tailor the regulations implementing the Volcker Rule, the proposed "accounting prong" would cover all purchases or sales of financial instruments that are recorded at fair value on a recurring basis under applicable accounting standards, which would subject a significantly higher number of financial activities to the rule.

(a) Given the agencies' policy goals of simplification and tailoring, how do you intend to revise the proposal to remain faithful to these goals?

The accounting prong was intended to give banking entities greater certainty and clarity about what financial instruments would be included in firm trading accounts, and would therefore be subject to the requirements of the regulation. The proposal specifically requested comment as to whether the proposed accounting prong might be overly broad, and if there were alternatives or modifications to the accounting prong that may be more appropriate.

The comment period for the proposal revising the rule implementing section 13 of the Bank Holding Company Act closed on October 17, 2018. The agencies received and are reviewing the comments addressing the accounting prong. Federal Reserve Board (Board) staff is currently in the process of carefully considering all comments received on the proposed rule, and will consider comments on the accounting prong and metrics reporting, as well as on other the aspects of the rule.

(b) The proposed amendments to the Volcker Rule would also introduce new metrics that could result in a nearly 50 percent increase in metrics reporting. How do you intend to revise the proposal to ensure that covered institutions are not subject to additional compliance burdens?

The proposal aims to streamline the metrics reporting and recordkeeping requirements under the current regulations by further tailoring or eliminating certain metrics and providing additional time for reporting. In furtherance of this goal, the proposal requested comment on a broad range of issues related to metrics reporting and recordkeeping requirements. As noted above, the comment period for the proposal closed on October 17, 2018, and the Board is currently in the process of carefully considering all comments received on the proposal rule, including those related to the proposed metrics reporting and recordkeeping amendments.

4. Recently the "Interagency Statement Clarifying the Role of Supervisory Guidance" was issued. I think this directive is a very important step in ensuring that the regulation and supervision of financial institutions is conducted pursuant to legal standards. Each of you is the leader of an organization that has thousands of employees and examiners and are responsible for its implementation.

(a) How are you making sure examiners on the ground are following this statement?

We have taken a number of steps to reaffirm the role of supervisory guidance in our communications to examiners and to supervised institutions. First, on October 4, 2018, we conducted an internal, mandatory training session for all our supervisory staff to reinforce the distinctions between laws and regulations versus guidance and to clarify the use of guidance in the supervisory process. Second, we are helping examiners with outreach to supervised institutions in answering questions about the policy statement. Third, we are reviewing the templates examiners use when they reference supervisory guidance in their communications with supervised institutions. Fourth, we will continue to review supervisory findings to confirm that our examiners are referencing guidance appropriately. Finally, we regularly solicit the views of the firms we supervise on our supervisory process to include their views on our use of guidance in supervisory communications.

(b) Have you considered a formal rulemaking so that staff take this important statement seriously?

We have not yet assessed whether this matter should be the subject of a formal rulemaking, but we will consider this question in conjunction with our fellow regulators. This is an important issue. We are taking steps to ensure our examiners understand the issues and are acting in accordance with the public statement. We have a range of tools to ensure that examiners are following directives and instructions from the Board. As indicated above, we have already employed some of those tools in this particular case. If we determine that the steps we have employed so far are not sufficient, we will escalate the issue and take additional steps. But so far, we have evidence that our examiners understand the issues and are acting in accordance with the public statement.

(c) How will you independently verify that this statement is followed? (audits, surveys from supervised entities, other independent verification)

As described above, we will review samples of supervisory findings to confirm that our examiners are appropriately referencing supervisory guidance. As also noted, we regularly solicit feedback from supervised firms regarding our supervisory process, to include their views on our use of guidance in supervisory communications.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

May 8, 2019

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the remaining questions you submitted following the October 2, 2018, and the November 15, 2018, hearings before the Committee on Banking, Housing, and Urban Affairs. [1] A copy also has been forwarded to the Committee for inclusion in the respective hearing records. This constitutes the completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to these hearings were received on October 11, 2018, and November 27, 2018, respectively.

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

After Nasdaq became an exchange in 2006, it is my understanding that the Federal Reserve has not undertaken any effort to update its rules to provide a pathway to margin eligibility for companies traded over-the-counter (OTC). Margin eligibility of OTC-traded stocks can be an important part of the growth of small and emerging companies, as it helps to improve the market quality of those securities, impact an investor's willingness to purchase those securities, and as a result have a direct impact on capital formation. In addition, U.S investors in the American depositary receipts (ADR) for Roche [$10bn yearly net income] and other large, international OTC traded firms are also negatively impacted by the Federal Reserve's inaction on this issue.

- **Will the Federal Reserve take action to revive the margin list for certain OTC securities? If not, please explain why.**

Responding to your question above and as previously posed regarding the List of Over-the-Counter Margin Stocks (OTC List) that is no longer published by the Federal Reserve Board (Board), staff have continued to monitor OTC market developments in the years since the publication of the OTC List ceased. Any expansion of the types of securities that are margin eligible would require careful consideration by the Board of the benefits of such an approach weighed against potential increased burden on banks and other lenders.

Please know that I appreciate your concerns as noted in your questions, and we are looking into potential approaches that may be considered while ensuring any changes would not pose additional regulatory burdens. By way of background, I am including a brief summary of the history of the Board's OTC List.

In 1968, Congress amended section 7 of the Securities Exchange Act of 1934 (SEA) to allow the Board to regulate the amount of credit that may be extended on securities not registered on a national securities exchange, or those securities known as "over-the-counter" or "OTC" securities. The following year, the Board adopted criteria to identify OTC stocks that have "the degree of national investor interest, the depth and breadth of market, the availability of information respecting the security and its issuer, and the character and permanence of the issuer" to warrant treatment similar to equity securities registered on a national securities exchange. The Board's first periodically published OTC List became effective on July 8, 1969.

In 1975, Congress further amended the SEA to direct the Securities and Exchange Commission (SEC) to facilitate the development of a "national market system" (NMS) for securities to accomplish several goals, including price transparency. The SEC's criteria for NMS securities came to cover both exchange-traded stocks (which were always marginable) and a subset of stocks traded on Nasdaq, the largest and most technologically advanced over-the-counter market at that time. The majority of the securities traded on Nasdaq's NMS tier were covered by the Board's OTC margin stock criteria and appeared on the Board's OTC List. The Board's analysis, however, indicated that the liquidity and other characteristics of NMS securities generally compared favorably with those of exchange-traded securities. Accordingly, the Board amended its margin regulations in 1984 to give immediate margin status to OTC securities that qualified as NMS securities without regard to whether the stock appeared on the Board's OTC List. This action established a precedent for relying on NMS status under SEC rules as a substitute for identifying margin-eligible OTC securities through the application of Board-established criteria.

The Board ceased publication of its OTC List in 1998, and provided margin status to all securities listed on the Nasdaq Stock Market, after Nasdaq raised the listing standards for non-NMS securities trading on its market, making them comparable to those traded on national securities exchanges. Indeed, Nasdaq subsequently became a national securities exchange.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

January 16, 2019

The Honorable Tim Scott
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the October 2, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 11, 2018.

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

1. There is growing concern that the upcoming transition to the Current Expected Credit Loss accounting standard beginning in 2020 will adversely impact banks' ability or inclination to make certain types of loans, including many forms of consumer credit that are essential for a healthy economy -- mortgages, auto loans, and student loans.

I believe that the Federal Reserve, in conjunction with the OCC, SEC, and FASB, should act quickly to reevaluate this standard and assess its impact on financial institutions, consumers, and the overall health and stability of the financial sector. The analysis should account for how CECL may precipitate a change in regulatory capital requirements and pay special attention to the interaction between regulatory capital and the impact of increased loan loss reserve requirements.

Please answer the following with specificity:

(a) Does the Federal Reserve believe that the economic impacts of CECL have been adequately studied to date?

The Financial Accounting Standards Board (FASB) is an independent, private sector organization that establishes financial accounting and reporting standards for public and private companies and not-for-profit organizations that follow Generally Accepted Accounting Principles (GAAP). Prior to finalizing the current expected credit loss (CECL) accounting standard, the FASB followed its established due process, which included cost-benefit analysis and extensive outreach with all stakeholders, including users, preparers, auditors and regulators. Economists, institutions and independent organizations have produced impact analyses of CECL.

To address concerns about the potential initial impact stemming from CECL implementation, the federal banking agencies have finalized a rule that provides a three-year phase-in of CECL's day-one impact on regulatory capital. This will allow additional time to study the measure's effects as the agencies continue to monitor the impact of CECL adoption.

(b) Would you support measures to delay implementation of CECL pending completion of a thorough quantitative impact study?

Our supervised institutions are required by statute to apply GAAP as established by the FASB. We support an independent accounting standard-setting process, and as such, we defer to the FASB on the implementation timeline for financial reporting purposes. However, as mentioned in the response to Question 1(a), the federal banking agencies have finalized a rule that provides a three-year phase-in of the effect on regulatory capital. This will allow additional time to study the measure's effects as the agencies continue to monitor the impact of CECL adoption.

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

There is growing concern that the upcoming transition to the Current Expected Credit Loss accounting standard beginning in 2020 will adversely impact banks' ability or inclination to make certain types of loans, including many forms of consumer credit that are essential for a healthy economy -- mortgages, auto loans, and student loans.

I believe that the Federal Reserve, in conjunction with the OCC, SEC, and FASB, should act quickly to reevaluate this standard and assess its impact on financial institutions, consumers, and the overall health and stability of the financial sector. The analysis should account for how CECL may precipitate a change in regulatory capital requirements and pay special attention to the interaction between regulatory capital and the impact of increased loan loss reserve requirements.

Please answer the following with specificity:

- Does the Federal Reserve believe that the economic impacts of CECL have been adequately studied to date?

- Would you support measures to delay implementation of CECL pending completion of a thorough quantitative impact study?

Committee on Banking, Housing, and Urban Aff
The Semiannual Testimony on the Federal Reserve's Supervision a
Financial System
November 15, 2018

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, from Senator Catherine Cortez Masto:

Wells Fargo

Wells Fargo Bank admitted to creating more than 3.5 million accounts without customers' authorization. Wells Fargo forced hundreds of thousands of automobile loan customers to pay for unnecessary insurance policies, with the added expense leading some borrowers to default and lose their vehicles. Wells Fargo also admitted to charging improper fees to some mortgage borrowers. Wells Fargo did not offer help to 870 mortgage borrowers that they were entitled; 545 of those borrowers had their homes taken from them in foreclosure proceedings. Three of them were from Nevada.

In February, the Federal Reserve cited those and other issues when it ordered the bank to halt expansion until it can prove to regulators that it has systems in place to prevent consumer abuses.

- What issues remain with Wells Fargo leadership's remediation plan?

- Will the Fed object to Wells Fargo capital distribution plan until a remediation plan has been accepted and the consent decree released?

- Why did the Federal Reserve not use the Comprehensive Capital Analysis and Review process to object to Wells Fargo's capital distribution plan?

The most recent news from Wells Fargo -- 870 mortgage borrowers not appropriately assisted – more than 500 wrongly foreclosed on – was reported AFTER the consent order was signed in February.

- Should we expect more problems of unfair, deceptive and abuse practices harming Wells Fargo's customers in the coming year?

    - Does the Fed and other banking regulators feel they have a handle on the harmful practices at Wells Fargo?

- Is the asset cap the Fed put in place adequate for changing Wells Fargo's behavior?

The Supervisory Reports states that that sales practices and incentive-based compensation is an area of priority. [Page 27]

- What will the Fed do to change incentive pay and sales practices at banks?

- What is the status of the Incentive-based compensation rule mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act? I would note that this is a mandatory law, not discretionary.

Bank Secrecy Act/Anti-Money Laundering

In the Fed's Supervisory Report released last week, you note that of the supervisory findings currently outstanding, nearly 20 percent relate to weaknesses in BSA/AML programs. [Page 26]

- Can you be more specific about how "machine-based learning" could help banks more easily comply with the Bank Secrecy Act?

- Are the banking regulators working with FinCEN on future joint guidance? What would such guidance include?

    - What impact would the guidance have under the new decision that guidance does not have the force of law?

Merger and Acquisition Risk

In the Fed's Supervisory Report released last week, you note that upcoming Regional Banking Organizations Supervisory Priorities include merger and acquisition risks. A number of banking experts said that reducing the capital requirements and other rules for banks above $50 billion would lead to more bank mergers.

- Do you expect to see more bank mergers this year and next year than the past few years? Can you estimate the number of bank mergers you expect in 2019?

- How much of merger activity is due to changes from S. 2155 and bank regulator actions to reduce some rules?

- Since you note risks to regional banks arising from mergers and acquisitions, what are those risks?

Liquidity Coverage Ratio/Stress Tests

Banks are required to retain enough assets they can easily convert to cash to cover 30 days of expenses. You recommend reducing this cash cushion for all but the largest banks by revisions to the Liquidity Coverage Ratio. You say the reduction is minimal. Others say it is large and significant. Your Federal Reserve colleague, Governor Lael Brainard says it "weakens the buffers that are core to the resilience of our system."

- How will you know if your analysis is wrong?
    - How will you know if banks have less capital than prudent based on these regulatory changes you propose?

- If banks or their trade associations start taking the Federal Reserve to court due to their differences in how the tailoring worked, a stress test result or a cost-benefit analysis they do not agree with, will you feel your analysis was wrong?

This isn't just one weakening of buffers. There are numerous reductions at from several rulemakings that I think collectively have a material effect in weakening safeguards.

- Are you concerned that this "death by a thousand cuts" will result in much less of a capital cushion for banks that may find themselves in trouble in the future?

While you praise transparency in regulation, some warn that providing the textbook prior to the test or describing rigorous requirements for regulation allows banks to skirt the law in areas not yet covered. For example, there was probably little oversight of cryptocurrencies yet they have become a huge problem with Initial Coin Offering frauds.

- How will your focus on transparency avoid giving banks the option to make an argument that they not be tested or held accountable for something not clearly defined in the rules?

Standard & Poor's and Moody's stated that weakening bank requirements is a credit negative for bank bond investors. An S&P report said "the Fed's proposals are incrementally negative for bank creditors." Moody's report stated that the "reduced frequency of capital and liquidity stress testing could lead to more relaxed oversight and afford banks greater leeway in managing their capital and liquidity stress testing could lead to more relaxed oversight and afford banks greater leeway in managing their capital and liquidity, as well as reduce transparency and comparability, since fewer firms will participate in the public supervisory stress test."

- Do you concur with two of the Credit Rating Agencies that your proposals – reducing or recalibrating capital requirements and stress tests – are "credit negative"? Why or why not?

Community Reinvestment Act and Regulatory Coordination

In your response to my questions for the record last Spring, you neglected to answer one of my questions.

- Which, if any recommendation from the Treasury Department or Comptroller Otting do you disagree with regarding the Community Reinvestment Act?

- As the Vice Chair of Supervision at the Fed, can you explain why there appears to be less interagency coordination, and more controversial proposals being advanced, since you took over the Supervisory role at the Fed?

- What is the potential for reducing public confidence and certainty in the regulatory actions you and others are attempting to take quickly and unilaterally?

Labor Market/Housing Market

The U.S. has seen consistent positive private sector job growth now for more than 100 consecutive months.

- To what extent are these gains sustainable?
  - What risks to the labor market do you see on the horizon?

More than half of renters pay more than 1/3 of their income for rent. Nearly half of Americans cannot handle a $400 emergency.

- What are your concerns about the housing market where prices are high and supply – both rental and homeownership – is inadequate in many communities?
  - What should federal policy makers do to increase the supply of affordable homes?

Banks Hoarding Interest Income as the Fed Raises Rates

Since the Fed began raising interest rates, banks have seen a significant jump in net interest income and charged consumers more for loans, all while keeping the interest rate paid on customer deposits relatively flat.

- Why are depositors not getting higher interest rates?

Cannabis Banking

As more states begin to legalize marijuana, it becomes imperative that Congress act on offering financial services for cannabis and cannabis affiliated businesses. In its first year of legalization, the state of Nevada collected $69.8 million in tax revenue from cannabis alone – this figure indicates that there is not an insignificant amount of cash that is floating around our financial system.

- Are you able to discuss whether, if any, how a lack of financial services for cannabis businesses impacts our monetary system?

- Could you discuss the regulatory burden that this prohibition places on federally chartered banks?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

May 13, 2019

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1-3, 6(a), 6(b), 7, 10(a), 10(b), 11, 13, 14(a), and 14(b) you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses have also been forwarded to the Committee for inclusion in the hearing record. On April 9, I provided responses to questions 4, 5, 8, 9, and 12. This constitutes the completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

[1] Questions for the record related to this hearing were received on November 27, 2018.

<u>Questions for The Honorable Randal K. Quarles, Vice Chair for Supervision, Board of Governors of the Federal Reserve System, from Senator Cortez Masto:</u>

Wells Fargo

1. Wells Fargo Bank admitted to creating more than 3.5 million accounts without customers' authorization. Wells Fargo forced hundreds of thousands of automobile loan customers to pay for unnecessary insurance policies, with the added expense leading some borrowers to default and lose their vehicles. Wells Fargo also admitted to charging improper fees to some mortgage borrowers. Wells Fargo did not offer help to 870 mortgage borrowers that they were entitled; 545 of those borrowers had their homes taken from them in foreclosure proceedings. Three of them were from Nevada.

In February, the Federal Reserve cited those and other issues when it ordered the bank to halt expansion until it can prove to regulators that it has systems in place to prevent consumer abuses.

- **What issues remain with Wells Fargo leadership's remediation plan?**
- **Will the Fed object to Wells Fargo capital distribution plan until a remediation plan has been accepted and the consent decree released?**
- **Why did the Federal Reserve not use the Comprehensive Capital Analysis and Review process to object to Wells Fargo's capital distribution plan?**

Thank you for your question. Please note that I have recused myself from participating in official matters specific to Wells Fargo, as detailed in a press release dated December 15, 2017.

2. The most recent news from Wells Fargo – 870 mortgage borrowers not appropriately assisted – more than 500 wrongly foreclosed on – was reported AFTER the consent order was signed in February.

(a) Should we expect more problems of unfair, deceptive and abuse practices harming Wells Fargo's customers in the coming year? Does the Fed and other banking regulators feel they have a handle on the harmful practices at Wells Fargo?

Please see my response to question 1.

(b) Is the asset cap the Fed put in place adequate for changing Wells Fargo's behavior?

Please see my response to question 1.

3. The Supervisory Reports states that that sales practices and incentive-based compensation is an area of priority. [Page 27]

(a) What will the Fed do to change incentive pay and sales practices at banks?

As noted in the Federal Reserve Board's (Board) November 2018 Supervision and Regulation Report, the Board conducted reviews of sales and incentive compensation practices at certain state member banks with total assets between $10 billion and $50 billion. The reviews identified acceptable practices. When exceptions were noted, however, findings were determined to be correctable in the normal course of business.

Through our existing supervisory process, we will continue to monitor firms' progress towards appropriately balancing risks concerning sales and related incentive compensation practices.

(b) What is the status of the Incentive-based compensation rule mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act? I would note that this is a mandatory law, not discretionary.

In June 2016, the Board, Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the National Credit Union Administration (NCUA), and the Federal Housing Finance Agency (collectively, the agencies), jointly published and requested comment on a proposed rule under section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This joint effort proposed several requirements to address incentive compensation arrangements. The agencies received over one hundred comments on the proposed rule. Development of a final rule on an interagency basis in light of those comments is now under active work by the agencies.

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

The Board's supervision focuses on encouraging robust risk management and governance around incentive compensation practices rather than prescribing amounts and types of pay and compensation.

Liquidity Coverage Ratio/Stress Tests

6. Banks are required to retain enough assets they can easily convert to cash to cover 30 days of expenses. You recommend reducing this cash cushion for all but the largest banks by revisions to the Liquidity Coverage Ratio. You say the reduction is minimal. Others say it is large and significant. Your Federal Reserve colleague, Governor Lael Brainard says it "weakens the buffers that are core to the resilience of our system."

(a) How will you know if your analysis is wrong? How will you know if banks have less capital than prudent based on these regulatory changes you propose?

The Board's liquidity framework for large banking organizations has two general components: standardized measures, such as those included in the liquidity coverage ratio rule or net stable funding ratio proposed rule, and firm-specific measures, such as liquidity risk management requirements and internal liquidity stress testing requirements.

The recent proposals to further tailor prudential standards would reduce or remove standardized liquidity requirements for some firms, but they would retain the firm-specific measures for all firms with $100 billion or more in total assets. As a result, the proposals would continue to require these firms to meet liquidity risk management standards, conduct internal liquidity stress tests, and hold a buffer of highly liquid assets sufficient to meet projected 30-day stressed cash-flow needs under internal stress scenarios. The proposals would also require these firms to maintain regulatory reporting of key liquidity data, which facilitates the Board's supervision of liquidity-related risks. In addition, the Board will continue to assess the safety and soundness of firms in the normal course of supervision.

Taken together, these firm-specific standards and data reporting requirements will allow supervisors to continue to achieve regulatory objectives while improving upon the simplicity, transparency, and efficiency of the regime. In this manner, the proposals build on the Board's existing practice of tailoring regulatory requirements based on the size, complexity, and overall risk profile of banking organizations.

(b) If banks or their trade associations start taking the Federal Reserve to court due to their differences in how the tailoring worked, a stress test result or a cost-benefit analysis they do not agree with, will you feel your analysis was wrong?

The Board takes seriously the importance in the rulemaking process of seeking comment from the public, carefully considering those comments, and assessing the costs and benefits of its rulemaking efforts. The Board believes strongly that public comment and cost-benefit analysis can enlighten our regulatory actions and inform the implementation of our statutory responsibilities. In addition to seeking public comment on its proposals, the Board often collects impact information directly from parties that may be affected. Under the Board's current practice, consideration of costs and benefits occurs at each stage of the regulatory or policymaking process. Recent examples of the publication of quantitative analyses in connection with its rulemakings include the global systemically important bank (GSIB) surcharge rule, the single-counterparty credit limit rule, and the long-term debt rule.

The Board has established processes that allow institutions to respond to and appeal certain types of administrative actions, such as stress test results. In addition, the Administrative Procedure Act (APA) provides for judicial review of final regulations issued by the Board. Affected firms have the legal right to challenge the actions of any administrative agency under the APA, including whether the agency has engaged in reasoned decision-making. Although the Board strives to robustly support all of its supervisory and regulatory actions, these appeal and judicial review processes help to ensure fair and effective implementation of our statutory responsibilities, consistent with applicable administrative requirements.

7. This isn't just one weakening of buffers. There are numerous reductions at from several rulemakings that I think collectively have a material effect in weakening safeguards. Are

you concerned that this "death by a thousand cuts" will result in much less of a capital cushion for banks that may find themselves in trouble in the future?

Reforms implemented since the financial crisis have resulted in substantial gains in the resiliency of large banking organizations and the financial system as a whole. The proposals issued in October 2018 and April 2019, seek to tailor the Board's prudential requirements for certain U.S. banking organizations and foreign banking organizations in accordance with the risk profiles of these firms while still maintaining the core reforms and gains made over the past decade.

For liquidity standards, the proposals would continue to ensure that firms with the most significant risk profiles are subject to the most stringent liquidity requirements. For example, all U.S. GSIBs and firms with very substantial size or cross-jurisdictional activity would be subject to the full liquidity coverage ratio and proposed net stable funding ratio requirements. The proposals would also require any firm with a high reliance on unstable short-term wholesale funding to meet the full requirements. This distinction would reflect these firms' elevated vulnerability to liquidity risk, and help to reduce the risk of asset fire sales that could transmit distress to other market participants and destabilize the system.

As noted in my response to question 6(a), all firms with assets greater than $100 billion will continue to be subject to firm-specific liquidity requirements. As a result, these firms will still be required to conduct internal stress tests and hold liquidity buffers sufficient to meet projected 30-day net stressed cash-flow needs.

Further, with respect to capital, the proposals do not modify capital requirements of the largest, most systemically important banking organizations (U.S. GSIBs and banks either that are very large or have substantial cross-jurisdictional activity). The proposals may result in an adjustment of capital requirements for smaller, less-systemic firms, although the impact on capital levels for these firms could vary under different economic and market conditions. The proposals also would also lower these firms' compliance costs. As a result, the proposed requirements would reduce costs appropriately for those firms that have a limited impact on the financial system as a whole, relative to firms with more significant systemic footprints.

Community Reinvestment Act and Regulatory Coordination

10. In your response to my questions for the record last Spring, you neglected to answer one of my questions.

(a) Which, if any recommendation from the Treasury Department or Comptroller Otting do you disagree with regarding the Community Reinvestment Act?

Recommendations offered by the Treasury Department and Comptroller Otting on opportunities to modernize the Community Reinvestment Act (CRA) regulations have contributed to valuable analysis and dialogue among the agencies, as well as input from the public. As I have stated previously, I support the goal of improving the current supervisory and regulatory framework for CRA based on feedback from industry and community stakeholders. We are reviewing the information the OCC has received in response to its advanced notice of proposed rulemaking on the CRA, as well as information gathered through the Federal Reserve's listening sessions at many of the Federal Reserve Banks around the country to determine whether there are steps we might take as regulators to come closer to both the letter and intent of the statute. That review is ongoing, and our evaluation of any particular proposal or element of a proposal will depend on a full analysis of the available information upon completion of that review.

(b) As the Vice Chair of Supervision at the Fed, can you explain why there appears to be less interagency coordination, and more controversial proposals being advanced, since you took over the Supervisory role at the Fed? What is the potential for reducing public confidence and certainty in the regulatory actions you and others are attempting to take quickly and unilaterally?

The Board consults and coordinates on a regular basis with its fellow bank regulatory agencies on a wide range of matters affecting depository institutions and their affiliates. This consultation and coordination facilitates a more cohesive regulatory framework, which is intended to promote the safety and soundness of the banking system in the most efficient and least burdensome way possible. The Board also consults regularly with the SEC, Consumer Financial Protection Bureau (CFPB), Commodity Futures Trading Commission (CFTC), OCC, FDIC, NCUA, and Treasury Department, in areas where regulatory responsibilities overlap. Coordination and cooperation with other agencies occurs at staff levels as well as through senior officers and members of the Board. In addition, the Board participates in the Federal Financial Institutions Examination Council (FFIEC) and in the Financial Stability Oversight Council, both of which facilitate interagency consultation and cooperation. These many avenues of consultation at multiple levels increase the coordination and consistency of regulation across a banking industry that has multiple regulators and charters.

Many of the proposals and final rules issued by the Board in recent months have been issued in coordination with other agencies. Recent examples of proposed or final rules issued in coordination with the OCC and FDIC include amending the definition of high-quality liquid assets under the agencies' liquidity rules; expanding eligibility for an extended examination cycle for insured banks and branches of foreign banks; raising the threshold for residential real estate transactions requiring an appraisal; and tailoring of liquidity and capital requirements for large banking organizations. Other recent examples of proposals issued in coordination with the FDIC and OCC include a proposal to establish a community bank leverage ratio, a proposal to streamline reporting requirements for small institutions, and a proposal to exclude community banks from the Volcker rule. The agencies continue to work together to implement other provisions of S. 2155 and on other matters of common interest.

Labor Market/Housing Market

11. The U.S. has seen consistent positive private sector job growth now for more than 100 consecutive months. To what extent are these gains sustainable? What risks to the labor market do you see on the horizon?

As you noted, private sector payrolls have increased every month since the spring of 2010. The labor market remains strong, and I expect the expansion to continue, with further positive job gains.

As always, there are risks to the outlook, and admittedly, recessions are hard to foresee. But many studies demonstrate that economic expansions do not end simply because they have persisted for a long time. Rather, some shock or collection of shocks occurs that is sufficient to push the economy into recession. At present, the banking system is well capitalized and highly liquid, and the Federal Reserve is committed to do everything we can to sustain the ongoing expansion. The Federal Reserve's recently inaugurated Financial Stability Report discussed risks and the resilience of our financial system in some detail. Other risks to the outlook could come from abroad, in the form of a material downturn to some of our trading partners or from the effects of government policies, including trade policy and Brexit.

While such downside risks are present, as reported recently in the Summary of Economic Projections, most Federal Reserve policymakers view the risks around our projections as balanced. Most importantly, policy is not on a preset course, and we will respond to changes in the economic outlook as warranted.

Banks Hoarding Interest Income as the Fed Raises Rates

13. Since the Fed began raising interest rates, banks have seen a significant jump in net interest income and charged consumers more for loans, all while keeping the interest rate paid on customer deposits relatively flat. Why are depositors not getting higher interest rates?

Banks' profits are partly determined by the difference in interest expense they must pay on deposits and other liabilities and the interest they earn on their assets, including loans. Interest rates on bank deposits are determined by private markets, as are the interest rates on loans, bonds, and other financial savings and investment products. A significant share of banks' funding comes from customer deposits, for which banks must compete with other banks and non-banks, such as money market mutual funds. Banks must also compete with other banks, non-banks, and markets when setting lending rates for borrowers. Historically, we have seen that banks do not raise the rates they offer on customer deposits as much or as quickly as interest rates on other bank products, such as loans, when the Federal Reserve raises its policy rate. Moreover, the rate paid by banks on their deposit accounts does not tend to rise as much or as quickly as the yields savers earn on alternative savings investments, such as money market mutual funds.

Of note, average advertised deposit rates are often an incomplete indicator of how banks attract and retain customer deposits. Presently, the range of rates offered by banks is wide, and many banks temporarily offer promotional rates. In addition, banks may use alternative methods to compete for deposits vis-à-vis other banks and money market mutual funds. Such alternative methods of compensating depositors include cash incentives, special rates that are not broadly advertised, and special offers on other services. We continue to study these trends and the ways in which changes in monetary policy transmit to the broader economy.

Cannabis Banking

14. As more states begin to legalize marijuana, it becomes imperative that Congress act on offering financial services for cannabis and cannabis affiliated businesses. In its first year of legalization, the state of Nevada collected $69.8 million in tax revenue from cannabis alone – this figure indicates that there is not an insignificant amount of cash that is floating around our financial system.

(a) Are you able to discuss whether, if any, how a lack of financial services for cannabis businesses impacts our monetary system?

We understand that cannabis business may largely be conducted via cash transactions. Although the volume (and the attendant risk) of cash transactions may be large for any individual business, the scale of these businesses relative to the scale of the United States economy is quite small. As such, any additional cash activity from these businesses does not appear to be having any impact on the Federal Reserve's ability to provide currency and coin nor on its ability to conduct monetary policy.

(b) Could you discuss the regulatory burden that this prohibition places on federally chartered banks?

Federal law makes it a federal crime to possess, grow, or distribute marijuana, and prohibits an entity from knowingly engaging in a monetary transaction in criminally derived property.[1] Therefore, financial transactions that are related to marijuana are defined as money laundering under federal law, even those related to operations that are licensed or approved under state law. The conflict between federal and state law has created challenges for marijuana-related businesses and banks.

In 2014, the Financial Crimes Enforcement Network (FinCEN) issued guidance to "clarify how financial institutions can provide services to marijuana-related businesses (MRBs) consistent with their Bank Secrecy Act (BSA) obligations."[2] Similar to other BSA guidance, a reference to the 2014 FinCEN guidance was incorporated into the FFIEC BSA/AML Examination Manual. If there are legislative changes or if FinCEN repeals or revises its guidance, the Board, along with the other FFIEC agencies, will evaluate whether additional steps would be appropriate.

Examiners assess whether the bank management has implemented controls that are commensurate with the bank's risks, and when those risks involve MRBs as customers, examiners assess if the bank is complying with FinCEN's 2014 marijuana guidance, including its suspicious activity report filing requirements. In general, examiners determine if the bank's controls are commensurate with the risks posed by its products, services, and customers. As a general matter, the decision to open, close, or decline a particular account or relationship is made by a depository institution, without involvement by its supervisor.

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[1] *See* the Controlled Substances Act and 18 USC 1957.

[2] https://www.fincen.gov/sites/default/files/shared/FIN-2014-G001.pdf.

Examiners assess whether the bank management has implemented controls that are commensurate with the bank's risks, and when those risks involve MRBs as customers, examiners assess if the bank is complying with FinCEN's 2014 marijuana guidance, including its suspicious activity report filing requirements. In general, examiners determine if the bank's controls are commensurate with the risks posed by its products, services, and customers. As a general matter, the decision to open, close, or decline a particular account or relationship is made by a depository institution, without involvement by its supervisor.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

March 8, 2019

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 5 and 6 from the questions you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On February 14, 2019, I provided responses to questions 1 through 4, and 7. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record. This constitutes the completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 27, 2018.

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

5. The Fed is apparently also considering seeking the public's "input on scenarios and salient risks facing the banking system each year," providing another opportunity for interested parties to shape the stress tests. Under the current framework, the scenarios are determined by the Fed's economists, with input from the reserve banks.

- **Have you lost confidence in the ability of these experts to foresee risks and develop effective stress test scenarios? If not, what is the value of allowing industry actors to influence the tests they will receive?**

The stress test provides a forward-looking measurement of bank capital, a view of common and systemic risks across the banking sector, and a broader understanding of the health of the financial system. By helping us ensure that the largest firms have sufficient capital to absorb losses and continue to lend in stressful conditions, the stress test helps to reduce the potential that distress from a single large firm will spill over to the broader economy. The results are valuable for markets, analysts, and ultimately, the participating firms.

The Federal Reserve Board's (Board) supervisory stress test independently assesses the resilience of the financial system under stress. I believe that our ability to provide an independent view of capital adequacy enhances the credibility of the test and of our supervisory program. Our independent assessment of post-stress capital relies on models and scenarios developed by Federal Reserve staff, which is comprised of a wide range of experts that drive innovation in their fields. Across the Federal Reserve System, our diverse workforce publishes a wide range of economic and policy research and plays an active role in academic discourse.

Yet we recognize that we are not, and cannot be, a monopoly on insight and wisdom. In the past, the Board has sought and benefitted from multiple and diverse perspectives on elements of its stress testing program. For example, the Board recently invited public comment on principles governing stress test model design and amendments to further clarify the scenario design framework. Through that process, we received valuable feedback which we incorporated in the finalized amendments.

We will continue to push the frontier of stress testing, through our own research and through the insights we gain from our engagement with the public. We recently announced that we will host a stress testing conference in July that will be open to the public. During the conference, we expect that a number of diverse stakeholders, including academics, public interest representatives, and financial sector representatives, will share their thoughts on certain aspects of the stress test program, including our current approach to scenario design.

6. In the recent stress capital buffer (SCB) proposal, you shifted the stressed leverage ratio requirement from the supplemental leverage ratio to the less stringent Tier 1 leverage ratio. In your recent speech you then proposed to eliminate the stressed leverage ratio requirement altogether. You justified elimination of this requirement by claiming that including the leverage ratio in the stress tests made the operational effect of the leverage

ratio more dependent on modeled risks.

- **But won't eliminating the stressed leverage ratio altogether significantly increase the role of risk modeling and risk weights in the capital system?**

- **Could you please provide information on how many firms experienced the current stressed leverage ratio requirement to be their binding or most significant constraint in the stress test process?**

The Board's notice of public rulemaking entitled Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules[2] issued in April 2018 sought comment on the introduction of a stress leverage buffer requirement in addition to the current capital rule's four percent minimum tier 1 leverage ratio requirement. However, the stress buffer concept would not be extended to the supplementary leverage ratio. Our analysis indicates that the stressed supplementary leverage ratio was the binding constraint for one firm based on the results of the Comprehensive Capital Analysis Review 2018.

Leverage ratios are intended to function as a backstop to traditional risk-based capital requirements. Whether or not there is an additional stress leverage buffer, global systemically important banks would continue to remain subject to the capital rule's enhanced supplementary leverage ratio standards so leverage capital requirements would continue to serve as a strong backstop. Board staff are currently reviewing all comments on the proposal and will carefully consider whether any changes to the proposed stress leverage buffer requirement or more generally are appropriate.

[2] https://www.govinfo.gov/content/pkg/FR-2018-04-25/pdf/2018-08006.pdf.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

February 14, 2019

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1 through 4, and 7 from the questions you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions are forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 27, 2018.

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

1. You recently made a speech about the Federal Reserve's "Stress Capital Buffer" proposal, which makes significant changes to the annual supervisory Comprehensive Capital Analysis and Review (CCAR) administered by the Fed. You indicated that the Fed would make a second proposal in response to some industry comments.

According your remarks, the Fed is considering allowing a firm to develop a capital distribution plan after its stress tests because "firms have told us that they would be able to engage in more thoughtful capital planning if they had knowledge of that year's stress test results before finalizing their distribution plans for the upcoming year."

What evidence has the Fed received that firms will actually be more thoughtful rather than simply plan to distribute the maximum amount permitted by the stress tests, thereby outsourcing their capital decisions to the Fed?

Currently, and under the Stress Capital Buffer proposal, a firm must decide whether to increase or decrease its planned dividends and share repurchases for the upcoming year without knowledge of a key constraint: the results of the stress test. While this practice is intended to encourage firms to think rigorously about their capital uses and needs in developing their capital plans, it also introduces significant uncertainty into a firm's capital planning process.

Adjusting the operation of the rule such that firms know their stress capital buffer before they decide on their planned distributions for the coming year would remove this uncertainty. This change would not change the expectation that firms continue to engage in meaningful capital planning and use their internal capital planning processes to set their planned capital distributions. The Federal Reserve would continue to use the supervisory process to evaluate the strength of each firm's capital planning process, including identifying its material risks and determining the capital necessary to withstand those risks during stressful conditions.

2. You indicated in your speech that "reducing volatility" of stress test demands would be the goal of a future proposal. The purpose of a stress test is to determine how a firm will fare under an unanticipated shock.

- **How is a goal of reducing or minimizing changes in stress test results to avoid "management challenge" to banks compatible with this purpose?**

The supervisory stress test allows the Federal Reserve to assess the resilience of banking organizations under various economic stress scenarios. It is essential to the continued success of the stress test as a supervisory tool that we preserve the dynamism of the stress test, and we seek to balance this objective with other supervisory objectives in evaluating future proposals.

One of these supervisory objectives is to mitigate excessive volatility in stress test results. It is typical for supervisory stress test results for a given firm to change year-over-year, as the scenarios and firms' portfolio characteristics change, and we want to maintain that feature.

However, large changes in year-over-year stress test results, particularly those not driven by portfolio changes, can make it difficult for firms to engage in responsible capital planning.

Maintaining the dynamism of the supervisory stress test need not be at odds with mitigating excessive volatility in supervisory stress test results. We are in the process of carefully considering how to achieve an appropriate balance of these two goals in future proposals.

3. The 2008 crisis created financial stress because firms were not anticipating significant losses from mortgage-backed securities, which were assumed to be relatively safe assets until unanticipated losses rapidly materialized over the 2007-2008 period. Over that period banks were permitted to return about a hundred billion in capital to shareholders, which later had to be made up by taxpayers through public capital injections.

- **How will a low-volatility stress test effectively require banks to preserve capital during such sharp turns in the market?**

Mitigating excessive volatility in loss estimates, and estimates of post-stress capital, need not be synonymous with maintaining a static stress test that does not take emerging risks into the economic and financial environment into account.

Indeed, it is essential to the continued success of the stress test as a supervisory tool that we preserve the dynamism of the stress test, and we seek to balance this objective with other supervisory objectives in evaluating future proposals.

The severely adverse scenario used in the Board's annual stress test reflects a sharp deterioration in macroeconomic and market conditions, similar to what we experienced during the 2007-2008 period.

Several elements of the Federal Reserve's stress testing and scenario framework are geared toward capturing shifts in the economic environment and in firms' risk profiles. These types of shifts would continue to be captured in the supervisory stress test results. Specifically, supervisory models are regularly re-estimated with newly available data, and the Board's scenario design framework allows for the incorporation of salient risks to the current economic outlook. Further, the Federal Reserve's supervisory modeling policies seek to limit reliance on past outcomes, so that supervisory models can incorporate events or outcomes outside of historical experience.

4. You also indicated that the Fed would begin to "disclose additional detail about supervisory stress tests models and results . . . allow[ing] firms to benchmark the results of their own models against those of the supervisory models."

- **Won't a lower-volatility stress test in which details of models and assumptions are widely known result in a system where stress tests are functionally equivalent to the Basel III risk-based capital rules? If so, what would be the justification for having multiple systems of risk-based capital?**

Maintaining the dynamism of the supervisory stress test—and therefore its distinction from the Basel III risk-based capital rules—is one of our key objectives, and need not be at odds with mitigating excessive volatility in supervisory stress test results. Supervisory stress test results for a given firm will continue to change year-over-year, as the scenarios and firms' portfolio characteristics change. We seek to reduce potentially excessive changes in year-over-year stress test results, which can make it difficult for firms to engage in responsible capital planning.

We believe that the additional model disclosures that we proposed late last year appropriately increase the degree of transparency into supervisory models while preserving the dynamism of the exercise.

In evaluating future proposals, we will continue to consider how best to achieve an appropriate balance of the objectives of mitigating excessive volatility in capital requirements and preserving the dynamism of the stress test exercise.

7. Your remarks also indicated that you were motivated by the view that the "[t]ransparency of the stress test and its inputs and outputs is key to the credibility of the stress test."

- **Does the Fed have any evidence that firms or the market aren't taking stress tests seriously under the current regime?**

The Federal Reserve's stress test remains an effective supervisory tool. We believe it is important to seek public input and to assess ways to further enhance the test's effectiveness.

Since the inception of the supervisory stress test, the Board has gradually increased the breadth of its public disclosure. By increasing the amount of information about the assessment that is available to the public, the Board has invited the public to engage and make an independent evaluation of the stress test's soundness. Since the supervisory capital assessment program exercise in 2009, incremental disclosures of supervisory models and results have benefitted banking organizations and those seeking to understand the resilience of firms in times of economic stress. The December 2017 proposals to increase transparency of the supervisory stress test are the latest incremental step to increase disclosure.

In evaluating each incremental disclosure, the Board considers how to disclose information about the stress tests in a manner that appropriately balances the costs and benefits of transparency. For example, we have not disclosed the full details of our models, in large part due to the Board's concerns about convergence of stress testing, which would make them less effective and would undermine the financial stability gains we have made. We also seek to guard against the risk of firms making modifications to their businesses that change the results of the stress test without changing the risks they face. This behavior could result in the stress test giving a misleading picture of the actual vulnerabilities faced by firms. It could also result in all firms increasing their holdings of assets that perform better in the supervisory stress test, which would make the financial system as a whole less diversified and more vulnerable to shocks.

Committee on Banking, Housing, and Urban Aff
The Semiannual Testimony on the Federal Reserve's Supervision a
Financial System
November 15, 2018

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

You recently made a speech about the Federal Reserve's "Stress Capital Buffer" proposal, which makes significant changes to the annual supervisory Comprehensive Capital Analysis and Review (CCAR) administered by the Fed. You indicated that the Fed would make a second proposal in response to some industry comments.

According your remarks, the Fed is considering allowing a firm to develop a capital distribution plan after its stress tests because "firms have told us that they would be able to engage in more thoughtful capital planning if they had knowledge of that year's stress test results before finalizing their distribution plans for the upcoming year."

- What evidence has the Fed received that firms will actually be more thoughtful rather than simply plan to distribute the maximum amount permitted by the stress tests, thereby outsourcing their capital decisions to the Fed?

You indicated in your speech that "reducing volatility" of stress test demands would be the goal of a future proposal. The purpose of a stress test is to determine how a firm will fare under an unanticipated shock.

- How is a goal of reducing or minimizing changes in stress test results to avoid "management challenge" to banks compatible with this purpose?

The 2008 crisis created financial stress because firms were not anticipating significant losses from mortgage-backed securities, which were assumed to be relatively safe assets until unanticipated losses rapidly materialized over the 2007-2008 period. Over that period banks were permitted to return about a hundred billion in capital to shareholders, which later had to be made up by taxpayers through public capital injections.

- How will a low-volatility stress test effectively require banks to preserve capital during such sharp turns in the market?

You also indicated that the Fed would begin to "disclose additional detail about supervisory stress tests models and results . . . allow[ing] firms to benchmark the results of their own models against those of the supervisory models."

- Won't a lower-volatility stress test in which details of models and assumptions are widely known result in a system where stress tests are functionally equivalent to the Basel III risk-based capital rules?

- If so, what would be the justification for having multiple systems of risk-based capital?

The Fed is apparently also considering seeking the public's "input on scenarios and salient risks facing the banking system each year," providing another opportunity for interested parties to shape the stress tests. Under the current framework, the scenarios are determined by the Fed's economists, with input from the reserve banks.

- Have you lost confidence in the ability of these experts to foresee risks and develop effective stress test scenarios?
  - If not, what is the value of allowing industry actors to influence the tests they will receive?

In the recent stress capital buffer (SCB) proposal, you shifted the stressed leverage ratio requirement from the supplemental leverage ratio to the less stringent Tier 1 leverage ratio. In your recent speech you then proposed to eliminate the stressed leverage ratio requirement altogether. You justified elimination of this requirement by claiming that including the leverage ratio in the stress tests made the operational effect of the leverage ratio more dependent on modeled risks.

- But won't eliminating the stressed leverage ratio altogether significantly increase the role of risk modeling and risk weights in the capital system?
  - Could you please provide information on how many firms experienced the current stressed leverage ratio requirement to be their binding or most significant constraint in the stress test process?

Your remarks also indicated that you were motivated by the view that the "[t]ransparency of the stress test and its inputs and outputs is key to the credibility of the stress test."

- Does the Fed have any evidence that firms or the market aren't taking stress tests seriously under the current regime?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

February 4, 2019

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 27, 2018.

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

1. In South Dakota, many farmers use derivatives to manage the risk of price disruptions due to any number of factors in the marketplace. Given the challenges that farmers are facing on several fronts, it's important that South Dakotans are able to access tools like derivatives in a way that's as cost-effective as possible.

When our farmers do choose to access derivatives markets they're required to provide margin against their derivative contracts. Banks hold that margin in the event the farmer can't meet their obligations, thereby reducing the risk of default for the bank and for the marketplace.

Unfortunately the Fed's methodology for the leverage ratio doesn't recognize this reduced risk. As a result, an additional cost is imposed on farmers across the country when they hedge against price fluctuations.

When will the Fed act on this issue and provide relief on client margin? Farmers are in need of relief wherever they can get it.

I'm proud to be the Senate sponsor of S. 3577, the Financial Stability Oversight Council Improvement Act of 2018. As we continue to look at ways to make our financial system safer and more resilient, it's important that FSOC also regulates nonbanks based on the risk profile of a specific business or industry, not for the sake of regulation, and not based only on size.

Last year the Treasury Department released a report recommending how FSOC can further improve the SIFI designation process for non-bank institutions. Similar to my interest in tailoring regulations, Treasury suggested that an activities–based approach would be appropriate. I'm also pleased to hear reports that FSOC may be taking action on this front by the end of 2018.

- **Can you elaborate on FSOC's forthcoming proposals?**
- **If you could, I'd like you to share some of the advantages to the activities-based approach that FSOC is considering.**
  - **How will it help the Fed's work?**
  - **And how will it help the economy more broadly?**

In October 2018, the Federal Reserve Board (Board), along with the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) (collectively, the Agencies), issued a proposal that would revise the capital rule to require banking organizations to use a more risk-sensitive methodology known as the standardized approach for counterparty credit risk (SA-CCR) for reflecting derivative contracts in the supplementary leverage ratio. The Agencies believe that SA-CCR, which recognizes the shorter default risk horizon applicable to margined derivative contracts, provides a more appropriate measure of derivative contracts for leverage capital purposes than does the current approach. Analysis conducted by the Agencies indicates that, compared to the current methodology, the implementation of SA-CCR would increase covered banking organizations' supplementary leverage ratios.

As noted in the proposal, the Agencies are sensitive to impediments to banking organizations' willingness and ability to provide client-clearing services. The Agencies also are mindful of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) mandate to mitigate systemic risk and promote financial stability by, in part, developing uniform standards for the conduct of systemically important payment, clearing, and settlement activities of financial institutions. In view of these important, post-crisis reform objectives, the Agencies are inviting comment on the consequences of not recognizing collateral provided by a clearing member client banking organization in connection with a cleared transaction. The Agencies will carefully consider the comments received on the proposal.

With respect to your second question on the Financial Stability Oversight Council (FSOC), the Council has been considering revisions to the interpretive guidance on the designation of nonbanks that include taking an activities-based approach (see, for example, the minutes of the June 15, 2018, FSOC meeting).[2] Of course, any revisions to the FSOC's current guidance on the designation of nonbank financial institutions will have to be approved by the FSOC.

In principle, an activities-based approach toward the designation of individual nonbank financial institutions would shift the focus toward reviewing potential risks to U.S. financial stability from a financial system perspective by examining financial activities and products throughout various industries. This approach offers some potential advantages, including the consideration of how certain activities undertaken by nonbanks could threaten financial stability and how best these threats could be addressed. In addition, such an approach could complement the FSOC's effort to monitor broader vulnerabilities in the U.S. financial system.

In terms of helping the Federal Reserve's work, should a firm be designated and thus subject to supervision by the Federal Reserve, a clear statement from the FSOC of the particular activities of concern could help focus supervisory efforts to limit systemic risk. Further, the activities-based approach proposed in the November 2017 Treasury Department report[3] could complement the Federal Reserve's monitoring of financial stability risks. The Board provided an overview of the framework it uses to monitor financial stability in the November 2018 *Financial Stability Report*.[4] This framework focuses on monitoring vulnerabilities in the financial system, such as elevated valuation pressures, excessive leverage within the financial sector, excessive borrowing by businesses and households, and funding risks.

Monitoring of financial vulnerabilities and activities that could pose a threat to U.S. financial stability could help regulators design policies to reduce the likelihood of financial market disruptions or of credit crunches.

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[2] See https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/June152018_minutes.pdf.
[3] See https://www.treasury.gov/press-center/press-releases/documents/pm-fsoc-designations-memo-11-17.pdf.
[4] See https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf.

2. Thank you for the ongoing dialogue on the "standardized approach for measuring counterparty credit risk" rule in derivatives markets. I appreciate regulators enacting risk-based rules in any sector of the economy.

I understand that the Fed's goal was to follow the Basel Committee's approach when it was designing the SA-CCR rule. I also understand that the SA-CCR methodology as designed by the Basel Committee recognized that margin posted by derivative users reduces the risk of default. That being said, based on my review of the Fed's SA-CCR rule, I noticed that the Fed omitted the margin exposure provisions of the Basel SA-CCR rule.

One of the purposes of implementing the Basel Committee's SA-CCR rule was to make American companies more competitive with our European counterparts, all of whom have implemented the Basel-driven version of SA-CCR.

(a) Why did the Fed choose not to include margin exposure in the U.S. SA-CCR rule? Will this lack of recognition on margin perpetuate the disparities between the U.S. and Europe and put our financial institutions at a disadvantage?

The proposal is generally consistent with the Basel Committee's standards on the recognition of margin in the risk-based and leverage capital frameworks. In particular, the proposal to require use of SA-CCR in calculating the supplementary leverage ratio is generally consistent with the Basel Committee's standard on leverage capital requirements, which currently limits collateral recognition. The Agencies are sensitive to impediments to firms' willingness and ability to provide client-clearing services, and recognize the wide support for the migration of derivative contracts to central clearing frameworks. In particular, in October 2018, the Basel Committee issued a consultative document seeking views on whether to recognize collateral in their leverage capital requirement.[5] Accordingly, the Agencies are inviting comment on the consequences of not recognizing collateral provided by a clearing member client banking organization in connection with a cleared transaction. The Agencies will carefully consider each comment on the proposal.

(b) As you know, Section 402 of S. 2155 exempted the cash deposits of custody banks held at central banks from the supplemental leverage ratio.

- **Can you give us an update on when section 402 will be implemented?**
- **And can you shed a bit more light into how this section of the law will interact with changes to the supplemental leverage ratio that the Fed announced back in April?**

Balancing these two priorities is important given that regulatory changes announced in April could potentially blunt the impact of S. 2155.

[5] See Consultative Document, "Leverage ratio treatment of client cleared derivatives," Basel Committee on Banking Supervision, October 2018, available at https://www.bis.org/bcbs/publ/d451.pdf.

As you indicate, the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) requires the federal banking agencies to amend the supplementary leverage ratio as applied to custodial banks. The federal banking agencies are actively working to issue a notice of proposed rulemaking and expect to issue it for public comment in the near future.

The April 2018 proposal to recalibrate the enhanced supplementary leverage ratio standards assumed that the components of the supplementary leverage ratio used the capital rule's existing definitions of tier 1 capital (the numerator of the ratio) and total leverage exposure (the denominator); however, the definition of total leverage exposure will change for certain banking organizations through the implementation of section 402. As the Board and OCC noted in the April 2018 proposal, significant changes to either component of the supplementary leverage ratio would likely necessitate reconsideration of the proposed recalibration, as the proposal was not intended to materially change the aggregate amount of capital in the banking system. Accordingly, staff is evaluating the April 2018 proposal in light of the statutory change, in addition to comments received on the proposal. The Board also plans to implement the requirements of section 402 in the near-term.

3. I've reviewed remarks you gave at the Brookings Institution on November 9th and appreciate efforts you're undertaking to implement S. 2155 by tailoring capital and liquidity for banks based on risk. As the Senate lead on S. 366, the TAILOR Act, I appreciate any and all steps our banking regulators take to tailor regulations to the risk profile and business model of a given institution as opposed to regulating based on arbitrary asset thresholds.

During your remarks at Brookings you stated that S. 2155 did not provide relief for large banks and that after the Fed finalizes its tailoring proposal it will turn its focus to other parts of our regulatory system.

- **Can you shed a bit more light into what you meant by that?**
    - **What issues will you be considering in your efforts to bring greater efficiency to our regulatory system?**

The proposals approved by the Board for public comment on October 31, 2018, are designed to efficiently tailor prudential standards to the risks of large U.S. banking organizations while ensuring that firms maintain sufficient resources and risk management practices to be resilient under a range of economic conditions.[6] The proposals build on the Board's existing tailoring of its rules and experience implementing those rules, and account for changes made by the EGRRCPA to the enhanced prudential standards requirements under section 165 of the Dodd-Frank Act.

In the proposals, the Board stated its plans to propose at a later date similar amendments that would tailor capital planning and resolution planning requirements for large U.S. banking organizations. The Board also stated its plans to issue a separate proposal relating to foreign banking organizations that would implement section 401 of the EGRRCPA for these firms, take

[6] See https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181031a.htm.

into account the structures through which these firms conduct business in the United States, and reflect the principles of national treatment and equality of competitive opportunity.

In addition, the Board in general aims to reduce unnecessary costs associated with and streamline regulatory requirements based on its experience implementing the rules and consistent with the statutory provisions that motivated the rules.

4. The June 2017 Treasury Report on banks and credit unions recommended, "The application of U.S. enhanced prudential standards to foreign banking organizations (FBOs) should be based on their U.S. risk profile, using the same revised threshold as is used for the application of the enhanced prudential standards to U.S. bank holding companies, rather than on global consolidated assets."

- **How will the Federal Reserve tailor its regulations according to this recommendation and the longstanding principle of national treatment?**

The Board is in receipt of the June 2017 Department of Treasury report and has carefully reviewed its contents including its recommendations. As noted above, the Board is considering the appropriate way to assign the U.S. operations of foreign banking organizations to the categories of prudential standards described in the Board's October 31, 2018, proposal to tailor prudential standards for domestic firms, in light of the special structures through which these firms conduct business in the United States.

- **Given that foreign regulators may retaliate against American institutions for overly aggressive actions taken by U.S. regulators, what steps will the Federal Reserve take to focus its tailoring on the risk profile of intermediate holding companies and not the branch networks of international banks, which are subject to regulation by their home countries?**

In developing a proposal for foreign banking organizations, the Board will consider the special structures through which these firms conduct business in the United States. The Board's current enhanced prudential standards were designed to increase the resiliency of the U.S. operations of foreign banking organizations, including the U.S. branches and agencies of these firms. In developing the proposal, the Board will continue to consider the principles of national treatment and equality of competitive opportunity along with the extent to which a foreign banking organization is subject, on a consolidated basis, to home country standards that are comparable to those applied to financial companies in the United States.

Committee on Banking, Housing, and Urban Aff
The Semiannual Testimony on the Federal Reserve's Supervision a
Financial System
November 15, 2018

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

In South Dakota, many farmers use derivatives to manage the risk of price disruptions due to any number of factors in the marketplace. Given the challenges that farmers are facing on several fronts, it's important that South Dakotans are able to access tools like derivatives in a way that's as cost-effective as possible.

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When will the Fed act on this issue and provide relief on client margin? Farmers are in need of relief wherever they can get it.

I'm proud to be the Senate sponsor of S. 3577, the Financial Stability Oversight Council Improvement Act of 2018. As we continue to look at ways to make our financial system safer and more resilient, it's important that FSOC also regulates nonbanks based on the risk profile of a specific business or industry, not for the sake of regulation, and not based only on size.

Last year the Treasury Department released a report recommending how FSOC can further improve the SIFI designation process for non-bank institutions. Similar to my interest in tailoring regulations, Treasury suggested that an activities–based approach would be appropriate. I'm also pleased to hear reports that FSOC may be taking action on this front by the end of 2018.

- Can you elaborate on FSOC's forthcoming proposals?
    - If you could, I'd like you to share some of the advantages to the activities-based approach that FSOC is considering.
        - How will it help the Fed's work?
        - And how will it help the economy more broadly?

Thank you for the ongoing dialogue on the "standardized approach for measuring counterparty credit risk" rule in derivatives markets. I appreciate regulators enacting risk-based rules in any sector of the economy.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System
November 15, 2018

I understand that the Fed's goal was to follow the Basel Committee's approach when it was designing the SA-CCR rule. I also understand that the SA-CCR methodology as designed by the Basel Committee recognized that margin posted by derivative users reduces the risk of default. That being said, based on my review of the Fed's SA-CCR rule, I noticed that the Fed omitted the margin exposure provisions of the Basel SA-CCR rule.

One of the purposes of implementing the Basel Committee's SA-CCR rule was to make American companies more competitive with our European counterparts, all of whom have implemented the Basel-driven version of SA-CCR.

- Why did the Fed choose not to include margin exposure in the U.S. SA-CCR rule?
    - Will this lack of recognition on margin perpetuate the disparities between the U.S. and Europe and put our financial institutions at a disadvantage?

As you know, Section 402 of S. 2155 exempted the cash deposits of custody banks held at central banks from the supplemental leverage ratio.

- Can you give us an update on when section 402 will be implemented?
    - And can you shed a bit more light into how this section of the law will interact with changes to the supplemental leverage ratio that the Fed announced back in April?

Balancing these two priorities is important given that regulatory changes announced in April could potentially blunt the impact of S. 2155.

I've reviewed remarks you gave at the Brookings Institution on November 9th and appreciate efforts you're undertaking to implement S. 2155 by tailoring capital and liquidity for banks based on risk. As the Senate lead on S. 366, the TAILOR Act, I appreciate any and all steps our banking regulators take to tailor regulations to the risk profile and business model of a given institution as opposed to regulating based on arbitrary asset thresholds.

During your remarks at Brookings you stated that S. 2155 did not provide relief for large banks and that after the Fed finalizes its tailoring proposal it will turn its focus to other parts of our regulatory system.

- Can you shed a bit more light into what you meant by that?
    - What issues will you be considering in your efforts to bring greater efficiency to our regulatory system?

The June 2017 Treasury Report on banks and credit unions recommended, "The application of U.S. enhanced prudential standards to foreign banking organizations (FBOs) should be based on their U.S. risk profile, using the same revised threshold as is used for the application of the enhanced prudential standards to U.S. bank holding companies, rather than on global consolidated assets."

- How will the Federal Reserve tailor its regulations according to this recommendation and the longstanding principle of national treatment?

    - Given that foreign regulators may retaliate against American institutions for overly aggressive actions taken by U.S. regulators, what steps will the Federal Reserve take to focus its tailoring on the risk profile of intermediate holding companies and not the branch networks of international banks, which are subject to regulation by their home countries?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

January 11, 2019

The Honorable Pat Toomey
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record. Please let me know if I may be of further assistance.

Sincerely,

[1] Questions for the record related to this hearing were received on November 27, 2018.

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

1. Section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act instructed bank regulators to issue a rule exempting custody banks' cash deposits placed at central banks from the Supplemental Leverage Ratio calculation.

- **When do you expect to implement Section 402?**

As you indicate, the recent Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) legislation requires the federal banking agencies to amend the supplementary leverage ratio as applied to custodial banks. The federal banking agencies are actively working to issue a notice of proposed rulemaking and expect to issue it for public comment in the near future.

The April 2018 proposal to recalibrate the enhanced supplementary leverage ratio standards assumed that the components of the supplementary leverage ratio used the capital rule's existing definitions of tier 1 capital (the numerator of the ratio) and total leverage exposure (the denominator); however, the definition of total leverage exposure will change for certain banking organizations, through the implementation of section 402. As the Federal Reserve Board (Board) and the Office of the Comptroller of the Currency noted in the April 2018 proposal, significant changes to either component of the supplementary leverage ratio would likely necessitate reconsideration of the proposed recalibration, as the proposal was not intended to materially change the aggregate amount of capital in the banking system. Accordingly, staff is evaluating the April 2018 proposal in light of the statutory change, in addition to comments received on the proposal.

2. Holding almost $5 trillion in U.S. banking and non-banking assets, foreign banking organizations (FBOs) play an important role in the U.S. financial system and overall economy. FBOs operating within the U.S. and U.S. firms operating abroad should compete on a level playing field. For that reason, I was encouraged to learn that you intend to review and possibly update regulations applicable to FBOs early in 2019. Previously, you have highlighted Total Loss-Absorbing Capital (TLAC) requirements for the intermediate holding companies (IHCs) of FBOs as worthy of review.

- **Will TLAC requirements be a part of your 2019 efforts?**
- **If so, what are your plans to tailor and streamline internal TLAC and long-term debt requirements?**

In October 2018, the Board issued notices of proposed rulemaking (NPR) to tailor certain prudential standards for domestic banks. The Board plans to develop a separate proposal, for public comment, relating to foreign banking organizations (FBOs) and their U.S. operations. The October 2018 NPRs did not modify the Total Loss-Absorbing Capital (TLAC) requirements for U.S. firms; the specific content of a forthcoming FBO tailoring NPR remains under consideration.

- **Finally, are you considering adjusting the January 1, 2019 compliance date currently in effect?**

In the remarks I gave on May 16, 2018, I noted that the Board should consider whether the internal TLAC calibration for intermediate holding companies (IHCs) could be adjusted to reflect the practice of other regulators without adversely affecting resolvability and U.S. financial stability. This matter remains under consideration and the Board continues to monitor relevant developments in other jurisdictions. The Board's rule establishing TLAC, long-term debt, and clean holding company requirements for U.S. IHCs of foreign global systemically important banks became effective as of January 1, 2019. Any change to the internal TLAC requirements for IHCs, or any other aspect of the rule, would need to be adopted through the normal public rulemaking process.

Committee on Banking, Housing, and Urban Af[f]

The Semiannual Testimony on the Federal Reserve's Supervision (

Financial System

November 15, 2018

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Committee on Banking, Housing, and Urban A
The Semiannual Testimony on the Federal Reserve's Supervision
Financial System
November 15, 2018

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

The Fed's regulation report released on November 9, 2018 said that foreign banking organizations (FBOs) still face challenges in complying with Dodd-Frank Act enhanced prudential standards (EPS). And yet your testimony noted that FBOs can expect a rule to "tailor" EPS in the coming year.

- Why would the Fed alter taxpayer protections with regard to FBOs when the Fed's own report says that banks aren't fully complying with existing requirements?

In April, the Fed proposed weakening the enhanced supplemental leverage ratio (eSLR) by $121 billion for the insured depository institutions of the eight largest banks and proposed weakening the version of the leverage ratio used in stress tests. In a recent speech, you went further, saying that the leverage ratio should be eliminated altogether in stress tests. More than half of global systemically important banks (GSIBs) have had their stock buybacks and dividends limited in recent years because the leverage ratio was the binding constraint on capital distributions.

- How do you justify letting large banks send capital to shareholders and executives when it could otherwise be protecting taxpayers from bailouts?

In a recent comment letter, the Federal Reserve Bank of Minneapolis noted that the "proposed tailoring of the eSLR and alterations to the existing stress testing that the Board is considering will weaken taxpayer protection from bailouts. Recent evidence – some of which economists from the Board of Governors itself has produced – finds that equity funding requirements for the largest banks are too low, not too high. Even measures of the credit cycle and financial stability risk indicate that it is likely prudent for banks to continue to build capital."

- Please provide your perspective on this statement.

In a recent speech, you noted that the Fed is going to re-propose a rule on its stress testing regime in light of comment letters it received. Then your speech goes on to list a whole host of changes the Fed may make – each of which is more favorable to the banks.

- If the Fed re-proposing the Stress Capital Buffer (SCB) proposal as you've outlined, would GSIBs be required to hold more or less capital relative to the original SCB proposal?
    - o Can you point us to an example of a proposed change, as noted in your speech, which would require GSIBs to hold additional capital?

- Does the Fed plan to incorporate the GSIB surcharge into the Comprehensive Capital Analysis and Review (CCAR) for 2019?

- Will you commit to making your meeting schedule transparent so that the Congress and the public can see who you're talking to before the Fed announces any proposed rules changing bank capital, leverage, liquidity or other standards?

You have proposed eliminating the qualitative objection currently included in CCAR. Previously, banks such as Deutsche Bank, Santander, Citigroup, HSBC, RBS, Ally and BB&T have received objections to their capital distribution plans based on qualitative factors.

- What is your justification for eliminating the qualitative objection under CCAR?

When you were asked about the Community Reinvestment Act at a recent House of Representatives hearing, you said that the law had become too "formulaic" and that it was therefore less effective.

- If that's the case, would you oppose the aspect of the OCC's proposal – which would make the CRA even more formulaic by grading banks' performance according to one simple ratio?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

April 9, 2019

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1, 4(a), and 4(b) from the questions that you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On March 15, 2019, I provided responses to questions 4(c), 5, and 6. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions are forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 27, 2018.

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

1. The Fed's regulation report released on November 9, 2018 said that foreign banking organizations (FBOs) still face challenges in complying with Dodd-Frank Act enhanced prudential standards (EPS). And yet your testimony noted that FBOs can expect a rule to "tailor" EPS in the coming year.

- **Why would the Fed alter taxpayer protections with regard to FBOs when the Fed's own report says that banks aren't fully complying with existing requirements?**

The Board of Governors of the Federal Reserve System (Board) has taken, and will continue to take, a risk-based approach to supervision, focusing its resources on those institutions (both domestic and foreign) that pose the greatest risk to safety and soundness and financial stability. On October 31, 2018, the Board approved two notices of proposed rulemaking that would establish a revised framework for applying enhanced prudential standards to large U.S. banking organizations based on their risk profiles. The proposals would establish four categories of standards that reflect the different risks of firms in each group and would largely keep existing requirements in place for the riskiest and largest firms. The proposals build on the Board's existing tailoring of its rules and experience implementing those rules, and account for statutory changes enacted by the Economic Growth, Regulatory Relief, and Consumer Protection Act.

The changes proposed on October 31, 2018, do not apply to foreign banking organizations. As a part of the Board's current effort to develop a tailoring proposal for foreign banks, we are considering the appropriate way to assign foreign U.S. operations to the category of prudential standards described in the tailoring proposal for domestic firms, in light of the structures through which these firms conduct business in the Unites States.

I expect that this proposal and the two proposed rulemakings from October 31, 2018, by applying enhanced prudential standards based on risk profile, will enable the Board to continue to apply its risk-based approach to supervision in a more effective and efficient manner.

4. In a recent speech, you noted that the Fed is going to re-propose a rule on its stress testing regime in light of comment letters it received. Then your speech goes on to list a whole host of changes the Fed may make – each of which is more favorable to the banks.

(a) If the Fed re-proposing the Stress Capital Buffer (SCB) proposal as you've outlined, would GSIBs be required to hold more or less capital relative to the original SCB proposal?
Can you point us to an example of a proposed change, as noted in your speech, which would require GSIBs to hold additional capital?

The Board's notice of public rulemaking entitled Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules[2] issued in April 2018 would integrate the Board's regulatory capital rules, the Board's Comprehensive Capital Analysis and Review (CCAR), and stress test

[2] https://www.govinfo.gov/content/pkg/FR-2018-04-25/pdf/2018-08006.pdf.

rules. Under the proposal, the Board's supervisory stress test would be used to establish the size of a firm's stress capital buffer requirement. As noted in the proposal, the stress capital buffer requirement would generally maintain or in some cases increase common equity tier 1 capital requirements for global systemically important banking organizations (GSIBs). That said, the impact of the proposal on firms would vary through the economic and credit cycle based on the risk profiles and planned capital distributions of individual firms, as well as the specific severely adverse stress scenario used in the supervisory stress test. The same potential impact on individual firms also would exist under the changes that I have outlined previously in greater detail.[3]

Board staff are currently reviewing all comments on the proposal and will carefully consider whether any changes to the proposal are appropriate.

(b) Does the Fed plan to incorporate the GSIB surcharge into the Comprehensive Capital Analysis and Review (CCAR) for 2019?

In 2019, as in past CCAR cycles, the Board intends to evaluate each firm's ability to maintain capital ratios above the post-stress minimum requirements. The global systemically important bank holding company surcharge is not a minimum requirement, and thus, would not be considered as part of the CCAR's quantitative assessment.

We are continuing to evaluate ways to simplify the Board's capital framework by more closely integrating the regulatory capital rules and stress testing. The Board's proposal, issued in April 2018 as noted in the response to 4(a), would introduce the concept of stress buffer requirements into the regulatory capital rules. This proposal would integrate the results of the Board's supervisory stress test into the regulatory capital rules, which already incorporates the GSIB surcharge.

The goal of the proposal is to provide a more integrated and cohesive framework that reduces redundancies and inconsistencies across the capital rules and stress testing rules. The proposal includes other modifications as well, such as changes to the assumptions used in our stress test.

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[3] See, "A New Chapter in Stress Testing," at https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

April 25, 2019

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2 and 3 from the questions that you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. On April 9, 2019, I provided responses to questions 1, 4(a), and 4(b). In addition, on March 15, 2019, I provided responses to questions 4(c), 5, and 6. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record. This constitutes completion of my responses to all of your written questions submitted.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 27, 2018.

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

In April, the Fed proposed weakening the enhanced supplemental leverage ratio (eSLR) by $121 billion for the insured depository institutions of the eight largest banks and proposed weakening the version of the leverage ratio used in stress tests. In a recent speech, you went further, saying that the leverage ratio should be eliminated altogether in stress tests. More than half of global systemically important banks (GSIBs) have had their stock buybacks and dividends limited in recent years because the leverage ratio was the binding constraint on capital distributions.

- **How do you justify letting large banks send capital to shareholders and executives when it could otherwise be protecting taxpayers from bailouts?**

Post-crisis regulatory reforms, including the supplementary leverage ratio, were designed to improve the safety and soundness and reduce the probability of failure of banking organizations, as well as to reduce the consequences to the financial system if such a failure were to occur. For large banking organizations in particular, the objective of the Federal Reserve Board (Board) has been to establish capital and other prudential requirements at a level that not only promotes resiliency at the banking organization and protects financial stability, but also maximizes long-term, through-the-cycle credit availability and economic growth. In reviewing the post-crisis reforms both individually and collectively, the Board has sought ways to streamline and tailor the regulatory framework, while ensuring that such firms have adequate capital to continue to act as financial intermediaries during times of stress.

Consistent with these efforts, the Board proposed to recalibrate the enhanced supplementary leverage ratio (eSLR) to align leverage capital requirements with risk-based capital requirements for the GSIBs. In particular, leverage capital requirements should generally act as a backstop to the risk-based requirements. If a leverage ratio is calibrated at a level that makes it generally a binding constraint, it can create incentives for firms to reduce participation in or increase costs for low-risk, low-return businesses. Over the past few years, however, concerns were raised that in certain cases the eSLR has become a binding constraint rather than a backstop to the risk-based standards. With respect to the April 2018 proposal, a decrease in capital requirements at a subsidiary depository institution does not necessarily result in its holding company being able to distribute those funds to shareholders. This happens because the capital rule and other regulatory restrictions at the holding company level, such as the Board's annual stress tests, limit the amount of capital that a holding company can distribute to shareholders. The analysis that accompanied the April 2018 proposal showed that the banking organizations that would be subject to the proposal—global systemically important banking organizations (U.S. GSIBs)—would be able to release only up to $400 million of tier 1 capital (or approximately 0.04 percent of the amount of tier 1 capital held by these firms) to their shareholders.

With respect to the stress testing program, explicitly assigning a leverage buffer requirement to a firm on the basis of risk-sensitive post-stress estimates, as the stress testing framework is intended to do, may be inconsistent with the goals of the leverage ratio.

In a recent comment letter, the Federal Reserve Bank of Minneapolis noted that the "proposed tailoring of the eSLR and alterations to the existing stress testing that the Board is considering will weaken taxpayer protection from bailouts. Recent evidence – some of which economists from the Board of Governors itself has produced – finds that equity funding requirements for the largest banks are too low, not too high. Even measures of the credit cycle and financial stability risk indicate that it is likely prudent for banks to continue to build capital."

- **Please provide your perspective on this statement.**

Maintaining the safety and soundness of the largest U.S. banks is critical to maintaining the stability of the U.S. financial system and the broader economy. Accordingly, post crisis, the Board along with the other U.S. banking agencies substantially strengthened regulatory capital requirements for large banks. The Board's capital rules have been designed to significantly reduce the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure, were it to occur. Capital rules and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle, credit availability and economic growth. In general, I believe overall loss-absorbing capacity for our largest banking organizations is at about the right level.

More recently, the Board has proposed various regulatory refinements to pursue its long-standing goal of applying prudential standards based on a bank's risk profile and size. This tailoring of regulations enables the Board to supervise banking organizations in an effective and efficient manner while maintaining their safety and soundness.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

March 15, 2019

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 4(c), 5, and 6 from the questions that you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record. Responses to the remaining questions are forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 27, 2018.

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

4. In a recent speech, you noted that the Fed is going to re-propose a rule on its stress testing regime in light of comment letters it received. Then your speech goes on to list a whole host of changes the Fed may make – each of which is more favorable to the banks.

(c) Will you commit to making your meeting schedule transparent so that the Congress and the public can see who you're talking to before the Fed announces any proposed rules changing bank capital, leverage, liquidity or other standards?

In my work as a Federal Reserve Board (Board) Governor, as well as the Vice Chair for Supervision and Regulation, I regularly meet with a wide range of representatives from the industry, peer domestic and foreign regulators, academics, public interest groups and others. These meetings inform me and, in turn, the Board on a broad array of critical issues. Consistent with the practice of other Board members, I have always provided my calendar to the public upon request and will be happy to provide a copy to your staff.

5. You have proposed eliminating the qualitative objection currently included in CCAR. Previously, banks such as Deutsche Bank, Santander, Citigroup, HSBC, RBS, Ally and BB&T have received objections to their capital distribution plans based on qualitative factors.

- **What is your justification for eliminating the qualitative objection under CCAR?**

Capital planning is a core aspect of financial and risk management that helps ensure the financial strength and resilience of a firm. Strong, forward-looking capital planning processes ensure that large firms have sufficient capital to absorb losses and continue to lend to creditworthy businesses and consumers, including during times of stress.

In 2017, the Federal Reserve eliminated the qualitative objection as part of the Comprehensive Capital Analysis and Review (CCAR) for large and noncomplex firms, which are generally firms with less than $250 billion in assets, in part because of improvements in risk management at these firms. I believe that the removal of the qualitative objection for these firms has not diminished the effectiveness of supervision.

Similarly, larger firms have also generally improved their risk management in the years since the inception of CCAR. Removing the public objection tool and continuing to evaluate firms' stress testing practices through normal supervision for all firms would align the outcome of the CCAR qualitative assessment with other supervisory programs. Firms would remain subject to the same supervisory expectations, and examiners would continue to conduct rigorous horizontal and firm-specific assessments of a firm's capital positions and capital planning, tailored to the risk profile of the firm. While much of the examination work would center on a firm's capital plan submissions, examination work would continue on a year-round basis, taking into account the firm's management of other financial risks. The evaluation of the firm's capital position and capital planning would culminate in a rating of the firm's capital position and planning. Firms with deficient practices would receive supervisory findings through the examination process, and would be at risk of a ratings downgrade or enforcement action if those deficiencies were sufficiently material or not addressed in a timely manner.

6. When you were asked about the Community Reinvestment Act at a recent House of Representatives hearing, you said that the law had become too "formulaic" and that it was therefore less effective.

- **If that's the case, would you oppose the aspect of the OCC's proposal – which would make the CRA even more formulaic by grading banks' performance according to one simple ratio?**

I was referring to the fact that, over the years, practices have developed among both banks and their supervisors that result in much Community Reinvestment Act (CRA) compliance being satisfied with a single type of activity. The drafters of the CRA contemplated, and the language of the statute itself supports, a much broader potential for involvement in community development and a much wider range of qualifying investments than currently tends to result from CRA compliance. We are reviewing information the Office of the Comptroller of the Currency has received in response to its advance notice of proposed rulemaking on the CRA, as well as information gathered through the Federal Reserve's listening sessions at many of the Federal Reserve Banks around the country, to determine whether there are steps we might take as regulators to come closer to both the letter and intent of the statute. That review is ongoing, and our evaluation of any particular proposal or element of a proposal, including any potential measurement standards, will depend on a full analysis of the available information upon completion of that review.

Committee on Banking, Housing, and Urban Aff
The Semiannual Testimony on the Federal Reserve's Supervision (
Financial System
November 15, 2018

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

After Nasdaq became an exchange in 2006, it is my understanding that the Federal Reserve has not undertaken any effort to update its rules to provide a pathway to margin eligibility for companies traded over-the-counter (OTC). Margin eligibility of OTC-traded stocks can be an important part of the growth of small and emerging companies, as it helps to improve the market quality of those securities, impact an investor's willingness to purchase those securities, and as a result have a direct impact on capital formation. In addition, U.S investors in the American depositary receipts (ADR) for Roche [$10bn yearly net income] and other large, international OTC traded firms are also negatively impacted by the Federal Reserve's inaction on this issue.

- Will the Federal Reserve take action to revive the margin list for certain OTC securities?
    - If not, please explain why.

In previous reports on the state of supervision and regulation, you have stated, "the Federal Reserve relies to the fullest extent possible" on state insurance departments in the supervision of Insurance Savings & Loan Holding Companies (ISLHC) and that you have worked closely with state officials and the National Association of Insurance Commissioners (NAIC) to maximize supervisory efficiencies and avoid duplication.

I continue to hear from my constituents and insurance companies in my state that "tailoring" is not occurring. It is difficult to point to a single specific action the Federal Reserve has taken to tailor for these companies, and they continue to exit the business of banking, with several exits in the last year.

- Is the Federal Reserve concerned about this trend?
    - What specific further actions will the Federal Reserve take to make sure that ISLHCs are not being driven from the business of banking by inefficient and overly burdensome regulation?

Board of Governors of the Federal Reserve System
Washington, D. C. 20551

Randal K. Quarles
Vice Chairman for Supervision

May 8, 2019

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the remaining questions you submitted following the October 2, 2018, and the November 15, 2018, hearings before the Committee on Banking, Housing, and Urban Affairs. [1] A copy also has been forwarded to the Committee for inclusion in the respective hearing records. This constitutes the completion of my responses to all of your written questions.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to these hearings were received on October 11, 2018, and November 27, 2018, respectively.

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

After Nasdaq became an exchange in 2006, it is my understanding that the Federal Reserve has not undertaken any effort to update its rules to provide a pathway to margin eligibility for companies traded over-the-counter (OTC). Margin eligibility of OTC-traded stocks can be an important part of the growth of small and emerging companies, as it helps to improve the market quality of those securities, impact an investor's willingness to purchase those securities, and as a result have a direct impact on capital formation. In addition, U.S investors in the American depositary receipts (ADR) for Roche [$10bn yearly net income] and other large, international OTC traded firms are also negatively impacted by the Federal Reserve's inaction on this issue.

- **Will the Federal Reserve take action to revive the margin list for certain OTC securities? If not, please explain why.**

Responding to your question above and as previously posed regarding the List of Over-the-Counter Margin Stocks (OTC List) that is no longer published by the Federal Reserve Board (Board), staff have continued to monitor OTC market developments in the years since the publication of the OTC List ceased. Any expansion of the types of securities that are margin eligible would require careful consideration by the Board of the benefits of such an approach weighed against potential increased burden on banks and other lenders.

Please know that I appreciate your concerns as noted in your questions, and we are looking into potential approaches that may be considered while ensuring any changes would not pose additional regulatory burdens. By way of background, I am including a brief summary of the history of the Board's OTC List.

In 1968, Congress amended section 7 of the Securities Exchange Act of 1934 (SEA) to allow the Board to regulate the amount of credit that may be extended on securities not registered on a national securities exchange, or those securities known as "over-the-counter" or "OTC" securities. The following year, the Board adopted criteria to identify OTC stocks that have "the degree of national investor interest, the depth and breadth of market, the availability of information respecting the security and its issuer, and the character and permanence of the issuer" to warrant treatment similar to equity securities registered on a national securities exchange. The Board's first periodically published OTC List became effective on July 8, 1969.

In 1975, Congress further amended the SEA to direct the Securities and Exchange Commission (SEC) to facilitate the development of a "national market system" (NMS) for securities to accomplish several goals, including price transparency. The SEC's criteria for NMS securities came to cover both exchange-traded stocks (which were always marginable) and a subset of stocks traded on Nasdaq, the largest and most technologically advanced over-the-counter market at that time. The majority of the securities traded on Nasdaq's NMS tier were covered by the Board's OTC margin stock criteria and appeared on the Board's OTC List. The Board's analysis, however, indicated that the liquidity and other characteristics of NMS securities generally compared favorably with those of exchange-traded securities. Accordingly, the Board amended its margin regulations in 1984 to give immediate margin status to OTC securities that qualified as NMS securities without regard to whether the stock appeared on the Board's OTC List. This action established a precedent for relying on NMS status under SEC rules as a substitute for identifying margin-eligible OTC securities through the application of Board-established criteria.

The Board ceased publication of its OTC List in 1998, and provided margin status to all securities listed on the Nasdaq Stock Market, after Nasdaq raised the listing standards for non-NMS securities trading on its market, making them comparable to those traded on national securities exchanges. Indeed, Nasdaq subsequently became a national securities exchange.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

February 1, 2019

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 2 of the questions that you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record. A response to the remaining question is forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 27, 2018.

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

2. In previous reports on the state of supervision and regulation, you have stated, "the Federal Reserve relies to the fullest extent possible" on state insurance departments in the supervision of Insurance Savings & Loan Holding Companies (ISLHC) and that you have worked closely with state officials and the National Association of Insurance Commissioners (NAIC) to maximize supervisory efficiencies and avoid duplication. I continue to hear from my constituents and insurance companies in my state that "tailoring" is not occurring. It is difficult to point to a single specific action the Federal Reserve has taken to tailor for these companies, and they continue to exit the business of banking, with several exits in the last year.

- **Is the Federal Reserve concerned about this trend?**
- **What specific further actions will the Federal Reserve take to make sure that ISLHCs are not being driven from the business of banking by inefficient and overly burdensome regulation?**

In supervising insurance savings and loan holding companies (ISLHCs), the Federal Reserve has aimed to develop policies that are insurance-centric and appropriate for the insurance business and regulatory environment. For instance, the Board's advance notice of proposed rulemaking on insurance capital requirements set out two frameworks for capital standards that are each unlike the Board's capital rules for bank holding companies.[2] The Federal Reserve recognizes that ISLHCs have multiple functional regulators and that state insurance regulators are the primary functional supervisors of the insurance companies. In supervising the consolidated insurance organization, the Federal Reserve remains committed to working cooperatively with state insurance regulators to reduce the potential for duplication and undue burden of supervisory activities. The Federal Reserve also tailors its supervisory activities and guidance to account for the unique characteristics, organizational and regulatory structures associated with ISLHCs. Examples of tailoring for these companies include the Board's exemption of ISLHCs from Federal Reserve consolidated capital, stress testing and liquidity rules which are generally applicable to banking organizations.

Federal Reserve examination teams rely on state insurance regulators to the fullest extent possible for the assessment of insurance risks and activities. For example, supervisory evaluations and findings from state insurance regulators are incorporated into the Federal Reserve's consolidated supervision assessments. Federal Reserve examiners defer to state insurance regulators for the evaluation of insurance activities pertaining to insurance underwriting, reinsurance, reserving, market conduct and compliance with state insurance laws.

The Federal Reserve also coordinates with state insurance regulators through information sharing agreements and supervisory colleges. Additionally, Federal Reserve examination staff meet with

[2] Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38,631 (June 14, 2016), https://www.federalregister.gov/documents/2016/06/14/2016-14004/capital-requirements-for-supervised-institutions-significantly-engaged-in-insurance-activities.

each ISLHC's primary state insurance regulators to share supervisory information (e.g., inspection reports, supervisory plans), coordinate supervisory activities, and identify opportunities to leverage each agency's work to complement supervisory efforts and avoid duplication.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIRMAN FOR SUPERVISION

February 1, 2019

The Honorable Tom Cotton
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the November 15, 2018,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 27, 2018.

Questions for The Honorable Randall K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, from Senator Cotton:

1. FINRA rule 4210

Two years ago, I sent a letter to the SEC expressing concern about FINRA Rule 4210, which established margin requirements on To-Be-Announced (TBA) securities such as mortgage-back bonds. The key problem here is that rule 4210 applies to broker-dealers but NOT to banks. Thus broker-dealers can use their banking arm to evade this requirement, creating an uneven playing field. Earlier this year, Federal Reserve staff confirmed this "inequity" in a call with my staff.

Last April, we spoke about this rule in a hearing with this committee. You promised to review that rule to ensure it did not create an unequal playing field between small and medium broker-dealers and large, bank-affiliated broker-dealers. I'm sure we agree that restricting market competition isn't good for anyone except the privileged few banks that would gain business. The day after that hearing, FINRA delayed rule 4210 until March of 2019.

- **What steps can the Fed take to ensure that rule 4210 does not create an unequal playing field between small & medium-sized broker dealers and bank-affiliated broker dealers? Please list them.**
- **Do you agree that as implemented, rule 4210 creates an unequal playing field for the aforementioned financial institutions?**

As you noted above in your question, the Financial Industry Regulatory Authority's (FINRA) Rule 4210 To-Be-Announced (TBA) amendments are not scheduled to be implemented until spring 2019 at the earliest. In addition, recent action by FINRA suggests it is working towards reducing the rule's burden. For example, in September 2018, FINRA's Board approved revisions to its Rule 4210 TBA requirements that would eliminate the two percent maintenance margin requirement contained in the rule. FINRA's Board also approved revisions that would allow member firms to take a capital charge in lieu of collecting margin for mark to market losses, subject to specified limitations and conditions.[2] These changes would substantially reduce possible inequities between FINRA firms and bank dealers. FINRA has not yet sought comment on these revisions, and the Federal Reserve is monitoring FINRA's efforts. If the final result creates an unequal playing field, we will work with fellow bank regulatory agencies to address disparities between FINRA firms and bank dealers in this area, taking into account the differences between them.

2. Mortgage Servicing Assets

As you know, many lenders prefer to keep the relationship with the customer via servicing the mortgage, even if the bank sells the mortgage itself. There has been a bipartisan view in Congress that the original rule on MSAs, which came out as part of the Basel process, was mis-guided and, indeed, punitive as applied to small and mid-size banks. Many of us were

[2] *See* https://www.finra.org/industry/update-finra-board-governors-meeting-092618.

encouraged when the regulators put out a proposal to change the existing rule. But that proposal came out over a year ago and still nothing has been done to finalize it. The current situation is driving mortgage servicing out of regulated entities and into unregulated ones, which I assume is not your objective.

- **When can we expect a final rule on mortgage servicing assets to be issued?**

As part of the 2017 Economic Growth and Regulatory Paperwork Reduction Act report, the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies), and the National Credit Union Administration highlighted their intent to meaningfully reduce regulatory burden, especially on community banking organizations, while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system. Consistent with that objective, the agencies issued a proposal in 2017 to simplify certain aspects of the regulatory capital rules for non-advanced approaches banking organizations, including a simplified treatment for mortgage servicing assets (MSAs) (simplifications proposal).

The agencies are working jointly to implement Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA),[3] which addresses and supersedes aspects of the simplifications proposal. For example, the agencies recently issued a proposed rule to conform the regulatory capital treatment of certain acquisition, development, or construction loans to that under EGRRCPA.[4] The agencies are actively considering the comments received on the simplifications proposal in the context of the changes made by the EGRRCPA.

In addition, on November 21, 2017, the agencies finalized a rule to extend the current transition provisions in the capital rules for certain capital deductions that would be affected by the simplifications proposal.[5] Thus, while the agencies continue to evaluate comments on the simplifications proposal, for most banking organizations, MSAs not deducted under the capital rules will continue to be subject to a 100 percent risk weight rather than the fully phased-in 250 percent risk weight.

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[3] See, e.g., Interagency Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (July 6, 2018), available at https://www.fdic.gov/news/news/press/2018/pr18044a.pdf.

[4] 83 Fed. Reg. 48,990 (Sept. 28, 2018).

[5] 82 Fed. Reg. 55,309 (Nov. 21, 2017). The final rule extended the transition provisions for banking organizations that are not subject to the capital rule's advanced approaches. Banking organizations subject to the capital rule's advanced approaches remain subject to the stricter requirements beginning on January 1, 2018.

Committee on Banking, Housing, and Urban Aff
The Semiannual Testimony on the Federal Reserve's Supervision a
Financial System
November 15, 2018

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

FINRA rule 4210

Two years ago, I sent a letter to the SEC expressing concern about FINRA Rule 4210, which established margin requirements on To-Be-Announced (TBA) securities such as mortgage-back bonds. The key problem here is that rule 4210 applies to broker-dealers but NOT to banks. Thus broker-dealers can use their banking arm to evade this requirement, creating an uneven playing field. Earlier this year, Federal Reserve staff confirmed this "inequity" in a call with my staff.

Last April, we spoke about this rule in a hearing with this committee. You promised to review that rule to ensure it did not create an unequal playing field between small and medium broker-dealers and large, bank-affiliated broker-dealers. I'm sure we agree that restricting market competition isn't good for anyone except the privileged few banks that would gain business. The day after that hearing, FINRA delayed rule 4210 until March of 2019.

- What steps can the Fed take to ensure that rule 4210 does not create an unequal playing field between small & medium-sized broker dealers and bank-affiliated broker dealers? Please list them.

- Do you agree that as implemented, rule 4210 creates an unequal playing field for the aforementioned financial institutions?

Mortgage Servicing Assets

As you know, many lenders prefer to keep the relationship with the customer via servicing the mortgage, even if the bank sells the mortgage itself. There has been a bipartisan view in Congress that the original rule on MSAs, which came out as part of the Basel process, was mis-guided and, indeed, punitive as applied to small and mid-size banks. Many of us were encouraged when the regulators put out a proposal to change the existing rule. But that proposal came out over a year ago and still nothing has been done to finalize it. The current situation is driving mortgage servicing out of regulated entities and into unregulated ones, which I assume is not your objective.

- When can we expect a final rule on mortgage servicing assets to be issued?

Chairwoman Maxine Waters
Questions for the Record Full Committee Hearing
"Monetary Policy and the State of the Economy"
Tuesday, February 11, 2020

Witnesses:

- **The Honorable Jerome H. Powell,** Chairman, Board of Governors of the Federal Reserve System ("Federal Reserve" or "Fed")

Monetary policy

1. Post-financial crisis, IOER is supposed to define the top end of the benchmark fed funds rate while the actual fed fund rate floats in the middle between IOER and the reverse repo rate. Since summer 2019, the Fed has pushed down the IOER four times[1]. Does the Fed expect further adjustments to the IOER rate in the coming year?

2. In your press conference after the January FOMC meeting, you seemed to indicate that 2 percent is not a ceiling for inflation, especially since inflation has been running below 2 percent for a while despite being well into another round of expansion. Since establishing a 2 percent objective for inflation in 2012, Fed officials have repeatedly clarified that the target is symmetric, the inflation rate has remained stubbornly below 2% despite moderate wage gains, low unemployment, and high labor force participation. In a speech in late February, Governor Brainard called on the Fed to adopt "flexible inflation averaging," which will clarify that the Fed may temporarily allow inflation to run above two percent to make up for the prolonged periods that inflation has been below two percent. Will the Fed incorporate this inflation targeting methodology coming out of its monetary policy strategy review, and if not, why not?

Policy Normalization

3. Three years ago, the Fed decided the economy was healthy enough to start shrinking its $4.5 trillion balance sheet. However, following the repo market disruption in September 2019, the Fed embarked on a new program to buy $60 billion of short-term Treasury bills from banks a month, increasing the reserves available to banks to support repo operations and other market functions.[2] As of January 15, the Fed balance sheet was holding about $4.18 trillion.[3] What is the Fed's current timeline for completing balance sheet normalization?
    a. The Fed has repeatedly stated that this balance sheet expansion will taper off once there are "ample" reserves to conduct monetary policy. Can you clarify what is considered an "ample" level of reserves?

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[1] "Interest Rate on Excess Reserves". Federal Reserve Bank of Saint Louis. Accessed on Feb. 5, 2020. https://fred.stlouisfed.org/series/IOER

[2] "Credit and Liquidity Programs and the Balance Sheet". Board of Governors of the Federal Reserve System. Accessed on Feb. 5, 2020. https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

[3] Brian Cheung. "Powell: 'Hard to say' if balance sheet expansion is affecting risk assets". Yahoo Finance. Jan. 30, 2020. https://finance.yahoo.com/news/federal-reserve-powell-balance-sheet-expansion-not-designed-to-affect-risk-assets-120815002.html

4. You've stated repeatedly that this expansion should not be called QE4, yet we've seen an injection of $390 billion over a five-month period. Are you concerned that the market is treating this as a QE program? Do you think the stock market rise is linked in any way to this inflow of cash? How are you anticipating addressing another "taper tantrum" or other adverse market reaction once the Fed scales down Treasury purchases and active repo operations in the second quarter of 2020?

5. On January 29, you stated during a news conference on interest rate policy that the ongoing expansion of the Fed's balance sheet is not designed to affect risk assets.[4] What effects, if any, may be felt in the economy through the expansion of the Fed's balance sheet?

Repo Market Interventions

6. Has the Fed yet decided if it will establish a standing repo facility, even after it reduces its balance sheet? If the Fed's plan to gradually reduce its intervention extends beyond the current timeline, will the Fed decide to establish a standing repo facility?
    a. Former FDIC Chairman Sheila Bair has expressed skepticism that banks were constrained from intervening in repo markets due to their liquidity and capital requirements arguing that, "a bank is not truly liquid if it can't deploy its cash when market conditions dictate."[5] Window-dressing is the practice by which regulated entities adjust their activity around an anticipated reporting or disclosure date, with the objective of appearing safer or reducing bank capital requirements. In order to address this issue, regulators have started to move away from these point-in-time reporting requirements to reporting averages over a quarter or year, which reduces the ability of entities to artificially adjust their numbers to minimize their capital requirements. G-SIB surcharges, however, continue to be evaluated using point in time reporting, and former Fed Governor Dan Tarullo has urged further adoption of using averages instead of point in time reporting.[6] The Fed's own analysis has shown that G-SIBs do try to reduce their capital surcharges by adjusting activity around the end of the fourth quarter. Vice Chair Quarles said recently that, "Preliminary analysis suggests that changing those [year-end] inputs to averages may be helpful. If we were to propose that change, it would not alter the stringency of the [G-SIB] surcharge."

7. Should we be concerned that heightened market volatility around key reference dates, like the repo market crunch which coincided with corporate tax deadlines, a sign that banks are not as liquid as they appear to be?

8. Should the G-SIB surcharge rule be modified to incorporate averages instead of year-end inputs so that U.S. G-SIBs do not engage in window dressing? Can this be done without reducing capital requirements for G-SIBs? What's the timetable for such a change?

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[4] Ibid.

[5] Sheila Bair, "Why banks shouldn't blame the 'repo rupture' on regulation," Yahoo! Finance, Oct. 18, 2019, https://finance.yahoo.com/news/sheila-bair-repo-market-malfunctions-143450318.html.

[6] Daniel K. Tarullo, "The September Repo Price Spike: Immediate and Longer-Term Issues," Dec. 5, 2019, https://www.brookings.edu/wp-content/uploads/2019/11/BrookingsTalkonRepoMarketDisruption.pdf.

9. The Basel Committee has previously encouraged bank regulators to address window dressing concerns for capital requirements.[7] How do other jurisdictions, like Europe, compare to the United States on this issue, and can the Federal Reserve, through the Basel Committee and the Financial Stability Board, further encourage your international counterparts to address this concern too?

Community Reinvestment Act (CRA)

10. In a January speech at the Urban Institute, Governor Brainard described the Federal Reserve's development of a database to evaluate "how to strengthen the [CRA] by using metrics to provide greater certainty about how activities will be evaluated." In your testimony, you indicated that you were "not totally sure" whether you have used this database to evaluate the CRA proposal advanced by the OCC and FDIC. Would you commit to using this database to evaluate how activities will be evaluated?

Volcker Rule

11. In August 2019, federal regulators, including the Federal Reserve, finalized significant revisions to the Volcker Rule.[8] [9] The rule states that additional Volcker Rule reforms will be addressed in a future rulemaking. During your testimony, you indicated that your proposal is "entirely consistent with both the letter and the spirit of the law." In January, federal banking agencies proposed additional revisions to the Volcker Rule by allowing banks to invest in the same risky assets that contributed heavily to the financial crisis and to become more entangled in private equity and hedge funds. Critics have characterized the rule as effectively undoing the Volcker Rule's prohibition on speculative proprietary trading with federally insured deposits. What data or specific insights does that Federal Reserve have to suggest that weakening the Volcker Rule will not lead to another financial catastrophe similar to the one American taxpayers experienced in 2008?

Leveraged Lending

12. The leverage lending market has increased up to 80% over the past ten years, and this increase is primarily fueled by the same practices – lax underwriting standards, standardized loan terms, and funding companies with higher ratios of debt to income – that led to the financial crisis of 2008. On January 31, 2020, the Federal Reserve, OCC and FDIC issued the Shared National Credit Review report, which found risk remains elevated in leveraged loans.[10] Increasingly, leveraged loans are being used by non-bank institutions such as private equity firms, which fund acquisitions of highly indebted

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[7] Reuters, "Basel proposes crack down on banks inflating capital measure," Dec. 13, 2018, https://www.reuters.com/article/us-basel-banks-regulations/basel-proposes-crack-down-on-banks-inflating-capital-measure-idUSKBN1OC280.

[8] Federal Reserve, OCC, FDIC, SEC, and CFTC, joint statement, "Agencies Finalize Changes to Simplify Volcker Rule," press release, Oct. 8, 2019.

[9] For example, see Pete Schroeder, "U.S. regulators hand Wall Street a major win with stripped-down 'Volcker Rule'," Reuters, Aug. 20, 2019. Also see Statement by FDIC Board Member Martin Gruenberg, Aug. 20, 2019 ("The final rule before the FDIC Board today would effectively undo the Volcker Rule prohibition on proprietary trading by severely narrowing the scope of financial instruments subject to the Volcker Rule. It would thereby allow the largest, most systemically important banks and bank holding companies to engage in speculative proprietary trading funded with FDIC-insured deposits.")

[10] "Shared National Credit Review finds risk remains elevated in leveraged loans." Joint Press Release. Board of Governors of the Federal Reserve System. Federal Deposit Insurance Corporation. Office of the Comptroller of the Currency. Jan. 31, 2020. https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200131a.htm

companies with weak credit ratings. In your testimony, you reiterated the Fed's concern and said you were monitoring lending on behalf of a "sophisticated investor that is stably funded, we hope." Beyond monitoring, what specific actions is the Fed or FSOC taking to address these concerns?

13. Does the continued growth in leveraged lending warrant reconsideration of activating the countercyclical capital buffer?

14. How does the Fed reconcile the concern about nonbank leveraged lending with its loosening of Volcker Rule restrictions that prevented banks from investing in private equity firms and hedge funds?

Financial Deregulation

15. According to data from the Federal Reserve Bank of New York, Tier 1 leverage ratios at the largest banks have dropped steadily during your tenure as chair – almost 90 basis points since their peak in 2016. That may not sound like much, but it represents losing almost one-quarter of the gains in bank leverage capital since the financial crisis. As you know, leverage ratios are the broadest metric of the capital banks have available to absorb losses over their entire asset base. Does this development concern you at all? Does this decline in leverage ratios lead you to reconsider your removal of leverage ratio requirements from bank stress tests and the proposal to reduce the enhanced supplementary leverage ratio (eSLR)? Why hasn't the Fed activated the countercyclical capital buffer?

16. In 2007, Federal Reserve supervisors rated nearly all large bank holding companies as "satisfactory" or above. Today, Federal Reserve supervisors are rating only about 60% of large bank holding companies as "satisfactory" or above. While enhanced scrutiny of these large banks is helpful, I am concerned that it appears the Fed is planning to weaken bank supervision and restrict the ability of supervisors to effectively hold banks accountable. In a recent speech, Vice-Chair Quarles laid out a lengthy set of potential new limitations on supervisors, including restricting them from using violations of Federal Reserve guidelines to penalize banks, greatly increasing the requirements for supervisors to escalate an ongoing issue with bank management, and more.[11] Chair Powell, would you agree that maintaining the discretionary power of front-line bank supervisors to act when they see a risk to safety and soundness or to consumers is critical for protecting the public?

17. In a recent speech, Vice-Chair Quarles stated that "non-compliance with [supervisory] guidance may not form the basis for an enforcement action (such as a cease-and-desist order) or supervisory criticism (such as a Matter Requiring Attention (MRA)). This rule would be binding on the Board and on all staff of the Federal Reserve System, including bank examiners." It is our understanding that supervisory guidance is intended to instruct bank supervisors and banks concerning matters that are a high priority for supervisory attention because they reflect current risks and issues in bank practices. How exactly can supervisory guidance perform this function if putting a matter in supervisory guidance will prevent supervisors from actually acting on the matter through taking action to improve bank practices?

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[11] See speech by Vice Chair for Supervision Randal K. Quarles, "Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision," Jan. 17, 2020, https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm

18. In the same speech, Vice-Chair Quarles stated that "The fourth process improvement would be limiting future MRAs [matters requiring attention] to violations of law, violations of regulation, and material safety and soundness issues." MRAs are critical supervisory tools as they require banks to take action on an issue or else see their supervisor ratings possibly decline. If supervisors are not permitted to use this tool until banks have already violated a law or there are critical safety and soundness issues already outstanding, then it could be extremely difficult for bank supervisors to have banks take action on a concern before the issue has actually caused harm to the safety and soundness of a bank. Could you outline the materiality standard that would apply to issuing an MRA under this new "process improvement" and how it differs from the materiality standard that currently applies in issuing an MRA?

19. A bank holding company must be "well capitalized" and "well managed" in order to become and remain a financial holding company (FHC) eligible to engage in an expanded range of financial activities, such as merchant banking and underwriting or dealing in securities. Nearly all large bank holding companies, including all of the U.S. G-SIBs, have elected to become FHCs. According to the Federal Reserve's most recent Supervision and Regulation Report, however, more than 40 percent of BHCs with more than $100 billion in assets are in less-than-satisfactory supervisory condition and therefore do not satisfy the "well managed" requirement to continue engaging in expanded financial activities. Wells Fargo and Deutsche Bank are among these chronically noncompliant FHCs, according to media reports. Congress adopted the "well capitalized" and "well managed" requirements to ensure that only strong, well-run firms would be permitted to engage in potentially-risky financial activities. However, instead of using its statutory authority to revoke these firm's FHC status, the Federal Reserve has instead issued ineffectual "4(m) agreements," which critics have described as a "penalty box devoid of meaningful constraints." Why has the Federal Reserve never revoked a noncompliant company's FHC status? Why does the Federal Reserve allow Wells Fargo, Deutsche Bank, and the other 40 percent of large FHCs to continue engaging in risky financial activities despite not satisfying the minimum statutory requirements?

Climate Change

20. A March 25th report by the Federal Reserve Bank of San Francisco found that climate change increases the risk to financial institutions by increasing the potential for loan losses and bankruptcies caused by storms, droughts, wildfires, and other extreme weather events. These climate-related financial risks could also affect the broader economy through elevated credit spreads, greater precautionary saving, and, in the extreme, a financial crisis.[12] In October, Managing Director of the IMF, Kristalina Georgieva announced that the IMF is "is gearing up very rapidly to integrate climate risks into our surveillance work"

[12] Glenn D. Rudebusch "Climate Change and the Federal Reserve." Federal Reserve Bank of San Francisco. Mar. 25, 2019. https://www.frbsf.org/economic-research/publications/economic-letter/2019/march/climate-change-and-federal-reserve/ For additional research and materials from the Federal Reserve Bank of San Francisco, see https://www.frbsf.org/community-development/publications/community-development-investment-review/2019/october/strategies-to-address-climate-change-low-moderate-income-communities/, https://www.frbsf.org/economic-research/events/2019/november/economics-of-climate-change/, and https://www.frbsf.org/our-district/press/presidents-speeches/mary-c-daly/2019/november/why-climate-change-matters-to-us/.

and noted that central banks will increasingly need to factor climate change considerations into their economic forecasts and monetary policy.[13] Furthermore, a recent paper by Graham Steele published by The Great Democracy Initiative last month explained that the law, specifically the Dodd-Frank Wall Street Reform and Consumer Protection Act, provides regulatory tools to require financial institutions to internalize the financial risks associated with lending and investments that drive climate change. The proposal focuses on several authorities under Title I of Dodd-Frank to, for example, deploying enhanced prudential standards that incorporate climate risks. How has the Fed incorporated climate change considerations into its risk models and stress-testing?

   a. Are you open to convening a climate risk advisory council that includes climate experts and economists alike?
   b. Is the FSOC looking at these risks? Why or why not?

21. As Graham Steele notes in his paper, investments in assets that drive climate change, including fossil fuels and industries that engage in deforestation, all involve systemic risks. Section 165 of the Dodd-Frank Act provides the Federal Reserve with broad authority to use prudential standards to limit fossil fuel investments on the basis of their prospective risks to financial stability. Can you respond to why the Fed has not exercised this authority to implement measures such as updating capital rules to reflect the potential for capital-intensive losses based on financial climate risks, more stringent margin requirements for securities and derivatives tied to climate-damaging commodities, portfolio limits on CO2 emissions or entire sector exclusion on the basis of climate risk?

Diversity

22. According to a 2018 McKinsey report, ethnically diverse organizations are 35% more likely to outperform their competitors, operating margins increase by 48% when management is gender diverse, and $12 trillion would be added to the global economy by simply achieving gender equity in the workplace. All signs point to diversity being a tremendous asset. Despite data proving that diverse companies perform more successfully, we still find that the financial services industry is largely white and male at its highest levels. The same can be said for regulators such as the Fed where minorities comprise only 22% of executive and senior level positions but approximately 44% of the total workforce. What more can you do as Chair to incentivize diversity and equity within the Federal Reserve System? What are you doing to encourage diversity and equity at the firms you regulate and supervise? Please be specific about tangible next steps you and your staff are considering.

National Security

23. Please share the Federal Reserve's perspective on how we might better align the supervisory examination process with the Bank Secrecy Act mission and the national security threats faced by the US and our financial system, including those identified in the recently released "National Strategy for Combatting Terrorist and Other Illicit Financing?"

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[13] Gillian Tett. "Central banks are tuning in to climate change" Financial Times. Oct. 17, 2019. https://www.ft.com/content/e99d9b56-f0d2-11e9-ad1e-4367d8281195

Facebook, Libra, Cryptocurrencies

24. During your testimony, you characterized Facebook's proposed Libra currency as "a bit of a wakeup call that [digital currency] is coming fast," and affirmed your belief that "a single government currency at the heart of the financial system is something that has served us well." What is the Fed's stance on regulating cryptocurrencies, and what risks do you think cryptocurrencies and projects like Libras pose to economic stability?

Asset bubbles

25. The minutes from the January Federal Open Market Committee meeting reflect participants' general belief in the strength of the economy and the financial system, but also reported that "Some participants remarked... that keeping policy rates low to achieve both the Committee's dual-mandate objectives may contribute to a buildup of financial vulnerabilities, especially at times when the economy is at or above full employment, a development that could pose future risks to the economy and to the ability of the Committee to achieve its dual mandate." A 2016 report by economists Dean Baker and Josh Bivens examined whether higher interest rates are an appropriate tool for managing asset bubbles, and concluded that "the Federal Reserve has numerous tools besides rate increases that would be more effective and inflict less collateral damage on the nonfinancial side of the economy." Do you believe that increasing interest rates is the most effective tool for addressing "the buildup of financial vulnerabilities" identified by FOMC participants? What prudential tools are available to the Fed that might help policymakers target emerging asset bubbles without slowing down economic growth?

Defining Full Employment

26. Since its January 2012 publication of longer-run goals and monetary policy strategies, the Fed has established a 2% long-term target for inflation, but it has never set an explicit objective for labor market outcomes. The Fed's website contains the following language: "maximum employment, which means all Americans that want to work are gainfully employed." If the Fed has chosen to interpret price stability as 2% core PCE, how does it choose to interpret maximum employment? Following Chair Powell's February testimony, Evercore ISI economist Ernie Tedeschi told *Bloomberg*, "Defining full employment as 'anyone who wants to work and can work will have a job available to them' is different from defining it as the level of unemployment at which inflation will begin to rise, which could be interpreted as 'just a glorified inflation mandate.'" Is the maximum employment mandate actually "just a glorified inflation mandate"? If not, shouldn't the Fed further define a target for maximum employment?

Congresswoman Joyce Beatty (OH-03)
Questions for the Record
Full Committee hearing entitled, "Monetary Policy and State of the Economy"
February 11, 2020

Question #1

As you know the Federal Reserve is currently developing capital requirements for insurance companies that own depository institutions, otherwise known as insurance savings and loan holding companies, due to passage of the Insurance Capital Standards Clarification Act in 2014. This legislation clarified that the Federal Reserve should tailor capital standards for insurance companies. I am concerned and perplexed why the proposed rule would impose a separate Section 171 banking capital calculation from the Dodd-Frank Act on some of these insurance companies based on their organizational structure. This seems to me to stand in contradiction to congressional intent. Imposing a Basel banking capital calculation on insurance companies is the outcome that Congress was trying to avoid when we passed that law back in 2014.

As a primary co-sponsor of the 2014 legislation, I know Congress did not intend this outcome and am concerned with its inclusion in the proposed rule.

1. Can you provide your legal justification for inclusion of the Section 171 banking capital calculation within the Federal Reserve's insurance capital rule?

2. Will you commit to ensuring that all savings and loan companies who are primarily insurance companies will be subject to the same set of rules for capital calculation?

House Committee on Financial Services

Hearing: Monetary Policy and the State of the Economy

2-11-2020

Questions for the Record from U.S. Representative Ted Budd (R-NC)

Witnesses:

- **Jerome Powell,** Chairman of the Board of Governors of the Federal Reserve System

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Dear Chairman Powell,

1. Thank you for your collaborative work with the U.S. State Insurance Commissioners on solvency regulation. I also wanted to thank you for the pushback against the European efforts to try and force their system of insurance regulation onto our unique and sound 50-state insurance regulatory regime. I would like to respectfully request that you discuss this issue further with European Commission, Executive Vice President, Valdis Dombrovskis, who has political oversight for financial services in the European Commission.

February 11, 2020
Federal Reserve Hearing

Congressman Emanuel Cleaver Questions for the Record

Federal Reserve Chairman Powell

I would like to flag a Wallstreet Journal article that ran on January 15, titled "The Era of Fed Power is Over: prepare for a more Perilous Road Ahead[1]"

It features a report by former Treasury Secretary Larry Summers, which notes the economy has changed in ways that weaken its response to interest-rate cuts including past methods of Quantitative Easing and negative rates used by your European counterparts.

The economy's two most interest-sensitive sectors (durable goods manufacturing, such as auto, and construction,) fell as a share of output precipitously because America's aging population spends less on houses and cars.

- 10% of national output in 2018 from 20% in 1967

Over the same period, financial and professional services, **education** and **health care** nearly doubled (47% from 26%)

Do you concur with the findings of Secretary Summers research? Why or why not

Has the Federal Reserve explored means of putting pressure on these growing shares of our economy to effectuate a response to a crisis like a global recession?

- **If yes, what exactly has the Federal Reserve explored?**
- **If no, why not?**

Clearly these are closer to real people and where the economy is currently, and the Fed was able to design novel instruments through the commercial paper facility during the financial crisis.

Would the Fed be able to design a facility, as it did during the financial crisis, to put downward pressure on student loan rates as a means of exerting pressure on interest rates? Why or Why not?

Would the Fed be willing to conduct testing on such facilities? Why or Why not?

What alternative mechanisms of influencing interest rate pressure is the Federal Reserve exploring?

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[1] https://www.wsj.com/articles/shrinking-influence-of-central-banks-ends-decades-of-business-as-usual-11579103829

REPO

A number of press reports seem to indicate that markets have perceived the Federal Reserve intervention into REPO markets as quantitative easing by quantitative easing by other means. **Was this the Federal Reserve's intent, yes or no?**

- **If yes, how is this consistent with the FOMC's monetary policy strategy and how was the formal FOMC process for monetary policy action engaged?**
- **If no, was this miscommunication by the Board that will result in a review of the communion tool within this context?**

Does the Federal Reserve consider its intervention a in REPO markets a monetary policy action and why?

Climate Change

As you may be aware, my subcommittee hosted a hearing on climate change this past year and I submitted questions related to this point that I received a response to in November.

As you stated in your response, the federal reserve is actively working both within the Board and with outside institutions on climate change by "monitoring uncertainty and risks from such events in financial markets."

I was very pleased to hear this.

The Board has a vast and varied economic knowledge base that has proven invaluable to market participants and policymakers.

Would you be willing leverage that research base to coordinate with federal regulators to evaluate the macroeconomic effects of climate change? Why or why not?

What, if any, distinct research does the Board plan to undertake into the financial stability concerns related to climate change? (This would be separate from research undertaken at reserve banks.)

Community Reinvestment Act

Your opening statement noted that "there are troubling labor market disparities across racial and ethnic groups across regions of the country."

You also noted that while wages have been rising, that has been primarily the case for "lower-paying jobs"

As you may agree, the Community Reinvestment Act could go a long way in easing some of this pain.

I recall you noted as much when you visited Kansas City during your Fed Listens event.

I understand that you aligned yourself with Governor Brainard's remarks at the Urban Institute during your FOMC Press Conference.

Among the statements made by Governor Brainard was, "If the past is any guide, major updates to the CRA regulations happen once every few decades. So it is much more important to get reform right than to do it quickly,"

I assume you agree with this, is that right?
"Dividing evaluations into separate retail and community development tests is important," Brainard said. "In contrast, an approach that combines all activity together runs the risk of encouraging some institutions to meet expectations primarily through a few large community development loans or investments rather than meeting local needs."

What are the perils, as you understand them, with such an approach?

In the FOMC press conference you noted, "We think that an interagency final rule together would be the best outcome," said Powell. "We're sorry we haven't been able to get there, and we still hold out some hope that we will be able to."

You seem still open to a joint rulemaking, and based on Governor Brainard's remarks, it seems like you are trying to engage unwilling partners. Is the FDIC and OCC just more interested in minting their timeline and course than a comprehensive unified final rule?

<u>**Economic Growth Inconsistency**</u>

I am trying to get a clear understanding of the united states economy from a clearly objective actor

One of the reasons I am so admitted about federal reserve independence is because of the importance of objective truths and facts in economics.

With that in mind, what do you anticipate growth will be over the next ten years?

- The administration is projecting that economic growth will average around 3 percent over the next decade, which is more robust than what the Congressional Budget Office and others see it clocking in at.
    - **What are the Federal Reserve projections?**
    - **Please explain the discrepancy, with these growth projections and why you believe your analysis is more likely to be accurate.**
- The biggest area of disagreement appears to be that the administration believes the tax law will spur more long-term economic growth than CBO estimates, a senior administration official said Sunday.
    - **Do you agree or disagree with this holding and why?**
    - **What has analyses found on receipts due to the tax reform legislation?**

What the tax reform measure expanded the tax base and spurred economic growth on pace with projects made by the OMB?

While the federal reserve is no panacea, it is also no mere spectator.

How do you plan to help pull stalled investment and stagnant wages off the economic sidelines and into the homes of the working poor?

Diversity and Inclusion

Section 342 of Dodd-Frank directed the relevant Directors of the respective Office's of Minority and Women inclusion to ensure the fair inclusion and utilization of minority-owned and women-owned businesses in all business and activities of the agency and at all levels, including in procurement, insurance, and in all types of contracts.

The Federal Reserve manages funds for both its defined benefit and defined contribution plans.

What percent of Federal Reserve assets under management are invested with women-owned and minority-owned asset management firms?

- **Please provide the firm names, asset classes, total assets, and percent of total assets managed by minority- and women-owned asset management firms as an appendix to this response. (I would consider a failure to furnish this information and incomplete response)**

Is the federal reserve satisfied with the level of racial, ethnic, and gender diversity in systemwide boards of directors?

- **If yes, please explain.**
- **If no, please explain how the board intends to actively address this issue?**

Exchange Rates

Does the invoicing, reserve and safe harbor status put upward pressure on the dollar's exchange value thereby impacting with adjustments which would otherwise narrow the current account imbalance?

What would a realignment of the value of the US dollar versus other major currencies have on the US account deficit?

- **Would it reduce the US current account deficit in the medium term?**

Former Federal Reserve Chairman Ben Bernanke said in 2005 that there was a global savings glut in other countries that flowed to the US giving rise to the increased current account deficit. Do you agree with his analysis? Do you believe that there is a global savings

glut today that similarly flows to the US, pushing the current account deficit higher than it would otherwise be?

What is the Federal Reserve's perspective on a capital flow management policy?

<u>Coronavirus</u>

Has the Fed explored means of curbing the market impact of the corona virus?

- **If yes, please specific all mechanisms the Board has under consideration.**
- **If no, why not?**

Is there any recessionary risks posed by the coronavirus, yes or no? Please explain.

Questions for the Record to Federal Reserve Chairman Jerome Powell

Submitted by Rep. Al Green

Do you agree that further assessment is needed to better understand and address the impact of a $15 minimum wage on unemployment and the overall health of the U.S. economy?

Due to your authority on price stability and on wages I would like to request a study by the Federal Reserve to determine the economic impact of raising the minimum wage in the U.S. to $15 an hour.

Questions for the Record

From: Rep. Heck
Date: February 26, 2020
Re: Financial Services Committee: Humphrey-Hawkins Hearing

Economic Effects of Novel Coronavirus Outbreak

1) I have seen a variety of predictions on the degree to which worldwide spread of this new coronavirus would trigger an economic downturn. I'd like to ask you just about the United States. Do you expect that an uncontained outbreak of this coronavirus in the United States would cause our economy to shrink?

2) How does the Fed model the impact of a public health emergency like this? What other threats is it similar to? Are there past economic downturns that are instructive in understanding the economic impacts?

3) It seems to me that a public health emergency mainly hurts the economy by limiting our potential output while leaving demand largely untouched. A typical recession sees a decline in demand while leaving out economic potential untouched. The Fed has strong tools to bolster demand, which is needed in a typical recession. What tools would the Fed use in a recession driven by a supply shock? Does the Fed expect that a recession triggered by a public health emergency would be driven by a supply shock?

Monetary Policy Effect on Business Investment

1) As you know, I'm deeply interested in wage growth and how we can get more of it. I fully accept your framework that long-term wage gains requires productivity growth, which in turn requires capital spending. I'm deeply concerned at the slowdown in business investment in 2019 and the negative growth in the last two quarters.

So how do we get more business investment? You've stated that, at least in principle, the incentive for businesses to invest in labor-saving technologies should rise when the economy is nearing full employment and labor markets tighten. This seems to imply that we can increase productivity by increasing employment. Do you believe that the Fed can increase productivity growth through more aggressive pursuit of its full employment mandate?

Question for the Record
Rep. French Hill

Full Committee
Monetary Policy and the State of the Economy
February 11, 2020

Questions for Chair Powell

1. There were several proposals introduced in this Congress to impose caps on how much a lender can charge for a loan. Yet new data from the American Bankers Association show that millions of credit card holders – including 95% of subprime cardholders – could lose access to their cards. Do you think that interest rate caps can have unintended effects on access to credit?

2. The Fed currently believes in an "ample reserves regime," but in the past you have said that the level of needed reserves is uncertain, as we saw in September when there were challenges in the repo market.

    - What do you believe is the top of the range for "ample reserves," and how have you arrived at that figure?

    - You noted at your January press conference that the Fed has undertaken work to review what went wrong in the repo market last fall. What specific lessons has the Fed drawn from that review?

3. At your January press conference, you noted that the Fed is looking at joining the Network for Greening the Financial System, or NGFS.

    - The NGFS has said that it "emphasizes the importance of a robust and internationally consistent climate and environmental disclosure framework." If the Fed joined the NGFS, would that represent the Fed's endorsement of an enhanced disclosure regime for the entities you regulate?

    - How would you reconcile your legislative mandates with recommended actions by the NGFS, and how would this affect the clarity of the Fed's communications to the public?

4. Yield curve control has not allowed Japan to reach two percent inflation, and it is unclear how much the Fed would have to add to its balance sheet if it pursued such a policy. What evidence do you have that yield curve control would reliably allow the Fed to fulfill its legislative mandate?

5. In December testimony before the European Parliament, Christine Lagarde, the new President of the European Central Bank (ECB), discussed ECB initiatives in instant

payments, distributed ledger technologies, and oversight of digital currency. She concluded, "Looking ahead, the ECB will continue to act as a catalyst for change." How do you believe the Fed can most effectively shape the future of money in a way that maintains our economic leadership while nurturing private-sector innovation?

6. You have stated previously that, if there were an economic downturn, the Fed would have sufficient firepower using its balance sheet to address it. Quantitative easing is meant to stimulate the economy through increased risk-taking and higher asset prices, but some argue that this risk-taking effect could have an impact on financial stability, which the Fed is of course responsible for safeguarding. How does this tradeoff inform the Fed's thinking on the use of unconventional monetary policy tools?

7. You have previously cautioned against the risks posed by our national debt. Can a low interest rate environment and a commitment to quantitative easing in the future risk expanding our debt by facilitating lax fiscal policy?

Congressman Brad Sherman
Questions for the Record
House Financial Services Committee Hearing: "Monetary Policy and the State of the Economy"
Tuesday, February 11, 2020

Questions for Jerome Powell, Chairman of the Board of Governors of the Federal Reserve System.

1. In 2014 the Federal Reserve Board and the New York Fed jointly convened the Alternative Reference Rates Committee (ARRC) to address the broad spectrum of risks associated with U.S. Dollar LIBOR. During a meeting of the ARRC on November 15, 2019, ARRC members announced plans to work with the State of New York to pass legislation through the state legislature intended "to address the trillions of dollars of existing LIBOR-linked contracts that either lack contractual provisions to deal with the end of LIBOR or have contractual provisions that do not effectively address a permanent cessation of LIBOR."[1] What is the Federal Reserve Board's best estimate of the total value for each class of outstanding LIBOR-linked contract that the legislation described above is intended to address?

   If the State of New York were to adopt the legislation that ARRC members are advocating for, what would be the total value for each class of outstanding LIBOR-linked contract described above that would not be covered by the legislation?

2. On July 7, 2019, I sent you a letter along with Congressman Kustoff, and 41 of our colleagues, inquiring whether the Federal Reserve currently has sufficient authority to put in place a mechanism to require name matching, in addition to account and routing number matching, for wire transfers made through the Fedwire system, if not the broader U.S. wire system. In your response, you indicated that the Board regulation that governs the Fedwire Funds service is based on a model state law. However, this response did not address the underlying question. Please explain whether the Federal Reserve Board does or does not have the necessary authority to require name matching on U.S. wire transfers?

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[1] https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2019/ARRC-Minutes-Nov-2019.pdf

Questions for the Record

Financial Services Committee

"Monetary Policy and the State of the Economy."

Representative Rashida Tlaib

Questions Directed To:

- Jerome Powell, Chairman of the Board of Governors of the Federal Reserve System

The Bank of England, Bank of France, International Monetary Fund, Bank of International Settlements, and many other international bodies have released financial stability-related analyses on the risks of climate change. You are a voting member of the Financial Stability Oversight Council (FSOC).

- **Did FSOC include climate risk in its 2019 annual report?**
- **Has FSOC or the Fed Board released any financial stability analyses related to climate risk?**
- **Can you commit to doing so in the future?**

4) There is a growing international consensus around the severe risks that climate change poses to the financial system. It is critical for the Federal Reserve Board to have the expertise necessary to evaluate the risks of climate change and develop policy interventions to mitigate that risk.

- **Have you hired climate economists at the Fed to work on this issue?**
- **Have you been briefed or advised by any climate scientists inside or outside of government on this issue?**

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, DC 20510–6075

February 21, 2020

Honorable Jerome H. Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Chairman Powell:

Thank you for testifying before the United States Senate Committee on Banking, Housing, and Urban Affairs on February 12, 2020, at the hearing entitled, "The Semiannual Monetary Policy Report to the Congress."

In order to complete the hearing record, we would appreciate your answers to the enclosed questions as soon as possible. When formatting your response, please repeat the question, then your answer, single spacing both question and answer. Please do not use all capitals.

Send your reply to Mr. Cameron Ricker, the Committee's Chief Clerk. He will transmit copies to the appropriate offices, including the Committee's publications office. Due to current procedures regarding Senate mail, it is recommended that you send replies via e-mail in a Microsoft Word or PDF attachment to Cameron_Ricker@banking.senate.gov.

If you have any questions about this letter, please contact Mr. Ricker at (202) 224-5587.

Sincerely,

Mike Crapo

Mike Crapo
Chairman

MC/cr

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 12, 2020

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Tim Scott:</u>

1) Last week we all heard the President lay out all the ways this economy is booming and most importantly, working for everyone and not just the few at the top. Unemployment for minorities is down, unemployment for veterans is down, wage growth is rising faster for those at the bottom than for those at the top, labor force participation is rising, and household income has never been higher.

In particular, black homeownership (4Q 2008 46.8%; 4Q 2016 41.7%; 4Q 2019 44.0%) and black labor participation (Dec 2018 63.5%; Dec 2016 61.9%; Jan 2020 62.9%) have also increased!

This doesn't even begin to touch on all the other important metrics that show how tax cuts and deregulation have helped propel American families into a time of economic prosperity.

Ensuring not only my constituents in South Carolina, but those coast-to-coast, have the ability and access to more affordable credit is paramount. Often times, this is to purchase things like a home, a car, or an education. Things that require larger loans in order to invest in yourself.

But, there are also times when Americans need access to credit in order to just make ends meet. This could be a $500 loan to pay rent or $1000 for an unexpected car repair. Small-dollar loans are an instrument of good and we should work to keep the access for those loans available while increasing their affordability and soundness.

I understand that the FDIC has been working together with the Fed and OCC to find ways to improve access to small-dollar loans at a more reasonable cost.

Please answer the following with specificity:

A. Do you believe that affordable access to small-dollar loans could help a significant number of Americans?

2) I am focused on finding ways we can encourage small dollar lending to give Americans needed access to credit through responsible products that do not trap them in a cycle of debt. I was encouraged to see that Federal Reserve Governor Bowman raised an important issue this week, talking about the importance of the Fed implementing clear third party guidance that is consistent across all of the federal regulatory agencies.

A. Can you give us an update on the work you have been doing with the FDIC and OCC on this and what you believe possible regulatory outcomes might look like in order to encourage banks to provide these small dollar loans, and the benefits that community bankers see by innovating and working with fintech platforms?

B. Governor Bowman talked about the need to implement guidance; can you explain the pros and cons of using guidance in this area versus a rule making? And, how do we balance the need to create real rules of the road to encourage the small dollar lending we need without creating barriers to entry?

3) I'm sure you're familiar with my continued interest in the International Association of Insurance Supervisors' work on the ICS. I've made the point to Vice Chair Quarles that the U.S. insurance market fulfills a vastly different purpose than the European market – it doesn't make sense to regulate our insurers with foreign rules of the road. Doing so will compromise the ability of my constituents to plan for their retirement or manage their finances over the long-term. There's now a concrete path for the U.S. insurance solvency system to be deemed equivalent to the ICS.

Given all of the hard work you are doing at the Fed on the Building Block Approach (BBA) and the State Insurance Commissioners are doing on the Group Capital Calculation (GCC) –

Please answer the following with specificity:

A. How do you plan on ensuring the standards being developed in the U.S. will be deemed equivalent by the IAIS given the continued resistance you are facing from the Europeans?

4) I think we can agree that less unnecessary regulation is always better. But what's best for everyone is smart regulation. Regulations intended to appropriately capture and capitalize risk. We continue to hear that with regards to the FRTB (the capital treatment for trading instruments) the Fed has taken their goal of simplicity as license to remove risk sensitivity and increase capital.

The US capital markets are core to the economic fabric and our global prowess; in fact the capital markets fund 65% of economic activity in the US.

Please answer the following with specificity:

A. Can you ensure that U.S. regulators will right size this in the U.S. rulemaking?

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 12, 2020

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Ranking Member Sherrod Brown:

1) In 2016, the Board of Governors, along with the FDIC and OCC, released a report to Congress and FSOC on the activities and investments banking entities may engage in under state and federal law. That report states that supervisory oversight for FHCs engaging in physical commodities activities can include "review of the management of risks of those activities to the FHCs" and an assessment of "adequacy of the firms' controls relating to physical commodities activities." The report also mentions supervisory scrutiny related to merchant banking activities, complementary activities, and investments. The report also makes recommendations to Congress, including repealing the authority of FHCs to engage in merchant banking and commodities activities, and eliminating the ILC exemption.

A. An investment vehicle with significant ties to JPMorgan Chase has filed an application with FERC to purchase an El Paso franchise utility. Has the Board reviewed potential risks, pursuant to the supervisory activities referenced in the 2016 report, of this purchase to JPMC?

B. Has the board shared any of its supervisory documents related to reviews of JPMorgan Chase or the Infrastructure Investment Fund with FERC?

C. Does the Board stand by its 2016 recommendations to Congress?

D. Would IIF's purchase of the El Paso utility help or hinder federal banking agencies' stated desire to reduce safety and soundness concerns raised by financial holding companies' exposure to risks related to physical commodities, merchant banking, covered investments and complementary activities?

E. What authorities does the Board have related to the approval of this merger and/or the permissibility of JPMC's relationship with IIF?

2) On December 17, 2019, the Board and the FDIC announced they had found "no deficiencies" in the resolution plans required under 165(d) of the Wall Street Reform Act. Do you believe that Bank of America, Bank of New York Mellon, Citigroup, Morgan Stanley, State Street, Wells Fargo, Goldman Sachs and JPMorgan Chase could each be resolved in an orderly bankruptcy without affecting financial stability?

A. Do you believe that Bank of America could be resolved in an orderly bankruptcy without affecting financial stability?

B. Do you believe that Bank of New York Mellon could be resolved in an orderly bankruptcy without affecting financial stability?

C. Do you believe that Citigroup could be resolved in an orderly bankruptcy without affecting financial stability?

D. Do you believe that Morgan Stanley could be resolved in an orderly bankruptcy without affecting financial stability?

E. Do you believe that State Street could be resolved in an orderly bankruptcy without affecting financial stability?

F. Do you believe that Wells Fargo could be resolved in an orderly bankruptcy without affecting financial stability?

G. Do you believe that Goldman Sachs could be resolved in an orderly bankruptcy without affecting financial stability?

H. Do you believe that JPMorgan Chase could be resolved in an orderly bankruptcy without affecting financial stability?

3) When the Committee was considering S. 2155, you stated that the bill wouldn't require deregulating foreign banks. But in the Fed's October 2019 rule, you state that the Fed was required to weaken requirements for foreign banks because the law requires you to treat them similarly to domestic banks ("… the Dodd Frank Act directs the Board to give due regard to the principle of national treatment and equality of competitive opportunity.." and "the final rule facilitates a level playing field between foreign and US banking organizations operating in the United States, in furtherance of the principle of national treatment and equality of competitive opportunity").

A. When you testified in front of the Banking Committee, were you or your staff aware of the Dodd-Frank directive requiring the Board to give "due regard to the principle of national treatment and equality of competitive opportunity"? If so, how did that directive factor into your interpretation that S. 2155 would not require the Board to weaken regulations for foreign banks?

Committee on Banking, Housing, and Urban Affairs
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Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Catherine Cortez Masto:

1) In your testimony before the Banking Committee, we discussed the percentage of people who are currently working two jobs in order to make ends. A recently released Census report found that in 2013, 8.3% of workers had more than one job, and women were more likely to have a second job – 8.8% versus 8.0%. Additionally, 6.9% of those workers worked more than two jobs.[1] Data from the Bureau of Labor Statistics shows fewer workers working two or more jobs.[2]

A. Please share Federal Reserve research and or analysis related to the prevalence of workers holding more than one job.

B. Why are women more likely than men to work multiple jobs? According to the BLS, in 2017, the multiple job holding rate for women was 5.3%, while for men it was 4.6%.

C. What percentage of these jobs are seasonal jobs, such as a teacher holding a summer job?

D. In 2018 and 2019, the multiple jobholding rate for Black workers has remained higher than any other racial or ethnic group. Why is this disparity occurring for black workers?[3]

E. Are workers in rural areas more likely to hold multiple jobs than urban areas?

F. Are workers in communities with higher minimum wages less likely to hold multiple jobs than workers with the federal minimum wage of $7.25/hour?

G. The Federal Reserve has a mandate to increase employment. What tools does the Federal Reserve have to address disparities in labor force participation rates including women and African Americans who hold multiple jobs?

H. Does the Federal Reserve have any recommendations to Congress on policies that would mitigate these disparities of workers who hold two or more jobs?

2) In your testimony, we also discussed labor market disparities across racial and ethnic groups and across regions of the country.

A. Please provide research by the Federal Reserve related to the following: data on the causes of disparities in unemployment rates across racial and ethnic groups, why it's occurring, and how policymakers can address these gaps.

[1] https://www.census.gov/library/stories/2019/06/about-thirteen-million-united-states-workers-have-more-than-one-job.html
[2] https://www.bls.gov/opub/ted/2018/4-point-9-percent-of-workers-held-more-than-one-job-at-the-same-time-in-2017.htm?view_full
[3] https://www.bls.gov/cps/cpsaat36.htm#cps_eeann_mult_jobhder.f.1

B. Does the Federal Reserve have any recommendations to Congress on policies that would mitigate these disparities?

3) You also discussed the disparities between rural and urban areas.

A. What tools does the Federal Reserve have to address this disparity?

B. Does the Federal Reserve have any recommendations to Congress on policies that would mitigate these disparities?

4) In your exchange with Senator John Kennedy (LA), you discussed whether there is a link between our social safety net programs and participation in the labor market and argued that there was no link between our safety net programs and labor force participation.

A. Please elaborate on whether there is a link between our social safety net and labor force participation, and provide share data or research if appropriate.

B. During your comments, you noted that our safety net is not generous enough to discourage people from participating in the workforce. Please explain why you believe that our safety net does not discourage participation in the labor force.

5) The Census Bureau is in the process of recruiting and hiring thousands of employees throughout the United States to conduct the 2020 Census. In fact, the Census Bureau estimates that they need to hire up to 500,000 temporary, part-time census takers to get the job done.

A. How does today's tight labor market serve as a challenge for the Census Bureau to achieve their goals of hiring half a million workers?

B. The Census Bureau increased its hourly salary to encourage workers to apply. In Nevada, the pay rate is between $16 and $18 an hour – well above our minimum wage. Do you think the higher wage offered by the Census will result in wage increases generally? Do you think the Census will increase workforce participation rates?

C. How important is a complete and accurate Census to the Federal Reserve Banks?

6) Federal Reserve's Tools During a Crisis or Recession

A. Should the Federal Reserve experiment with capping yields on short to intermediate Treasury securities as Federal Reserve Governor Brainard recommended? What would be the impact of that?

7) We know that some communities in our nation do not benefit from wage increases, job growth and business success.

A. Do you agree with Larry Summers who said the Federal Reserve should promote the idea that government spending should be different in depressed areas than in successful markets?

B. Do you think public spending to support economic activity in communities with high unemployment avoid risking a rise in inflation the way public spending might in more prosperous places?

8) We know we have an affordable housing crisis. Not only are low-income families paying half or more of their income for rent, many families are unable to buy a starter home.

A. What do you think the impact of the Administration's proposal to double the guarantee fee charged by Fannie Mae and Freddie Mac from 0.10 to 0.20 percentage points?

B. How will this affect people seeking financing to buy a home?

9) You have spoken about the dangers of inequality. The gap between the richest and poorest households in the United States is at its highest point in more than 50 years. And household debt is now in excess of $14 trillion, exceeding the pre-recession high.

A. How much of our wage growth is due to increases in state and local minimum wages?

10) In your testimony before the House Financial Services Committee, you noted that we should put the federal budget on a sustainable path and reduce the federal deficit, which is projected to reach over a trillion dollars this year.

A. Please provide us with any statements you made about the impact of the Tax Cuts and Jobs Act law on the deficit. Please note the date you made those comments.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 12, 2020

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Tom Cotton:

1) In today's hearing, you spoke about the transition from LIBOR and how a number of banks have said they'd like to work on a rate that is separate from SOFR, i.e. a rate that is credit-sensitive (as is LIBOR). I was glad to hear you mention that the Federal Reserve is working with those banks to support their efforts to use a credit-sensitive rate. Is Ameribor appropriate to use for institutions for whom it more accurately represents their cost of funding?

A. Put another way, does the Fed support alternative benchmark interest rates to SOFR - such as Ameribor - for the replacement of Libor?

Committee on Banking, Housing, and Urban Affairs
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Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Doug Jones:

1) As you know, small businesses are crucial to the nation's economy. The Small Business Administration (SBA) reported that small businesses employ almost half of Alabama's workforce.

In the Federal Reserve's Survey on Minority Owned Small Businesses it acknowledges that the majority of small business owners, across all races, used their personal funds to finance their business. Additionally, when financing is needed small business owners use their credit cards.

A. Are you concerned about the large number of small business owners using their personal finances and credit cards to fund their business as opposed to credit from financial institutions? Is the sustainable in the long-term? Do you believe this has contributed towards the stagnant rate of new businesses?

2) During the hearing you mentioned that people receiving economic benefits like Supplemental Nutrition Assistance Program (SNAP), school nutrition programs, health care, child care assistance, Temporary Assistance for Needy Families (TANF) and housing are receiving less assistance than they have in the past. I want to expand on the complexities of economic assistance particularly for workers that have to turn down pay raises or promotions due to benefit cliffs.

Benefit cliffs is the sudden and unexpected decrease in public benefits that can occur with a small increase in earnings. When income increases, families can lose some or all economic supports, but the increase in earnings does not cover the costs associated with losing economic support.

A. The Atlanta Federal Reserve has done research into benefit cliffs and some states have started working on solutions to decrease the dramatic cliff. Do you believe there are economic consequences to benefits cliffs? What do you recommend for Congress to do to help alleviate the cliff?

3) As you know, the Federal Reserve, along with the other four regulators, recently proposed a rule that would clarify the definition of covered funds under the Volcker Rule in an effort to increase long-term investments in companies across the country.

This rulemaking should strike a balance between ensuring banks are able to engage in appropriate long-term investments in funds that can help spur innovation while not undermining safety and soundness.

A. Do you believe that modifying the definition of covered funds to allow banks to provide permissible long-term investments to businesses in Alabama and across the country would threaten the safety and soundness of the financial industry?

4) Historically, wages in the manufacturing sector are higher than those in the service sector. Men are more likely to hold jobs at any skill level in manufacturing, while women are more likely to hold jobs in the service sector, a sector that pays considerably less than manufacturing.

Women hold 77 percent of the jobs in health care and education — fast-growing fields in the service sector that eclipse the entire goods-producing sector of the economy.

The growing number of women in the workforce reflects a long-running evolution away from male-dominated industries like manufacturing toward the service side of the economy, where women have an edge.

A. Is the Federal Reserve aware of this pattern of an increase of women in the service sector workforce while earning significantly less than men in manufacturing workforce?

5) Over the last few years, the annual average earnings growth for American workers has remained below 3 percent. Yet at the same time, average house prices have increased more than 5 percent.

Rising housing costs coupled with relatively stagnant wage growth has made it hard for consumers to save for a down payment and the costs associated with buying a home like inspectors and appraisers.

Additionally, there are large disparities in homeownership between African Americans and their white counterparts. 73.1% of white Americans owned a home at the end of the second quarter of 2019 compared to 40.6% of African Americans and 46.6% of Hispanic American.

A. What, if any, are the consequences of not addressing the large homeownership disparities among minorities?

Committee on Banking, Housing, and Urban Affairs
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February 12, 2020

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Robert Menendez:

1) The FDIC will allow some of the banks it regulates the choice of opting into the new OCC led Community Reinvestment Act (CRA) regulatory framework or continue to be examined under the current system. One of reasons the OCC and FDIC decided to move forward with their own CRA proposal was to clarify CRA standards and reduce confusion. However, by creating a three tiered system (the OCC and FDIC joint rule, the opt-in option, and a potential new Federal Reserve rule), the OCC and FDIC seem to be creating more confusion about the CRA and its implementation. Are you concerned the OCC/FDIC rule, with the opt-in option, will increase confusion among banks and communities about how the CRA is implemented and what qualifies as a CRA activity?

2) Please describe what the aspects of the Fed's CRA proposal the OCC and FDIC satisfactorily incorporated into their joint proposal.

Committee on Banking, Housing, and Urban Affairs
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Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator David Perdue:

Fed Inflation Targeting

Since 2012, the FOMC has adopted an inflation target of 2% as part of its Longer-Run Goals and Monetary Policy Strategy. But as you mentioned in your opening statement, PCE inflation, which the Federal Reserve targets, was 1.6% last year, under your 2% target once again. It has been running under this 2% target for almost a decade now. As part of the motivation for the review of the Federal Reserve's policy strategy, many Governors, including yourself, have expressed concern over the disinflationary pressures occurring across the globe. If inflation expectations are anchored persistently lower, your interest rate policy could become less effective and give the Federal Reserve less room to cut in the face of future recession.

1) As the Federal Reserve continues their review, are you considering alternative monetary policy frameworks, such as NGDP targeting, that would allow for more variability in inflation around the 2% target, including above that target?

2) Do you believe any of these alternative approaches outside your current 2% inflation target would allow the Federal Reserve to better achieve your congressional mandate and to help mitigate the lower bound problem?

3) Also, do you believe the current framework properly allows for productivity and commodity shocks or would an alternative system allow for broader flexibility?

Basel III Revisions

Chair Powell, in the post-crisis world, the U.S. banks have worked to improve both their capital and liquidity standards. With the Federal Reserve now working to incorporate Basel III revisions into the U.S. regulatory framework, I am concerned that if the implementation is not done with a holistic view, these changes could have a compounding effect, placing far greater capital and liquidity constraints on financial institutions.

For example, one of my greatest concerns is that the new revisions would have a lasting impact in terms of capital markets activity and the cost of raising capital for U.S. firms. This is particularly significant because unlike our European counterparts on the BCBS (Basel Committee on Banking Supervision), roughly 2/3rds of all U.S. lending occurs in our capital markets. Furthermore, we have a deeper and more sophisticated capital markets structure than our counterparts around the world.

4) Would you share your views on how capital requirements on capital markets activities could impact the balance between bank-driven and market-driven finance in the U.S. financial system?

5) Additionally, would you please outline the specific steps that the Fed is taking to ensure that these provisions are not done piecemeal and that overall capital is not meaningfully changed or increased – as you have repeatedly stated that you believe current capital levels are "about right."

Committee on Banking, Housing, and Urban Affairs
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<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Jack Reed:</u>

1) Since 2019, the Federal Reserve has been engaged in a review of its monetary policy, strategy, tools, and communications practices. Could you please share what you have learned so far? What can I share with my constituents back home who are looking for jobs, especially those Rhode Islanders who are looking for jobs that pay fair and livable wages?

2) Can you comment on whether prior extensions of unemployment insurance have made it easier for workers to bounce back from a recession? Could stabilizers, such as unemployment insurance, be more successful if they are automatically triggered by a recession?

3) Taken together, how are global events — such as the coronavirus outbreak, Boeing's production slowdown, and trade tensions — impacting U.S. supply chains and the economic outlook, especially from the perspective of the average American household?

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 12, 2020

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Brian Schatz:</u>

1) According to the Federal Reserve's annual supervisory report for 2019, approximately 40-45% of financial holding companies (FHCs) with more than $100 billion in assets have a less than satisfactory rating, and thus are not meeting the Bank Holding Company Act standard of "well-managed." This is a trend that has spanned more than the last ten years. While we cannot know from aggregated supervisory data whether which firms are falling below the statutory standard year after year, it is a troubling trend. It suggests both a wide-spread failure of large FHCs to manage themselves well, as well as a persistent failure to correct their deficiencies. In addition, more than half of the Federal Reserve's supervisory findings have related to deficiencies in the governance and risk management of these large banks.

Wells Fargo is one of the most recent and high-profile examples of poor management. Wells Fargo has been responsible for a string of egregious consumer abuses in several business units, including (a) opening over 3.5 million fake accounts; (b) illegally repossessing military members' cars; (c) charging auto loan borrowers for insurance without their knowledge; (d) improperly levying fees for extending mortgage rate-locks; (e) failing to offer mortgage modifications because of a software glitch that resulted in several hundred foreclosures; and (f) charging wealth management services for inappropriate add-on products and steering them into investments that generated larger commissions for Wells. According to a report commissioned by Wells' independent directors, the firm's sprawling organizational structure inhibited effective risk management.

The Fed has responded by imposing an unprecedented asset cap until the company fixes its governance problems. But the Fed has the authority to require Wells Fargo, and other poorly managed FHCs, to make themselves smaller and less complex in order to regain control over their management.

A. Do you see any benefits to institutions like Wells Fargo being smaller and less complex?

B. What is the Fed doing to improve governance at large, poorly managed firms?

C. Has the Fed considered exercising its divestment authority under Section 4(m) of the Bank Holding Company Act of 1956 to require large FHCs that are poorly managed to shrink themselves until they are better able to manage themselves?

D. Why has the Fed never used this authority before?

E. Under what circumstances would the Fed use this authority going forward?

2) While unemployment has reach record lows, those numbers can obscure the economic reality of working Americans. For example, in Hawaii, 48% of households have incomes that are not high enough to afford a basic household budget that includes housing, child care, food,

transportation, and health care.[4] Almost a quarter of working adults in Hawaii report that they work multiple jobs to make ends meet.[5] For these households in Hawaii and in communities across the country, the unemployment rate may be low, but they are not enjoying the financial security that should come from working full-time.

A. As the Federal Reserve works to fulfill its dual mandate, does it consider data that provide insight into the quality of the jobs available or whether employment is providing wages that can support a basic household budget?

B. If yes, what data are the Fed using and how is it using them?

C. If no, why not?

3) During the hearing, you stated that in a future recession, the Federal Reserve would use tools that it used for the first time during the 2008 financial crisis, including quantitative easing through purchases of long-term assets and Treasury bills. Quantitative easing was successful in increasing the money supply and pushing down interest rates. But even with almost $2.6 trillion in quantitative easing, one quarter of American families lost at least 75% of their wealth and more than half lost at least 25% of their wealth.[6] And the pace of economic recovery was historically slow, averaging just 2% instead of the average of 3-5% typical of other economic recoveries.

The problem for households who lost their homes and for the broader economy was that not enough of the money that the Fed pumped into the financial system made it into the hands of American households and businesses. Instead, much of the extra supply of money remained within the financial system and was poured back into the stock market. Two years after the start of the financial crisis, the Fed cleared the largest banks to pay out dividends and buy back shares. Since then, stock buybacks in the financial sector—and economy-wide—have surged. In the past ten years, the financial sector spent $860 billion in stock buybacks, and in 2019, S&P 500 companies spent a record $1 trillion in stock buybacks. These data suggests that the Fed's reliance on using the financial system as its intermediary for stimulating the economy in a crisis was inefficient.

A. Do you think the financial system made the best use of the additional money supply from quantitative easing?

B. In the case of a future recession, do you think the economy would benefit more if the Fed used its tools to increase the money supply in a way that put money directly into the hands of American households?

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[4] https://www.auw.org/sites/default/files/ALICEoverview.pdf
[5] https://www.hawaiinewsnow.com/2020/01/31/survey-hawaii-adults-say-theyre-struggling-financially/
[6] https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4200506/

C. If American households had been able to keep up with their rent and mortgage payments, pay their bills, and maintain financial stability during the recession, do you think it would have enabled the U.S. economy to recover faster from the crisis? What do you think the impact would have been on household wealth today?

D. What tools could the Fed use to make sure that any increase in the money supply in a crisis gets into the hands of American households, rather than remaining in the hands of banks or shareholders?

4) Can you provide an update on what the Fed is doing to address the financial risks from climate change in its supervisory and financial stability responsibilities? Please be specific about the steps you are taking. What does the Fed hope to accomplish in the next year?

5) Does the Fed have the data it needs to assess climate financial risks?

6) Could you provide an update on the Fed's work to join the NGFS? Is there an estimated timeline for when the Fed would join, if it is going to? If the Fed joins as an observer, what would that mean?

7) Do you see value in conducting scenario analyses or stress tests, either of individual institutions or the financial system as a whole, to gauge resilience to climate financial risk?

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 12, 2020

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Kyrsten Sinema:

1) Businesses in Arizona are struggling to find workers with the skills they need. What effects have skilled labor shortages had on economic growth and social mobility?

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 12, 2020

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Jon Tester:

Agriculture and Rural Lending:

I asked your colleague Vice Chairman Quarles, and Chairs McWilliams and Hood, about this when they were before this committee in December. I have been hearing for the last year or more from community bankers in Montana that examiners seem more concerned lately when that their bank or credit union may be overly concentrated in ag. This is a hard issue for rural communities – we don't want to further jeopardize these farmers who are already fighting to survive against Trump's trade disaster and difficult growing seasons, but we cannot let these challenges take community banks down with them. Access to banks in these rural areas is critical to communities, and we've already seen too many close.

I'm focused on making sure that we support our farmers and ranchers and their families through the current challenges facing the agriculture sector, while continuing to prioritize the safety and soundness of our community financial institutions.

1) What are the risks to these banks as farmers are increasingly overleveraged and continue to struggle with the repercussions of these ongoing trade wars, extreme weather happening more and more frequently because of our changing climate, and persistently low commodity prices?

2) Does this pose a threat to rural America?

3) What can and should we be doing in these communities?

4) From a banking perspective, are you concerned about how this will effect community banks across rural America?

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 12, 2020

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Thom Tillis:

1) I am encouraged that Federal Reserve staff are working to update the rules governing margin eligibility of certain over-the-counter securities to better reflect developments in the OTC marketplace since Nasdaq became an exchange. Please provide me with an update on the progress to date, how the Federal Reserve is contemplating updates to the rules, and the expected timing of changes to the rules.

2) HSBC has just announced a major restructuring that includes a significant reduction in its US presence, and as a result a significant reduction in the capital it will provide U.S. corporations and the services it will provide U.S. consumers. On the global markets side, HSBC has determined that its U.S. returns are unacceptably low relative to what it can earn in other markets, primarily Asia, and announced that it will reduce its U.S. risk-weighted assets in those businesses by 45 percent; it will increase its presence in Asia in a corresponding amount. On the retail side, it will focus in the United States only on international, affluent and globally mobile clients; it will continue to provide retail services to the UK, Hong Kong, and Mexico. Do you believe this outcome is a good one for the United States? Given that HSBC is the world's largest trading bank, what do you believe the economic significance will be of its shift from the U.S. market to Hong Kong, where its primary clients will be in China? What role did the regulatory regime you impose on HSBC play in its decision?

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 12, 2020

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System from Senator Elizabeth Warren:

Monetary Policy

1) In 2018, the Fed began a review of the strategy, tools, and communications it uses to conduct monetary policy.[7]

A. Describe the implications of the apparent decline in the neutral rate of interest for future recessions and economic downturns.

i. Do you believe the Fed's current monetary policy tools will be sufficient to alleviate an economic downturn?

ii. What role do you believe fiscal policy will need to play in the next downturn?

iii. President Trump has repeatedly advocated for negative interest rates, arguing that they would boost economic growth.8 Do you agree? Describe the implications of negative interest rates.

B. Former Fed Chair Bernanke has argued that the decline in the rate may be partly due to structural factors such as demographic and technological change.[9] Do you agree?

i. If so, is the Fed proactively thinking about the trends in these structural factors and how they could impact the effectiveness of monetary policy in the future?

2) In response to developments in overnight lending markets in September 2019, the Fed began conducting repo operations to "stabilize money markets and provide reserves to keep the federal funds rate within its target range.[10]"

A. Some have pointed to the repo market concentration, with the largest banks being almost exclusively responsible for engaging in transactions with the Fed and lending that money out.[11] Can you describe the implications of the concentration levels of the current repo

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[7] Board of Governors of the Federal Reserve System, "Review of Monetary Policy Strategy, Tools, and Communications," June 25, 2019, https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm

[8] NBC News, "Trump keeps pushing 'negative' interest rates. What would that mean for your wallet?," Ben Popken, September 23, 2019, https://www.nbcnews.com/business/consumer/trump-keeps-pushing-negative-interest-rates-what-would-mean-your-n1056546

[9] The Brookings Institution, "The new tools of monetary policy," Ben Bernanke, January 4, 2020, https://www.brookings.edu/blog/ben-bernanke/2020/01/04/the-new-tools-of-monetary-policy/

[10] Board of Governors of the Federal Reserve System, "Monetary Policy Report," February 7, 2020, https://www.federalreserve.gov/monetarypolicy/files/20200207_mprfullreport.pdf

[11] Wall Street Journal, "Big Banks Loom Over Fed Repo Efforts," Daniel Kruger, September 26, 2019, https://www.wsj.com/articles/big-banks-loom-over-fed-repo-efforts-11569490202

market structure and how the concentration of participants has impacted the Fed's recent interventions?

B. If the Fed were to adopt a standing repo facility, as it has been considering even before the market disruption in September[12], what factors would the Fed use to determine which counterparties would be eligible?

Financial Stability

3) In previous questions regarding the Fed's response to climate change, you have claimed that the Fed uses "its authorities and tools to prepare financial institutions for severe weather events."[13] At the same time, science has clearly demonstrated that extreme weather events are becoming increasingly common as a result of climate change.[14]

A. To the extent that these weather events continue becoming more common and having a greater impact on the business cycle itself, do you believe that it would be appropriate for the Fed to more explicitly consider the risks associated with climate change in its decision-making?

B. Do you believe it would be appropriate for the Fed to hire economists that specialize in climate economics to address these changes? Should the Fed hire natural scientists to inform economic models? Do you have any plans to do so?

C. Do you support the Fed officially joining the Network for Greening the Financial System (NGFS)? If not, why not?

4) The most recent report from Shared National Credit (SNC) Review program conducted jointly by the Fed, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC), stated that "credit risk associated with leveraged lending remains elevated" and "lenders have fewer protections and risks have increased in leveraged loan terms through the current long period of economic expansion since the last recession."[15]

A. Please explain how the Fed monitors and evaluates the credit-risk management practices of a financial institution to ensure that these procedures, some of which are untested, will be sufficient during an economic downturn.

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[12] Board of Governors of the Federal Reserve System, "Minutes of the Federal Open Market Committee," June 18-19, 2019, https://www.federalreserve.gov/monetarypolicy/fomcminutes20190619.htm

[13] Letter from Federal Reserve Chairman Jerome H. Powell to Senator Elizabeth Warren, April 18, 2019

[14] National Oceanic and Atmospheric Administration, "Report: Climate change is making specific weather events more extreme," December 9, 2019, https://www.noaa.gov/news/report-climate-change-is-making-specific-weather-events-more-extreme

[15] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System Federal Deposit Insurance Corporation Office of the Comptroller of the Currency, "Shared National Credit Program: 1st and 3rd Quarter 2019 Reviews," https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200131a1.pdf

B. Do you believe that the Interagency Guidance on Leveraged Lending[16] issued in 2013 is sufficient to address the risks associated with leveraged lending, particularly with respect to the growth of non-bank lenders?

   i. Describe how the Fed monitors compliance with that guidance and what actions are taken when a bank is found to have inadequate credit risk protections.

C. Increasingly, the riskiest leveraged lending is occurring outside the banking system.

   i. Do those loans currently pose a risk to financial stability? If not, please explain why and under what circumstances the Fed would begin to judge them a threat to financial stability.

   ii. Many of these non-bank lenders fall into a regulatory gap. What tools does the Federal government have to mitigate the risks from the growth of leveraged lending and the deterioration of the terms of those loans?

   iii. Private equity firms often finance acquisitions through highly leveraged loans. According to the private equity industry, firms acquired in these acquisitions now employ more than 8 million workers.17 In an economic downturn, what would you expect to happen to employment in these firms?

Regulation

5) The OCC and FDIC made the decision to heed to the concerns of the Fed with respect to their plan to modify the Community Reinvestment Act (CRA) and issued a new proposed rule on the law jointly enforced by the three agencies without the Fed last December.[18] On January 8, 2020, Governor Brainard released her own alternative plan to modernize the CRA.[19] You have since stated that while the entire Board has not yet voted on the proposal, you supported the framework she described.

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[16] Federal Reserve Board of Governors, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Interagency Guidance on Leveraged Lending," March 21, 2013, https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf

[17] Office of Senator Elizabeth Warren, "Letter from Senator Elizabeth Warren et al to Carmine Di Sibio, Global Chairman and Chief Executive Office of Ernst and Young AG, November 18, 2019, https://www.warren.senate.gov/imo/media/doc/Letter%20to%20Ernst%20and%20Young%20re%20PE%20report.pdf.

[18] Comptroller of the Currency and Federal Deposit Insurance Corporation, Federal Register Notice, "Community Reinvestment Act Regulations," January 09, 2020, https://www.federalregister.gov/documents/2020/01/09/2019-27940/community-reinvestment-act-regulations

[19] Board of Governors of the Federal Reserve System, "Strengthening the Community Reinvestment Act by Staying True to Its Core Purpose," Governor Lael Brainard, January 08, 2020, https://www.federalreserve.gov/newsevents/speech/brainard20200108a.htm

A. Please describe in detail the aspects of the FDIC and OCC plan that prevented the Fed from joining the proposal.

   i. Does the Fed commit to not joining a final rule that does not address these issues?

B. Much of the criticism of the other agencies' plan focuses on the lack of analysis demonstrating the economic impact of the changes. However, according to Governor Brainard, the Fed has conducted some analysis with relevant data and would like to publish that data so the public can provide feedback.

   i. When does the Fed anticipate doing so?

   ii. Do you believe it is important for any new metrics included in a new CRA plan are grounded in data?

   iii. Do you believe that it is important for the public to have ample time to examine these data to provide input and ensure that reforming this critical civil rights law is done correctly?

C. You said during the hearing that the Fed was mostly focused on coming to consensus with the OCC and the FDIC before the proposal was issued, but hasn't formally engaged since that time. What is the Fed's plan going forward? Will the Fed formally vote on the proposal to be published in the Federal Register and subject to the traditional notice and comment period?

D. What are the consequences of having two separate CRA regimes for institutions with different regulators?

6) On January 30, 2020, the Fed finalized a rule to determine "when a company controls a bank or a bank controls a company." [20]

A. Reporting has indicated that the rule could allow private equity funds to control a greater portion of a bank's equity and thereby allow private equity investors to influence the operations of banks.[21] Given the various risks associated with the private equity business model and documented research that demonstrates that private equity investments in

[20] Board of Governors of the Federal Reserve System, "Federal Reserve finalizes rule to simplify and increase the transparency of the Board's rules for determining control of a banking organization," January 30, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200130a.htm

[21] New York Times, "The Fed Wants to Loosen Rules Around Big Banks and Venture Capital," Jeanna Smialek and Emily Flitter, January 30, 2020, https://www.nytimes.com/2020/01/30/business/economy/volcker-rule-banks-venture-capital.html

financial companies can increase the risk profile of those companies[22], do you believe that this rule increases the level of risk in the financial sector?

B. In her statement, Governor Brainard suggested that it will be important to "monitor the ownership structures of banking organizations in light of this control framework and industry trends" and "how the control framework interacts with other regulations that involve ownership thresholds." [23]

  i. Do you agree with Governor Brainard?

  ii. If so, please describe how the Fed will monitor these ownership structures and how the Fed will determine if there is a financial stability risk associated with a banking organization's ownership structure?

Supervision

7) In Wells Fargo's Q4 2019 Earnings Call, newly appointed CEO Charlie Scharf acknowledged the bank's many misdeeds, claiming "we made some terrible mistakes and have not effectively addressed our shortcomings."[24]

A. These comments suggest that Wells Fargo has not made substantial progress in remedying the issues at hand. In a written response to me in 2018, you stated that the terms of the Fed's current Consent Order require that "the firm must make significant progress in remedying its oversight and compliance and operational risk management deficiencies before relief from the asset growth restriction would be forthcoming."[25] Do you agree with Mr. Scharf that Wells Fargo still has a long way to go before the asset cap can be removed?

8) In a recent speech, Fed Vice Chair for Supervision Randal Quarles suggested that Fed bank supervisors use of MRAs should be limited, and that they should only be permitted to institutions "to violations of law, violations of regulation, and material safety and soundness issues"[26] -- a severe narrowing of Fed's authority.

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[22] Harvard University, " Private Equity Ownership, Risk-Taking, and Performance in the Life and Annuities Industry," Divya Kirti and Natasha R. Sarin, April 2, 2018, https://scholar.harvard.edu/nsarin/publications/private-equity-ownership-risk-taking-and-performance-life-and-annuities-industry
[23] Board of Governors of the Federal Reserve System, "Statement by Governor Lael Brainard," January 30, 2020, https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200130a.htm
[24] Bloomberg, "Q4 2019 Earnings Call," Wells Fargo, January 14, 2020
[25] Letter from Federal Reserve Chairman Jerome H. Powell to Senator Elizabeth Warren, May 10, 2018, https://www.warren.senate.gov/download/20180510-powell-response-re-wells-fargo
[26] Federal Reserve Vice Chair for Supervision Randal K. Quarles, " Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision," January 17, 2020, https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm

A. Does the Fed have any plans to alter the process, standards, and requirements under which MRAs and/or MRIAs are issued? If so, when do you expect to formally announce those changes?

   i. How will you be announcing these changes?

   ii. Will you put in place a formal notice and comment process so that outside experts and consumer advocates can review and comment on any proposal?

   iii. When do you anticipate implementing these changes?

B. The 2013 guidance on the communication of supervisory findings states, that standardization of the terms MRAs or MRIAs "facilitates the Federal Reserve's national systems of record for information related to examination and inspection issues" and "enables the Federal Reserve to access information about supervisory issues and remediation efforts and aids in the identification of systemic and programmatic challenges facing banking organizations supervised by the Federal Reserve."[27] If, as proposed, certain supervisory findings will no longer be categorized as MRAs, how will this impact the Fed's ability to assess progress in addressing these challenges?

C. In his speech, Vice Chair Quarles referenced the restoration of the "supervisory observation" category that was removed in 2013.[28] When the Fed used them, they were defined as "matters that are informative, advisory, or that suggest a means of improving performance or management operation of the organization. However, senior management of financial institutions had the discretion to decide whether or not to adopt the observations.[29]

   i. Does the Fed intent to restore the "supervisory observation" category based on the same definition that was used prior to 2013?
   ii. Is the Fed considering adding additional categories to describe supervisory communications?

D. Do you believe that it is possible for a bank examination to uncover an issue with a financial institution that could pose a threat to safety and soundness but does not represent a legal violation? Please describe some examples.

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[27] Federal Reserve Board of Governors, " Supervisory Considerations for the Communication of Supervisory Findings," https://www.federalreserve.gov/supervisionreg/srletters/sr1313a1.pdf
[28] Id.
[29] Federal Reserve Board of Governors, "Communication of Examination/Inspection Findings," January 24, 2008

E. The impact of any proposed changes to MRAs is largely dependent on the definition of "material safety and soundness." How will the Fed determine this definition?

F. How will the process for remediation differ for issues that were previously covered by MRAs but will no longer be? How will the process for escalating an unresolved issue to an enforcement matter?

G. Certain MRAs are issued on an industry-wide basis.[30] How would proposed changes affect the use of these types of MRAs?

[30] American Banker, "Wells Fargo not alone: OCC finds sales abuses at other banks," Kevin Wack, June 5, 2008, https://www.americanbanker.com/news/not-just-wells-fargo-occ-finds-sales-practice-abuses-at-other-banks

Committee on Banking, Housing, and Urban Affairs
Oversight of Financial Regulators
May 12, 2020

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Ranking Member Sherrod Brown:

1) Please provide to the committee a detailed list of all meetings with individuals or groups not directly affiliated with the agency you serve, from December 5, 2019 to present.

2) I have heard from small businesses in Ohio and across the country how difficult it's been to get a Paycheck Protection Loan. We know that some of the biggest banks put their wealthiest and best clients first and gave them preferential treatment, while thousands of Main Street businesses were left behind. What is the Fed doing to make sure that the biggest banks are serving the goals of the program and lending this taxpayer money fairly instead of serving their own self-interest?

3) How will your agencies collect and analyze PPP loan data to ensure the institutions you regulate accepted applications and processed loans equitably?

4) The Fed plans to do the 2020 stress tests as originally intended, but you announced that there will be some additional scenarios and adjustments to reflect the current economic and banking conditions we're in. Will these results be made public? Will these scenarios be included in future stress tests to ensure the banking system is resilient to future pandemics? Please be specific about what details and information the Fed will include in any modified stress test scenarios results.

5) On May 20, 2020, the OCC, Federal Reserve, FDIC, and NCUA issued Interagency Lending Principles for Offering Responsible Small-Dollar Loans.

A. A characteristic the agencies identified for responsible small-dollar lending programs is "[a] high percentage of customers successfully repaying their small dollar loans in accordance with original terms." What does the agency consider a "high percentage"? Does the agency agree that lenders should consider whether borrowers have the ability to repay a small dollar loan as part of their underwriting process?

B. Another characteristic the agencies identified for responsible small-dollar lending programs is "[r]epayment terms, pricing, and safeguards that minimize adverse customer outcomes, including cycles of debt due to rollovers or reborrowing." This suggests that some percentage of small dollar loans that have adverse customer outcomes, including cycles of debt, may be acceptable. If so, what percentage of loans that result in borrowers in a cycle of debt does the agency find acceptable? To prevent cycles of debt, has the agency considered imposing restrictions or prohibitions on rollovers or reborrowing?

C. Does the agency consider small-dollar loans with an annual interest rate of more than 36 percent "responsible" or "consistent with safe and sound banking"? If so, what is the basis for that determination?

D. Does the agency consider small-dollar loans that are illegal under state usury laws "responsible" or "consistent with safe and sound banking"?[1]

6) During the hearing, you advocated for statutory changes to the Dodd-Frank Wall Street Reform and Consumer Protection Act's Section 171 – commonly referred to as the Collins Amendment. In short, you advocated for the ability to reduce the stringency of capital requirements in the banking system. If it is your opinion that there is insufficient capital in the banking system to support additional lending, why has the Federal Reserve not mandated that banks end all capital distributions, like dividends and stock buybacks?

[1] *See, e.g.*, loans that lenders like Opploans and Elevate Credit, Inc. have been making, as discussed in Sen. Brown's Nov. 21, 2019 letter to OCC and FDIC.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

MICHELLE W. BOWMAN
MEMBER OF THE BOARD

June 14, 2019

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the June 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Michelle W. Bowman

Enclosure

[1] Questions for the record related to this hearing were received on June 7, 2019.

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Questions for The Honorable Michelle Bowman, Governor of the Board of Governors of the Federal Reserve System, from Senator Masto:

1. I am very concerned about climate-related financial risks. The most recent National Climate Assessment said the U.S. Southwest could lose $23 billion per year in region-wide wages as a result of extreme heat. Since you joined the Federal Reserve Board, what have you done to prepare community banks for long-term shifts in climate patterns, like increasing extreme heat and more severe and more frequent storms?

Congress has placed the responsibility to address climate change within other agencies. The Federal Reserve Board's (Board) supervisory framework guides supervisors in their work with these institutions on a wide range of risk management practices, including those around severe weather events. To supplement that broad framework, the Board also has issued guidance on lending to sectors where assessments of severe weather-related risks are especially critical, such as agriculture and energy lending. I can assure you that I appreciate the distinct concerns of community banks in this space, because of both their size and their important social role; I will continue to urge Federal Reserve examiners and supervisors to do the same in their daily work.

2. In March, Glenn Rudebusch published an economic paper on Climate Change and the Federal Reserve. The paper notes that droughts, floods and hurricanes amplified by climate change could result in more infrastructure damage, agricultural losses, and commodity price spikes. Rudebusch notes that "some have advocated that central banks use their balance sheet to support the transition to a low-carbon economy, for example, by buying low-carbon corporate bonds."

- **Do you think Congress should consider changing the law to support "green" quantitative easing as an option for the Fed?**

The Federal Reserve conducts monetary policy to promote its statutory goals of maximum employment and stable prices. Decisions about how to foster new technologies, new industries, or about channeling credit to particular sectors of the economy inevitably involve competing political interests. The Congress and the Administration are in the best position to make judgments balancing those interests on behalf of the U.S. taxpayer.

3. Which other Central Banks allow green quantitative easing? Do you believe those models could translate to the American financial system and economy?

I am not aware of any advanced-economy central bank that has a "green quantitative easing" program. As I noted in my response to #2, Congress and the Administration are in the best position to evaluate this question.

4. In the Federal Reserve's Supervisory Report released November, there was a section on merger and acquisition risks. The banking law passed last year changed the asset threshold for a small bank holding company from $1 billion to $3 billion. It also reduced capital requirements and other rules for banks above $50 billion. We have seen more bank mergers since the law passed.

- **Do you expect to see more bank mergers this year and next year than in previous years?**
- **How much of merger activity is due to changes from S. 2155 and other regulatory actions?**

Merger activity is affected by a number of factors, including economic environment, industry outlook, and factors unique to particular institutions or business models. As such, I am not able to draw conclusions on the effect of S.2155 or other regulatory actions at this time. Following the implementation of S.2155, we have not seen a significant change in applications for bank acquisitions and mergers submitted to the Federal Reserve System to date. In fact, the number of these types of applications submitted to the Board is lower now than in the years before the financial crisis.

Between May 24, 2018, the enactment date of S.2155, and December 31, 2018, the Federal Reserve System received 113 applications for the proposed merger and acquisition of banking organizations under the Bank Holding Company Act, the Bank Merger Act, and the Home Owners Loan Act. This number is lower than the number of merger and acquisition applications submitted during the same period for each year from 2006 to 2017.

5. What do you see as the risks from mergers and acquisitions beyond the impacts on the customer?

Like any firm, a variety of risks are always present, but when firms merge or make acquisitions, the chief risk is operational. Operational risk could present during the integration of systems related to risk management, information technology, Bank Secrecy Act/Anti-Money Laundering, and the Community Reinvestment Act. In reviewing bank merger and acquisition proposals, the Federal Reserve considers the applicant's plans for implementing the proposal and its capacity to do so effectively.

- **What are the risks to communities when banks merge?**

Congress has given the Federal Reserve a set of statutory factors to use during the evaluation of a merger or acquisition application, one of which is the convenience and needs of the communities to be served and public benefits. Furthermore, the Federal Reserve also must analyze the competitive effects of the proposal, including whether the proposal would substantially lessen competition in any section of the country. In addition, the Board considers the applicant institution's business model, its marketing and outreach plans, and the institution's plans following consummation of the proposal. I take this role seriously and intend to be thorough in my review of all current and future applications.

- **Are you concerned about a loss of branches? Types of products? Jobs?**

I understand and am sympathetic to the concerns raised with respect to the potential loss of branches, products and services and jobs following financial institution mergers. In evaluating convenience and needs factors in bank acquisition and merger proposals, the Board considers all relevant information, including the addition of new products, extended hours of service, or additional branch locations that will be subsequently available to the public. With respect to branch closures, banks are required to adhere to Federal Deposit Insurance Act public notice requirements[2] before closing branches, which include the following:

- The bank is required to provide reasons and other supporting data for the closure, consistent with the institution's written policy for branch closings.
- For branches to be closed in low- or moderate-income geographies, affected persons have the ability to request a public meeting to explore the feasibility of obtaining adequate alternative facilities and services for the area.
- The bank also is required to provide the public with at least 30 days' notice, and the appropriate federal supervisory agency with at least 90 days' notice, before the date of a proposed branch closing.

A pattern of branch closures in minority communities also may be relevant in determining whether a bank is in compliance with fair lending laws. For example, it may be a consideration in determining whether a bank is engaging in redlining. Branching is one of the factors that is considered in a redlining analysis, along with the bank's CRA assessment area, lending, marketing, and outreach practices. In evaluating branching for these purposes, we analyze whether there are bank branches in majority-minority census tracts.

The Federal Reserve considers applicants' plans for products and services to be offered by the combined institution, including significant anticipated changes to products and services currently offered by the individual institutions and plans to offer new, replacement, or enhanced products and services. Many acquiring banks plan to offer the products and services of both the acquiring bank and the target bank throughout the footprint of the combined bank, resulting in increased availability of products and services for customers of each bank.

The Federal Reserve reviews applications for consistency with the applicable statutory factors. These factors include the applicant's current and pro forma financial condition and future prospects, managerial resources, the convenience and needs of the communities to be served and public benefits, the competitive effects of the merger or acquisition, and impact of the proposal on financial stability.

6. At a time when community banks are earning record profits, why have you voted repeatedly to lower the amount of regulatory capital they hold?

The Board has not acted on any proposals to lower capital levels for community banks. However, as I stated in my testimony, as regulators, we need to ensure that we are not imposing unnecessary burdens on community banks. This is why I believe we must tailor our supervision and regulation to the size, complexity, capacity, and risks posed by an institution. Community banks are critical to so many local economies, which is why it is important to adapt our approach to supervision and regulation as the industry evolves.

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[2] Section 42 of the Federal Deposit Insurance Act (12 U.S.C. § 1831r-1), as implemented by the Joint Policy Statement Regarding Branch Closings (64 *Fed. Reg*. 34,844 (1999)). The Joint Policy Statement Regarding Branch Closings states that the federal banking agencies will examine institutions for compliance with branch closure requirements in accordance with each agency's consumer compliance examination procedures.

7. Why have you never joined Governor Brainard in a dissent of all these deregulatory actions, including those that weakened rules for the biggest banks?

As I stated in my testimony, the core reforms that resulted from the crisis were crucial to ensure the resilience of the U.S. financial system. At the same time, I believe that our regulatory and supervisory framework should be tailored according to banking firms' size, complexity, and risk profile, in a way that minimizes costs and is consistent with statutory provisions. I have appreciated the value placed on getting a broad range of external and internal views throughout our deliberative process.

8. How does your support for revising the capital and liquidity requirements for large banks help community banks?

One of the key goals of the recent tailoring proposals is to better reflect the differences in risk profiles between firms that qualify as U.S. global systemically important banks and other large banking organizations. U.S. firms with the most significant risk profiles would remain subject to the most rigorous existing requirements under the proposals. These proposals build on the Board's existing efforts to tailor its rules and experience implementing those rules, and account for changes to the enhanced prudential standards made by S.2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act.

9. How does your support for weakened stress test regimes for large banks help community banks?

I believe that a strong, resilient financial sector is important to banking institutions regardless of their size. Stress testing remains a core tool for the Federal Reserve. Our proposal aligns compliance requirements for firms with less risk while maintaining more stringent requirements for firms with more risk and more systemic importance. The proposal also provides banking organizations with additional transparency, so that they can better comply with the tests.

10. How does your support for changing the formula for derivatives so that less capital is held against derivative positions help community banks?

The Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (together, the agencies), estimate that the proposal would not significantly change the amount of regulatory capital in the banking system. The proposal updates standards for how large banking organizations measure counterparty credit risk posed by derivative contracts under the agencies' regulatory capital rules. The proposed changes are designed to better reflect the current derivatives market and incorporate risks observed during the 2007-2008 financial crisis. The new approach, called the "standardized approach for measuring counterparty credit risk," or SA-CCR, is intended to better reflect the current derivatives market and to provide important improvements to risk sensitivity, resulting in more appropriate capital requirements for derivative contracts exposure. The proposal would require large banks to adopt SA-CCR, but permit smaller firms to use the existing current exposure methodology (CEM).

While the agencies recognized that the proposed implementation of SA-CCR would offer several improvements to CEM, it may require, particularly for firms with relatively small derivatives portfolios, internal systems enhancements and other operational modifications that could be costly and present additional burden.

11. How does your support for reducing resolution plans for big banks from once a year to every four or six years help community banks?

Changing the frequency of resolution plan submissions for large firms will not have an impact on community banks. Community banks have total assets of $10 billion or less and therefore, are not subject to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) resolution planning requirement. The change in resolution plans is consistent with the Board's broader efforts to tailor supervisory expectations to the size and complexity of our supervised firms.

12. How does your support to end risk-reducing margin requirements for derivatives transactions between affiliates of large complex banks help community banks?

The banking agencies have not taken action on this matter. However, I believe it is sensible to review our regulatory requirements periodically to assess whether they can be made more efficient, consistent with the Dodd-Frank Act and considering other regulatory requirements applicable to the firm.

If the U.S. prudential regulators (the Board, FDIC, OCC, Farm Credit Administration, and Federal Housing Finance Agency) propose to eliminate inter-affiliate margin requirements, that change would likely have limited effects on community banks because community banks are already exempt from the swap margin rule. Community banks and other small financial institutions do not have to post margin for their non-cleared swap transactions. On August 1, 2016, the prudential regulators announced their final rules exempting banks, savings associations, Farm Credit System institutions, and credit unions with $10 billion or less in total assets from the OTC margin requirements under the Dodd-Frank Act. This relief is designed to allow such firms to use OTC derivatives to hedge normal business activity as they have done in the past (e.g., hedging the interest rate risk of loans).

13. If a fair lending exam detects a violation after a bank has been graded for its Consumer Reinvestment Act exam, do you think the bank should receive a retroactive downgrade?

I find discriminatory and other illegal credit practices unacceptable and they have no place in civil society. Moreover, such practices can have a negative effect on a bank's CRA rating. The Board's current regulation is explicit about how to consider illegal credit practices when assigning ratings. Consistent with the regulation, our process entails a fact-specific review of the matter before deciding whether it should prompt a downgrade of a CRA rating, including the nature of the practices, any corrective actions taken to address them, and the policies and procedures in place to prevent them.

Questions for Ms. Michelle Bowman, to be a Member of the Board of Governors of the Federal Reserve System, From Senator Elizabeth Warren:

1) The Federal Reserve Board of Governors is engaged in an interagency process to rewrite the Community Reinvestment Act (CRA) rules.

A. In your view, what is problem with the current Community Reinvestment Act (CRA) regulations?

B. Currently, more than 98% of banks pass their CRA examinations but lending discrimination and banking deserts still exist in communities all across the country. Does this suggest that CRA examinations are too esry?

C. More than half of mortgages are now made by non-bank mortgage companies. Should these non-bank lenders have CRA or other similar obligations to serve the whole communities in which they are located?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

MICHELLE W. BOWMAN
MEMBER OF THE BOARD

June 14, 2019

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the June 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Michelle Bowman

Enclosure

[1] Questions for the record related to this hearing were received on June 7, 2019.

E-MAIL: MIKI.BOWMAN@FRB.GOV • TELEPHONE: 202-452-3211 • FACSIMILE: 202-728-5860

<u>Questions for The Honorable Michelle Bowman, Governor of the Board of Governors of the Federal Reserve System, from Senator Warren:</u>

1. The Federal Reserve Board of Governors is engaged in an interagency process to rewrite the Community Reinvestment Act (CRA) rules.

- **In your view, what is problem with the current Community Reinvestment Act (CRA) regulations?**

The Federal Reserve Board of Governors (Board) takes our Community Reinvestment Act (CRA) responsibilities seriously and strives to conduct meaningful CRA evaluations. There has been considerable change since the time the regulations implementing the law were last revised. The Board supports modernizing CRA to improve the clarity, consistency, and predictability of how CRA performance is assessed, as well as the predictability of which community development investments and loans qualify for CRA consideration. While there is a lot that is good about the current regulations, many stakeholders have said that they are too complicated and that if they were made simpler and more transparent both banks and communities would benefit.

I believe that the regulations should recognize that banks serve communities with different credit needs. Additionally, the regulations should be tailored to evaluate a bank's CRA performance in light of its size, business strategy, capacity, and constraints as well as its community's demographics, economic conditions, and credit needs and opportunities. I also understand the need to update assessment areas to reflect how technology and other advancements have significantly changed how financial services are accessed and delivered.

My Board colleagues and I support working with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (OCC) to modernize CRA and believe the agencies should find a way to preserve this statutory intent in any future update of the regulation. We are continuing to evaluate public input from a wide range of stakeholders on ways to modernize the CRA, including through the OCC's Advanced Notice of Proposed Rulemaking and the roundtables that the Federal Reserve held across the country from October 2018 through January of this year.[1]

- **Currently, more than 98% of banks pass their CRA examinations but lending discrimination and banking deserts still exist in communities all across the country. Does this suggest that CRA examinations are too eary?**

The CRA regulations are very specific with respect to the criteria necessary to achieve a "Satisfactory" or "Outstanding" rating. In general, banks work to avoid poor CRA ratings, which can lead to community relations and public reputational issues, result in more frequent CRA evaluations, and pose a significant barrier to any future plans for expansion. Ratings also are made public, giving banks additional incentives to establish effective CRA programs. Given these factors, I believe that our CRA examination process is robust and rigorous.

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[1] *See* https://www.federalreserve.gov/publications/files/stakeholder-feedback-on-modernizing-the-community-reinvestment-act-201906.

Committee on Banking, Housing, and Urban Aff
Nomination Hearing
June 5, 2019

<u>Questions for Ms. Michelle Bowman, to be a Member of the Board of Governors of the Federal Reserve System, From Senator Mike Rounds:</u>

1) The community bank leverage ratio (CBLR) created pursuant to S. 2155 is of paramount interest to community banks in South Dakota. I am particularly concerned about how the CBLR was created because the current CBLR includes changes to the Prompt Corrective Action framework that would effectively eliminate any relief achieved from the creation of the leverage ratio. I've heard from several institutions in my state that they will decline to take advantage of the CBLR as a result.

A. Why was 9% chosen for the community bank leverage ratio?

B. S. 2155 required federal regulators to engage in a dialogue with state banking regulators regarding how the leverage ratio should be set. How did the Federal Reserve fulfill this requirement?

C. What changes will be made to the community bank leverage ratio so that community banks can actually avail themselves of this relief?

2) I am honored to be the sponsor of the Financial Stability Oversight Council Improvement Act of 2019, which would require FSOC to determine whether potential nonbank threats to financial stability could be better solved by allowing companies to work with their primary regulator or through the development of a risk reduction plan. This legislation is important because most FSOC members are banking regulators and applying banking regulations to nonbank companies would be harmful to our capital markets and to Main Street investors.

A. Do you agree that FSOC should focus on empowering primary regulators so that true systemic risks can be addressed?

B. Do you agree that it's important for FSOC to consult with primary regulators before voting on a SIFI designation?

C. Do you agree that addressing nonbank risk does not always have to include a SIFI designation?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

MICHELLE W. BOWMAN
MEMBER OF THE BOARD

June 14, 2019

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the June 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Michelle Bowman

Enclosure

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Questions for The Honorable Michelle Bowman, Governor of the Board of Governors of the Federal Reserve System, from Senator Rounds:

1. The community bank leverage ratio (CBLR) created pursuant to S. 2155 is of paramount interest to community banks in South Dakota. I am particularly concerned about how the CBLR was created because the current CBLR includes changes to the Prompt Corrective Action framework that would effectively eliminate any relief achieved from the creation of the leverage ratio. I've heard from several institutions in my state that they will decline to take advantage of the CBLR as a result.

- **Why was 9% chosen for the community bank leverage ratio?**

The federal banking agencies jointly issued a proposal that would allow community banking organizations that meet certain qualifying criteria to opt into a simple, leverage-based capital framework. Firms that opt into the framework would not be subject to the capital rule's risk-based capital requirements.

Under the proposal, a qualifying community banking organization may elect to use the community bank leverage ratio (CBLR) framework if its CBLR is greater than 9 percent. A 9 percent CBLR should generally maintain the current level of capital held by these banking organizations, while supporting the banking agencies' goals of reducing regulatory burden for community banking organizations and retaining safety and soundness in the banking system. Before finalizing the CBLR rule, I, along with my Federal Reserve Board (Board) colleagues will consider all public comments received as well as the input received from state bank supervisors.

- **S. 2155 required federal regulators to engage in a dialogue with state banking regulators regarding how the leverage ratio should be set. How did the Federal Reserve fulfill this requirement?**

The banking agencies have worked closely with state bank supervisors over the past several months to inform the rulemaking process, and are considering their constructive input and feedback as we work to finalize the CBLR framework.

- **What changes will be made to the community bank leverage ratio so that community banks can actually avail themselves of this relief?**

The banking agencies are still considering the public comments received on the proposal as well as the input received from state bank supervisors. Moving forward in the rulemaking process, the banking agencies will strive to develop a CBLR framework that is consistent with congressional intent.

2. I am honored to be the sponsor of the Financial Stability Oversight Council Improvement Act of 2019, which would require FSOC to determine whether potential nonbank threats to financial stability could be better solved by allowing companies to work with their primary regulator or through the development of a risk reduction plan. This

legislation is important because most FSOC members are banking regulators and applying banking regulations to nonbank companies would be harmful to our capital markets and to Main Street investors.

- **Do you agree that FSOC should focus on empowering primary regulators so that true systemic risks can be addressed?**

I believe that the Financial Stability Oversight Council (FSOC) should work closely with the relevant primary regulators when addressing systemic risks, and my understanding is that the proposed activities-based approach to nonbank designation strengthens such coordination.

- **Do you agree that it's important for FSOC to consult with primary regulators before voting on a SIFI designation?**

Yes, I agree on the importance of consultation with primary regulators before any FSOC vote on a systemically important financial institution designation to leverage the expertise of that regulator and explore alternative solutions to mitigate systemic risk. The activities-based approach envisions close cooperation between the FSOC and the relevant regulators.

- **Do you agree that addressing nonbank risk does not always have to include a SIFI designation?**

Yes, I believe that there are ways to address nonbank risks other than through designating firms as systemically important. Indeed, it is my understanding that the proposed amendments to the nonbank designation guidance are intended to capture instances where designating an entity may not effectively address the risk to the system.

Committee on Banking, Housing, and Urban Af
Nomination Hearing
June 5, 2019

<u>Questions for Ms. Michelle Bowman, to be a Member of the Board of Governors of the Federal Reserve System, From Senator Robert Menendez:</u>

1) My home state of New Jersey is moving towards legalization of recreational marijuana, and I have concerns that these new businesses as well as existing medical marijuana businesses in the state will continue to find themselves shut out of the banking system. And when these businesses are forced to operate exclusively in cash, they create serious public safety risks in our communities. I've already heard support from Chair Powell and Comptroller Otting on this issue, but I'd also like to know if you agree that financial institutions need legislative clarity on this issue?

2) Closely related to the provision of banking services is the ability for such businesses to access insurance products, a necessity for those looking to secure financing. Would it be helpful for Congress to also consider the role of insurance companies as states move towards legalization?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

MICHELLE W. BOWMAN
MEMBER OF THE BOARD

June 14, 2019

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the June 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

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Enclosure

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<u>Questions for The Honorable Michelle Bowman, Governor of the Board of Governors of the Federal Reserve System, from Senator Menendez:</u>

1. My home state of New Jersey is moving towards legalization of recreational marijuana, and I have concerns that these new businesses as well as existing medical marijuana businesses in the state will continue to find themselves shut out of the banking system. And when these businesses are forced to operate exclusively in cash, they create serious public safety risks in our communities.

- **I've already heard support from Chair Powell and Comptroller Otting on this issue, but I'd also like to know if you agree that financial institutions need legislative clarity on this issue?**

Yes, I do. However, only Congress can provide financial institutions legislative clarity on the conflict between federal and some state laws on the legalization of marijuana and whether banks can service marijuana businesses that are legal under state law. The Federal Reserve is monitoring the various legislative proposals Congress is considering to resolve this issue.

2. Closely related to the provision of banking services is the ability for such businesses to access insurance products, a necessity for those looking to secure financing. Would it be helpful for Congress to also consider the role of insurance companies as states move towards legalization?

Access to insurance products is an important aspect of commerce. If Congress decides to address the conflict between federal laws and some state laws on the legalization of marijuana and whether banks can service state legal marijuana businesses, it would likely be helpful to also address any similar issues related to insurance companies and products.

Committee on Banking, Housing, and Urbai
Nomination Hearing
June 5, 2019

<u>Questions for Ms. Michelle Bowman, to be a Member of the Board of Governors of the Federal Reserve System, From Ranking Member Sherrod Brown:</u>

1) Please provide to the committee a detailed list of all meetings with individuals or groups not directly affiliated with the agency you serve, from the date of your confirmation by the Senate to present.

2) In a recent speech entitled "Community Banking in the Age of Innovation," you explained that "fintech firms originate a larger share of personal loans than banks," but "we should not simply assume that gains by fintech lenders are necessarily at the expense of banks." You highlight the opportunities for community banks to partner with fintech firms.

A. Do you support these same fintech firms competing directly with community banks through industrial loan company (ILC) charters or OCC special purpose national bank charters?

3) During your testimony, in response to my question about consolidation making it harder for small banks to compete, you said that your concern was investment in local communities and that as branches are acquired in rural communities, home investment in the community tends to be dissipating.

A. What actions is the Fed taking to ensure that acquiring banks continue to invest in communities where all acquired branches are located? How will you ensure that banks distribute their investments in all communities, not only the location in which the charter is held? Would you support requirements for banks to continue to invest in these communities after an acquisition?

4) In your remarks at the Conference of State Bank Supervisors in April, you said that "we must continue to ensure that the institutions we supervise are proactively managing their risks to remain strong" and that "it's the [financial supervisors'] job to identify emerging risks to community banks and to ensure bankers are identifying and managing their risks appropriately."

A. What are the emerging risks to community banks today? Please describe what specific proactive measures the Fed is taking to ensure that banks are managing these risks. What additional steps should the Fed take to address these risks?

5) In your capacity as community bank designee, what is your definition of a community bank? What is the largest firm, by assets, that you consider to be a community bank? In how many states can a bank operate and still be considered a community bank? Are there any financial activities that you think disqualify a firm from inclusion as a community bank? What is the maximum number of distinct subsidiaries and affiliates at a bank or bank holding company that you would still consider to be a community bank?

6) If confirmed to a full 14-year term, what will be your top priorities as a member of the Board of Governors that serves as the community bank designee?

7) Systemic regulatory failures, like the savings and loan crisis and 2008 financial crisis, have been the largest contributors to community bank failures over the last 30 years. What actions are you taking to ensure that excessive risk-taking in corporate debt will not result in harm to the financial sector broadly and community banks specifically?

8) Are you concerned that the deregulation of foreign banking organizations (FBOs) as proposed in April will create additional competitive pressures on community banks? Are FBOs direct competitors with community banks in activities like small business and residential mortgage lending? If not, what activities do FBOs engage in that distinguish their business and risk profile from community banks?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

MICHELLE W. BOWMAN
MEMBER OF THE BOARD

June 14, 2019

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

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Please let me know if I may be of further assistance.

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Questions for The Honorable Michelle Bowman, Governor of the Board of Governors of the Federal Reserve System, from Senator Brown:

1. Please provide to the committee a detailed list of all meetings with individuals or groups not directly affiliated with the agency you serve, from the date of your confirmation by the Senate to present.

Please see the attachment in response to your question.

2. In a recent speech entitled "Community Banking in the Age of Innovation," you explained that "fintech firms originate a larger share of personal loans than banks," but "we should not simply assume that gains by fintech lenders are necessarily at the expense of banks." You highlight the opportunities for community banks to partner with fintech firms.

- **Do you support these same fintech firms competing directly with community banks through industrial loan company (ILC) charters or OCC special purpose national bank charters?**

I support innovations in financial services because I believe it can benefit consumers and small businesses through expanded access to financial services, greater efficiency, increased convenience, or potentially reduced transaction costs. The question of fintech companies operating through industrial loan company (ILC) charters requires careful consideration. As you know, the Federal Reserve does not supervise ILCs or their holding companies.

The Office of the Comptroller of the Currency's (OCC) proposed special purpose national bank charter raises interpretive and policy issues for the Federal Reserve Board (Board), for example, questions relating to Federal Reserve membership, status under the Bank Holding Company Act, access to Federal Reserve accounts and services, or access to the discount window. The Board would have to analyze these issues closely if any fintech firm was to obtain a special purpose national bank charter.

3. During your testimony, in response to my question about consolidation making it harder for small banks to compete, you said that your concern was investment in local communities and that as branches are acquired in rural communities, home investment in the community tends to be dissipating.

- **What actions is the Fed taking to ensure that acquiring banks continue to invest in communities where all acquired branches are located?**

- **How will you ensure that banks distribute their investments in all communities, not only the location in which the charter is held?**

- **Would you support requirements for banks to continue to invest in these communities after an acquisition?**

My interest is to see credit flowing to consumers and businesses in all communities consistent with safe and sound lending. This includes meeting credit needs in low- and moderate-income areas and furthering economic development and financial inclusion. The Community Reinvestment Act (CRA) is one of the tools we have to accomplish this goal. The CRA encourages banks to serve their entire community, in particular the credit needs of low- and moderate-income communities. To ensure that this is accomplished, the Federal Reserve evaluates the records of state member banks in helping to meet the credit needs of their communities. The CRA regulations define a bank's "assessment area" -- the area within which we evaluate their CRA performance -- as those areas around the bank's branches and deposit-taking ATMs. We are currently in discussions with the OCC and Federal Deposit Insurance Corporation (FDIC) regarding possible revisions to the CRA regulations. One aspect of the regulation that we are discussing is a better way to delineate the community served by a bank to provide better incentives for providing credit in every assessment area, not just its major markets.

When two banks merge, we evaluate the CRA performance of the resulting bank in all the areas where they retain a branch presence. In evaluating the convenience and needs of the communities to be served following a merger, an institution's most recent CRA performance evaluation is a particularly important consideration in the applications process because it represents a detailed on-site evaluation of the institution's performance under the CRA by its appropriate federal supervisor. In addition to CRA performance, Federal Reserve System staff considers recent actions taken to improve CRA performance, comments submitted by interested parties and the applicant's response to those comments, and the potential effects of the proposal on the convenience and needs of the communities to be served.

4. In your remarks at the Conference of State Bank Supervisors in April, you said that "we must continue to ensure that the institutions we supervise are proactively managing their risks to remain strong" and that "it's the [financial supervisors'] job to identify emerging risks to community banks and to ensure bankers are identifying and managing their risks appropriately."

- **What are the emerging risks to community banks today?**

Despite generally favorable economic and financial conditions, community banks continue to manage a moderate level of risk. Some emerging risks include cybersecurity, deposit competition, and agricultural and commercial real estate (CRE) lending.

Cybersecurity continues to be an area of elevated risk across the banking system as threats evolve and the banking industry continues to face challenges in establishing and maintaining adequate cyber defenses. Threat actors are active and innovative in seeking ways to exploit weaknesses in people, processes, and technology.

Agricultural-based lending remains an area of concern. Net farm income has declined since 2012 and continues to be an issue. Low commodity prices, trade uncertainty, and recent unfavorable weather conditions in the Midwest have added to an already challenging situation. Lower incomes and increasing debt-servicing costs are impacting borrowers management of operational debt. Weaknesses in credit at agricultural banks can be seen in the form of carryover debt from prior operating years, increasing levels of non-performing assets, and modest increases in the number of problem banks with significant agriculture-related exposure.

CRE risk is an area of elevated risk, mainly due to the widening gap between real estate values and property income used to service outstanding debt. For most property types, the primary driver of price appreciation appears to be new investor demand rather than increasing rents or other property-level fundamentals.

- **Please describe what specific proactive measures the Fed is taking to ensure that banks are managing these risks.**

With respect to these risks, the Federal Reserve has adopted common work programs to help examiners assess overall IT operations, including cyber security of community banks. The Federal Reserve also has included mandatory training for all community bank examiners in the area of IT in order to consistently identify and provide feedback to the banks supervised by the Federal Reserve.

Building on earlier supervisory guidance on managing agricultural lending, the Federal Reserve has sponsored a number of training and educational opportunities for examiners. In addition, the Federal Reserve closely monitors and provides updates on farming conditions and agricultural lending conditions to examiners.

As discussed in SR letter 19-9, Bank Exams Tailored to Risk (BETR), the Federal Reserve has revised its procedures for credit and liquidity risk to better identify risk and tailor exam procedures based on the risk profile of a particular bank. CRE concentrations and a bank's use of volatile funding sources are among the factors that examiners consider in determining whether a bank's activity is low, moderate, or high risk, which will determine the procedures examiners will complete during the examination.

- **What additional steps should the Fed take to address these risks?**

With respect to cybersecurity, we continue to review our program and have placed a high priority on building our expertise to ensure we and the institutions we supervise understand and manage the associated risk. With respect to agriculture lending, the Federal Reserve will continue to gather current information on industry factors that (1) affect the ability of farm producers to repay loans, (2) influence collateral values, and (3) affect the ability of producers and banks to hedge potential losses. We will continue to focus on examining banks with concentrations in agricultural lending, with particular emphasis on ensuring banks hold capital commensurate with their portfolio compositions. And, as mentioned, with respect to CRE concentrations, this remains to be an area of focus.

5. In your capacity as community bank designee, what is your definition of a community bank?

- **What is the largest firm, by assets, that you consider to be a community bank?**

- **In how many states can a bank operate and still be considered a community bank?**

- **Are there any financial activities that you think disqualify a firm from inclusion as a community bank?**
- **What is the maximum number of distinct subsidiaries and affiliates at a bank or bank holding company that you would still consider to be a community bank?**

There are a number of statutory definitions for community banking organizations, but the Board uses $10 billion in total assets as the threshold for its supervisory and regulatory purposes. It is my view that $10 billion is a reasonable ceiling. However, various statutes tailor requirements for community banks using differing threshold. For example, the Small Bank Holding Company policy statement provides relief for firms under $3 billion, while banks under $10 billion would be eligible for Community Bank Leverage Ratio.

While no formal restriction on financial activities exists that would disqualify a firm from being considered a community bank, community banks tend to have more traditional, low-risk banking operations. Additionally, there is no formal limit on the number of subsidiaries and affiliates a community bank may have and no restrictions exist on the number of subsidiaries and affiliates, according to the Federal Reserve's current operating practices. That said, as noted above, community banks tend to have simpler banking operations than large banks.

In general, I do not believe a community bank should be defined by the number of states in which it operates. Rather, a bank's size, risk profile, capacity, and complexity, tend to be more important factors.

6. If confirmed to a full 14-year term, what will be your top priorities as a member of the Board of Governors that serves as the community bank designee?

My top priority as a member of the Board of Governors will continue to be fulfilling the vital responsibilities Congress has given us: to support full employment and stable prices, regulate and supervise the banking system to ensure it remains safe and sound, enforce consumer protection laws that require everyone be treated fairly, and carry out the Board's important payments-related responsibilities.

As the first governor to fill the role the Congress designated for someone with community banking experience on the Board, I will continue to travel widely and listen closely to community bankers, consumers, small-business owners, and community leaders. I will make sure these diverse perspectives are represented in the Federal Reserve's deliberations and decisionmaking on both monetary policy and regulatory matters.

As I noted in my testimony, I firmly believe that, as regulators, we need to ensure that we are not imposing unnecessary burdens on community banks. That is why one of my priorities as governor has been to tailor appropriately our supervision and regulation to the size, complexity and capacity and risks posed by an institution. To further this effort, I recently formed a working group of experts from across the Federal Reserve System to launch a comprehensive review of our supervisory work with smaller, regional and community banks.

In carrying out each of my responsibilities, I am committed to accountability, transparency, and clear communication.

7. Systemic regulatory failures, like the savings and loan crisis and 2008 financial crisis, have been the largest contributors to community bank failures over the last 30 years. What actions are you taking to ensure that excessive risk-taking in corporate debt will not result in harm to the financial sector broadly and community banks specifically?

Widespread failures of community banks are indeed risks to economic growth, particularly in the communities they serve. The wave of community bank and savings and loan failures in the late 1980s and early 1990s was a strong headwind to the economy, requiring coordinated action by Congress and bank regulatory agencies. We absolutely want to avoid the need for such extraordinary measures in the future.

Community banks emerged from the financial crisis substantially more resilient than they were in the pre-crisis period. Their regulatory capital ratios are higher, and they now rely more on capital instruments with greater loss absorbency. There is no substitute for high quality capital in limiting stress on institutions from the risks they take in the normal course of the bank. The use of wholesale funding -- another source of pressure during stressful periods -- by community banks remains significantly below the levels that were typical prior to the financial crisis. We continue to closely monitor the solvency and liquidity risks among community banks.

Community banks traditionally have little exposure to leveraged loans, and legal lending limits combined with the minimum participation sizes would limit most banks of that size from becoming significantly active in that market. Community banks are exposed to the small business sector as well as unincorporated businesses through traditional commercial and industrial lending. The current credit performance in the small business sector is quite strong, and during the past two downturns, small business lending has not generated outsized losses after accounting for the size of the economic contraction. We also closely monitor community banks that do have high concentrations of business-related debt to ensure they have appropriate risk management processes in place.

That said, some community banks do have significant concentrations of CRE loans. We pay close attention to this sector, because it has played a role in previous episodes of widespread banking stress. The Commercial Real Estate Guidance issued in 2007 includes expectations that banks with concentrations in CRE have in place enhanced risk management programs, and the fraction of banks with large CRE concentrations is much lower than it was heading into the 2008 financial crisis. Moreover, our financial stability assessment highlights the attention we have given to CRE prices and lending standards. We will continue to closely monitor this sector as well as supervised banks with concentrated exposure to CRE.

8. Are you concerned that the deregulation of foreign banking organizations (FBOs) as proposed in April will create additional competitive pressures on community banks? Are FBOs direct competitors with community banks in activities like small business and residential mortgage lending? If not, what activities do FBOs engage in that distinguish their business and risk profile from community banks?

Most branches and agencies of foreign banks are not direct competitors of community banks, as foreign banking organizations (FBOs) tend to have a wholesale business model focused on large borrowers and home country customers operating in the U.S. FBOs generally engage in limited residential mortgage lending, most of which flows to employees of the bank.

Some U.S. commercial banks owned by FBOs may directly compete with community banks. Of the 4,751 commercial banks operating in the U.S. as of year-end 2018, FBOs operate 39 of them.

Attachment #1

Below, please see a list of individuals and groups that I have met with in my capacity as a member of the Board of Governors of the Federal Reserve System. I also met with White House staff as part of my nomination process. Between November 15, 2018, and January 2019, all of my meetings were with individuals or groups affiliated with the Federal Reserve.

January 2019

January 7	Americans for Financial Reform
January 8	Federal Reserve Board/Council of Economic Advisers Luncheon
January 9	American Bankers Association (ABA) Economic Advisory Committee
January 9	Call with Rob Nichols, President and CEO, ABA
January 18	Joseph M. Otting, Comptroller of the Currency

February 2019

February 5	Federal Reserve Board/Council of Economic Advisers Luncheon
February 5	Call with Rob Nichols, President and CEO, ABA
February 6	Prof. Joachim Wuermeling, Bundesbank
February 7	Rebeca Rainey, President and CEO of the Independent Community Bankers of America (ICBA) & Cam Fine, President and CEO of Calvert Advisors, LLC
February 11	Speech to ABA Community Banker Conference, San Diego
February 13	Treasury Borrowing Advisory Committee Meeting
February 15	Conference of State Bank Supervisors
February 15	Rebeca Rainey, President and CEO of ICBA & Karen Thomas, Vice President of Government Relations and Public Policy of ICBA
February 22	International Monetary Fund (IMF) Lunch
February 25	Call with NeighborWorks
February 26	NeighborWorks America Board Meeting
February 28	Call from Rob Nichols, President and CEO, ABA
February 28	ABA State Bankers Meeting – Ohio

March 2019

March 5	Federal Reserve Board/Council of Economic Advisers Luncheon
March 7	Meeting of Board members and staff with Marcus Brunnermeier, Princeton University; Monica de Bolle, Johns Hopkins University; Gita Gopinath, IMF; Rick Mishkin, Columbia University; Adam Posen, Peterson Institution; and Kenneth Rogoff, Harvard University
March 8	ABA State Bankers Meeting – Delaware
March 12	Ashwini Tewari, U.S. Head of Operations, State Bank of India
March 13	Communications Workers of America's Committee on Better Banks
March 13	California Reinvestment Coalition
March 22	Call with Marietta Rodriguez, CEO, NeighborWorks America
March 25	National Agricultural Credit Conference
March 25	Congressman Ben McAdams (UT)
March 25-26	National Agriculture Credit Conference
March 26	Congressman Blaine Luetkemeyer (MO)

March 27	Tour Project Vida and Discussion with Program Supervisors
March 28	Ag Lenders Conference, sponsored by the Independent Community Bankers Association of New Mexico
March 28	Farm Tour Locations: Billy the Kid Produce; New Mexico Chili Products; Luna Rossa Winery

<u>April 2019</u>

April 1	Board lunch with IMF Staff
April 1	Senator Ron Johnson (WI)
April 2	Congressman Emanuel Cleaver (MO)
April 2	Federal Reserve Board/Council of Economic Advisers Luncheon
April 2	Conference of State Bank Supervisors Listening Session and Dinner Remarks
April 4	Karen Lawson, Director, Office of Banking for the Michigan Department of Insurance and Financial Services
April 4	Richard Trumka and members of the Executive Council of the AFL-CIO
April 5	Community Depository Institution Advisory Council
April 8	Congressman Bryan Steil (WI)
April 8	Congressman Frank Lucas (OK)
April 9	CFPB Director Kathy Kraninger
April 10	Meeting with Santa Rosa and Sonoma County Leaders Participants: Michael Gossman, Director of the Sonoma County Office of Recovery and Resilience; David Guhin, Director of Santa Rosa Planning and Economic Development; Albert Lerma, Director of Business Development and Innovation at the Sonoma County Economic Development Board; Peter Rumble, CEO of the Santa Rosa Metro Chamber of Commerce; Tom Schwedhelm, Mayor of Santa Rosa; Ben Stone, Executive Director of Sonoma Economic Development Board; Margaret Van Vliet, Executive Director of the Sonoma County Community Development Commission; Tennis Wick, Director of the Sonoma County Permit and Resource Management Department
April 10	Charlie Hall, CEO, Alta-Pacific Bank
April 10	Jan Lynn Owen, Commissioner, California Department of Business Oversight
April 10	San Francisco Community Bank Panel Participants: Bruce Farrell, Liberty Bank; Walter Kaczmarek, Heritage Bank; Keith Wilson, Heritage Bank; Steve Heitel, Presidio Bank; Chris Courtney, Oak Valley Bank
April 11	Twelfth District Economic Advisory Council Meeting
April 11	"Fed Family" Luncheon at the Federal Reserve Bank of San Francisco
April 12	Andy Ryback, President and CEO, Plumas Bank
April 12	NeighborWorks Tour Locations/Executives: Tenderloin Neighborhood Development Corporation, Donald Falk, CEO; Chinatown Community Development Center, Norman Fong, Executive Director
April 15	FDIC Chairman Jelena McWilliams
April 15-16	NeighborWorks Board meeting

April 25	Call with Grovetta Gardineer, Senior Deputy Comptroller for Bank Supervision Policy, Office of the Comptroller of the Currency
April 26	Call with FDIC Chairman Jelena McWilliams

May 2019

May 2	Jennifer Burns, Associate Professor of History, Stanford University; Research Fellow, Hoover Institution
May 2	Brian Sack, Director of Global Economics, D.E. Shaw Group
May 3	2019 Hoover Institution Monetary Policy Conference
May 6	Risk Management Association Community Bank Council Meeting
May 7	Martin J. Gruenberg, member, FDIC Board of Directors
May 7-8	Joint Meeting of Audit Committee Chairs and General Auditors
May 8	Treasury Borrowing Advisory Council
May 8	Senator Chris Van Hollen (MD)
May 9	ABA State Bankers Meeting – Georgia
May 9	Congressman David Scott (GA)
May 9	Senator Richard Shelby (AL)
May 14	Opportunity Finance Network
May 14	ABA State Bankers Meeting – Tennessee
May 14	Sen. Tina Smith (MN)
May 15	National Association of Homebuilders
May 16	Senator Thom Tillis (NC) and Senator Jerry Moran (KS)
May 21	ABA State Bankers Meeting – Kentucky
May 22	Meeting of Board Members and Staff with Hayley Boesky, Bank of America Merrill Lynch; Joyce Chang, JP Morgan; Paul Harrison, DCI; Prakash Melwani, Blackstone; Jason De Sena Trennert, Strategas; Mark Wiedman, Blackrock
May 22	Senator Mike Crapo (ID)
May 29	Regional Banking Executives Roundtable Discussion Participants: Phil Green, Cullen/Frost Bankers, Inc. and Frost Bank; Archie Brown, Jr., First Financial Bankcorp and First Financial Bank; Kevin Riley, First Interstate Bancsystem; Michael Scudder, First Midwest Bancorp Inc.; Jim Reuter, FirstBank Holding Company; Steven Gardner, Pacific Premier Bancorp, Inc.; George Markis, Jr., Simmons First National Corp.; Richard Adams, Jr., United Bankshares, Inc.; Kenneth Vecchione, Western Alliance Bancorporation

June 2019

June 5	Senate Banking Committee Nomination Hearing
June 6	Douglas Elliot, Partner, Oliver Wyman
June 11	Senator Sherrod Brown (OH)

Committee on Banking, Housing, and Urban Afl
Nomination Hearing
June 5, 2019

Questions for Ms. Michelle Bowman, to be a Member of the Board of Governors of the Federal Reserve System, From Senator Thom Tillis:

1) The Federal Reserve's (Fed) regulatory approach to inter-affiliate margin transactions is an outlier. The margin requirements have the effect of locking up capital that could otherwise be used for economic growth and they discourage centralized risk management practices among firms. In addition, the current approach results in the movement of collateral out of the US insured depository institutions. These are all suboptimal policy outcomes. Regulatory authorities in the European Union, Japan, and most other G20 jurisdictions each currently provide such an exemption for these transactions. You have indicated you are aware of the issue but, to date, I've seen no official action from the Fed to fix the problem.

The recognition for the need for an exemption began under regulators nominated by President Obama. In 2013, CFTC Chairman Gary Gensler provided an exemption for central clearing and trade execution. In 2015, CFTC Chairman Tim Massad provided an exemption, determining that initial margin was not warranted and it was a "very costly and not very effective way" to enhance risk management. Yet, the Fed did not provide an exemption from initial margin in the 2016 margin rules, and as a result, as of the end of last year, US banking entities collected nearly $50 billion in initial margin from their own affiliates. In 2017, the Treasury Department noted that this rule puts US firms at a disadvantage both domestically and internationally, recommending that your agencies provide an exemption consistent with the margin requirements of the CFTC.

A. Do you agree that an exemption from initial margin is appropriate for inter-affiliate transactions?

B. Will you prioritize a rule to provide an exemption for inter-affiliate transactions, separate from any broader regulatory effort such as a Regulation W rewrite?

C. Please provide an explicit timeline for when the Fed will take action.

2) The reason a "Reg W" rewrite is suboptimal is that it will be counter-productive and slow. Most believe it will take 5 to 6 years to complete. This capital needs to be released soon because we have geopolitical risk emerging over the world that could destabilize markets. If we have a Brexit, the number of entities will double and more capital will be unfairly sequestered. With potential trade volatility, Middle East uncertainty, and other risks, our banks need to be able to use capital for risk management, not have it trapped for no reason.

A. Could a Reg W action be done outside of providing an exemption?

B. Please explain any reasoning for not allowing this exemption this year.

3) In October of last year, the Fed issued a request for public comment on "actions the Federal Reserve could take to support faster payments in the United States." We understand the Fed has been working collaboratively with the banks and other private-sector stakeholders for years on how best to facilitate faster payments. As Chairman Powell noted at a recent press conference, the Fed has thus far been "more of a convener, bringing industry and the public and public interest groups . . . around the table and . . . playing a constructive role" in encouraging the private sector in this area. In October, however, the Fed issued a request for public comment indicating that it will probably enter the market for faster payments as a direct competitor of the private sector solutions with its own Real-Time Gross Settlement" (RTGS) system.

A. Is it possible the Fed's proposal could hamper and delay, rather than facilitate, the arrival of real-time payments?

B. Please explain why the Fed is proposing the creation of a government-run real-time payments system when the private sector has already created one that is up and running?

C. The Fed's own policy statement on "The Federal Reserve in the Payments System" requires that the Fed satisfy three conditions before proposing a new service. Among those is a finding that the private sector "cannot be expected to provide such service with reasonable effectiveness, scope, and equity." Has the Fed made this finding, and, if so, on what grounds was it made?

D. How long would it take for the Fed to create its real-time system?

E. Would the Fed's proposed RTGS and the existing private sector real-time payments network be interoperable and, if so, why – specifically - do you believe that will be the case?

F. If you believe the systems would interoperate, would such interoperability require the private sector system to significantly alter its current design?

4) My understanding is that the Fed seeks to justify this potential action in part on a perceived need for "resiliency". The notion that having two systems would provide resiliency necessarily assumes that every bank in the country (or at least an overwhelming majority of them) would have to connect to two systems: the private sector system and the yet-to-be-built government-run system, which would create enormous inefficiencies and impose needless costs on the American taxpayer and the private sector.

A. Have you done any cost-benefit analysis, particularly in light of the other faster payment options currently in the market that already serve as near substitutes, like payments over the card networks, same-day ACH, PayPal, Venmo, Zelle, Fedwire Funds Service itself, to determine whether or not this proposal makes any sense?

B. Doesn't the Fed already regulate and supervise the private sector real-time payments operator, which we understand has an impressive track record for resiliency, operating with multiple data centers, redundant systems, etc? Are you contending that your regulatory and supervisory powers over the private sector operator are deficient in terms of your supervising the private sector's plans to ensure resiliency?

C. In light of the recent Fedwire Funds outage, which we understand came at a critical part of the day when private sector settlement relies on Fedwire, should the Fed's resiliency focus perhaps be on the Fedwire Funds system, which has vital systemic importance, rather than committing time and resources to standing up new infrastructure that may or may not provide resiliency?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

MICHELLE W. BOWMAN
MEMBER OF THE BOARD

June 14, 2019

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the June 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Michelle Bowman

Enclosure

[1] Questions for the record related to this hearing were received on June 7, 2019.

E-MAIL: MIKI.BOWMAN@FRB.GOV • TELEPHONE: 202-452-3211 • FACSIMILE: 202-728-5860

Questions for The Honorable Michelle Bowman, Governor of the Board of Governors of the Federal Reserve System, from Senator Tillis:

1. The Federal Reserve's (Fed) regulatory approach to inter-affiliate margin transactions is an outlier. The margin requirements have the effect of locking up capital that could otherwise be used for economic growth and they discourage centralized risk management practices among firms. In addition, the current approach results in the movement of collateral out of the US insured depository institutions. These are all suboptimal policy outcomes. Regulatory authorities in the European Union, Japan, and most other G20 jurisdictions each currently provide such an exemption for these transactions. You have indicated you are aware of the issue but, to date, I've seen no official action from the Fed to fix the problem.

The recognition for the need for an exemption began under regulators nominated by President Obama. In 2013, CFTC Chairman Gary Gensler provided an exemption for central clearing and trade execution. In 2015, CFTC Chairman Tim Massad provided an exemption, determining that initial margin was not warranted and it was a "very costly and not very effective way" to enhance risk management. Yet, the Fed did not provide an exemption from initial margin in the 2016 margin rules, and as a result, as of the end of last year, US banking entities collected nearly $50 billion in initial margin from their own affiliates. In 2017, the Treasury Department noted that this rule puts US firms at a disadvantage both domestically and internationally, recommending that your agencies provide an exemption consistent with the margin requirements of the CFTC.

- **Do you agree that an exemption from initial margin is appropriate for inter-affiliate transactions?**

The Board is actively discussing this aspect of the rule with the other prudential regulators. The goal is to assess what, if any, changes can be made consistent with the statutory directive that margin requirements help ensure the safety and soundness of covered swap entities and are appropriate for the risk associated with non-cleared swaps.

- **Will you prioritize a rule to provide an exemption for inter-affiliate transactions, separate from any broader regulatory effort such as a Regulation W rewrite?**

- **Please provide an explicit timeline for when the Fed will take action.**

Discussions with the other prudential regulators as mentioned above are separate and apart from any broader regulatory efforts. While I am not able to provide a specific timeline for you, we will strive to address the issue as soon as possible as we coordinate with other relevant agencies.

2. The reason a "Reg W" rewrite is suboptimal is that it will be counter-productive and slow. Most believe it will take 5 to 6 years to complete. This capital needs to be released soon because we have geopolitical risk emerging over the world that could destabilize markets. If we have a Brexit, the number of entities will double and more capital will be unfairly sequestered. With potential trade volatility, Middle East uncertainty, and other

risks, our banks need to be able to use capital for risk management, not have it trapped for no reason.

- **Could a Reg W action be done outside of providing an exemption?**

The swap margin rule, codified in the Board's Regulation KK, is different than and separate from Regulation W. I understand this question to be asking about the treatment of inter-affiliate transactions in the swap margin rule. The swap margin rule requires that a covered swap entity collect initial margin from an affiliate. If the Board were to change this requirement, it would do so through the normal public notice and comment rulemaking process consistent with the Administrative Procedure Act.

- **Please explain any reasoning for not allowing this exemption this year.**

While we are actively discussing this aspect of the rule with the other prudential regulators, I am not able to confirm a timeline on the result of our collaboration. I understand the importance of moving as quickly as possible.

3. In October of last year, the Fed issued a request for public comment on "actions the Federal Reserve could take to support faster payments in the United States." We understand the Fed has been working collaboratively with the banks and other private-sector stakeholders for years on how best to facilitate faster payments. As Chairman Powell noted at a recent press conference, the Fed has thus far been "more of a convener, bringing industry and the public and public interest groups . . . around the table and . . . playing a constructive role" in encouraging the private sector in this area. In October, however, the Fed issued a request for public comment indicating that it will probably enter the market for faster payments as a direct competitor of the private sector solutions with its own Real-Time Gross Settlement" (RTGS) system.

- **Is it possible the Fed's proposal could hamper and delay, rather than facilitate, the arrival of real-time payments?**

In its 2018 Federal Register Notice (2018 Notice) request for public comment, the Board of Governors (Board) requested feedback on the impact of Federal Reserve action(s) in faster payments settlement. In particular, the 2018 Notice specifically asked whether Federal Reserve action would help or hinder adoption of faster payment services by the financial services industry. This matter is still pending before the Board, and we are carefully reviewing the comments received.

- **Please explain why the Fed is proposing the creation of a government-run real-time payments system when the private sector has already created one that is up and running?**

The Federal Reserve has not committed to any action at this time. Any decision made by the Board will consider carefully the importance of the views of the private sector on this issue.

- **The Fed's own policy statement on "The Federal Reserve in the Payments System" requires that the Fed satisfy three conditions before proposing a new service.**

Among those is a finding that the private sector "cannot be expected to provide such service with reasonable effectiveness, scope, and equity." Has the Fed made this finding, and, if so, on what grounds was it made?

The Board has not made a determination at this time. However, throughout the Board's deliberations, it will adhere to the requirements of the Federal Reserve Act, the Monetary Control Act (MCA) and longstanding Federal Reserve policies and processes.

- **How long would it take for the Fed to create its real-time system?**

At this time, the Federal Reserve has not committed to any action. If the Board determines to pursue a Real-Time Gross Settlement (RTGS) service for faster payments, a subsequent Federal Register notice would be issued that outlines additional details of the proposed service.

- **Would the Fed's proposed RTGS and the existing private sector real-time payments network be interoperable and, if so, why – specifically - do you believe that will be the case?**

The Board's request for comment asked for feedback on several areas, including interoperability with existing or potentially new Real-Time Gross Settlement (RTGS) service providers. Various commenters responded to such questions. The Board is assessing these comments and seriously taking them into account.

- **If you believe the systems would interoperate, would such interoperability require the private sector system to significantly alter its current design?**

As I mentioned above, the Board is reviewing the comments received on the proposal, including those comments on interoperability, and will take this feedback into account throughout its deliberation.

4. My understanding is that the Fed seeks to justify this potential action in part on a perceived need for "resiliency". The notion that having two systems would provide resiliency necessarily assumes that every bank in the country (or at least an overwhelming majority of them) would have to connect to two systems: the private sector system and the yet-to-be-built government-run system, which would create enormous inefficiencies and impose needless costs on the American taxpayer and the private sector.

- **Have you done any cost-benefit analysis, particularly in light of the other faster payment options currently in the market that already serve as near substitutes, like payments over the card networks, same-day ACH, PayPal, Venmo, Zelle, Fedwire Funds Service itself, to determine whether or not this proposal makes any sense?**

The Board is considering the comments of the broad range of stakeholders throughout its deliberation, including the points you raise on resiliency and costs. We note that the Monetary Control Act of 1980 requires that Federal Reserve services must be priced to recover actual expenses associated with providing the services as well as certain imputed costs, including the taxes and cost of capital that would be paid by a private sector competitor. Importantly, the

Board is considering the comments from the broad range of stakeholders throughout its deliberation.

- **Doesn't the Fed already regulate and supervise the private sector real-time payments operator, which we understand has an impressive track record for resiliency, operating with multiple data centers, redundant systems, etc? Are you contending that your regulatory and supervisory powers over the private sector operator are deficient in terms of your supervising the private sector's plans to ensure resiliency?**

The Board does not have plenary regulatory or supervisory authority over the U.S. payment system. Rather, the Board has limited authority to influence the operations of private sector retail payment services providers in certain circumstances and pursuant to specific laws. For example, assuming the private sector operator is subject to the Bank Service Company Act (BSCA), the Board and other federal banking agencies would have authority to regulate and exam third party service providers that perform certain services for depository institutions that the agencies regulate. The BSCA, however, does not grant enforcement authority to the Board or other federal banking agencies over the third party service providers.

- **In light of the recent Fedwire Funds outage, which we understand came at a critical part of the day when private sector settlement relies on Fedwire, should the Fed's resiliency focus perhaps be on the Fedwire Funds system, which has vital systemic importance, rather than committing time and resources to standing up new infrastructure that may or may not provide resiliency?**

I recognize the critical role that the Fedwire Funds Service plays in the financial system. Maintaining and enhancing the resilience of this service is, and will continue to be, an area of focus for the Board. The Board, through its oversight of the Reserve Banks, holds the Fedwire Funds Service to the standards included in Part 1 of the Federal Reserve Policy on Payment System Risk, which include robust operational resilience expectations. These expectations are consistent with the international standards applicable to systemically important financial market infrastructures operated by the private sector. The Federal Reserve Banks strive to not just meet these standards, but to continuously strengthen Fedwire Funds' resiliency posture, and doing so will remain an ongoing area of focus.

The Fedwire Funds Service has historically provided a very high level of operational reliability. Having responded to the outage's immediate cause, efforts are underway to identify, understand, and respond to the outage's proximate causes so that the same high levels of operational reliability continue going forward.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Catherine Cortez Masto:

1) How much of the wage gains reported by the Federal Reserve researchers, especially those of those with a high-school education are less, are due to increases in the minimum wage at the state and local level and how much to market forces?

2) Does the Federal Reserve have data showing the wage gain impacts for workers with less than a college degree by state? If so, does that wage data differentiate between states with higher minimum wages and/or stronger unions?

3) Press reports that federal bank regulators have formed an interagency working group to consider increasing their coordination in assessing cybersecurity at large banks. Are these press accounts accurate? What do the bank regulators plan to do to assess cybersecurity at large banks?

4) The Federal Reserve Board has said it would consider on a case-by-case basis whether to allow a recipient of the OCC fintech charter to obtain direct access to the Federal Reserve payment systems. But the Federal Reserve Act requires national banks to become members of the Federal Reserve System and to become insured by the FDIC. Given that the recipient of a fintech charter would not be eligible for and could not obtain FDIC insurance, why would the decision as to whether to allow a fintech charter recipient to obtain a master account be made on a case-by-case basis?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 5, 2019

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome Powell, Chair, Board of Governors of the Federal Reserve System from Senator Cortez Masto:

1. How much of the wage gains reported by the Federal Reserve researchers, especially those of those with a high-school education are less, are due to increases in the minimum wage at the state and local level and how much to market forces?

Many factors affect the wages of individuals with differing levels of education. There is no consensus regarding their relative importance, but some of the factors cited by economists include minimum wages, the strength of unions, globalization, demographic change, hidden labor market slack (that is, the low labor force participation rate), rising employer concentration (which gives an employer more bargaining power in a given labor market), and an increase in the prevalence of non-compete and anti-poaching agreements. As a result, it is difficult to determine with any precision how much of the increase in wages of less educated workers over the past few years is due to an improving labor market and how much is due to increases in minimum wages or other factors.

2. Does the Federal Reserve have data showing the wage gain impacts for workers with less than a college degree by state? If so, does that wage data differentiate between states with higher minimum wages and/or stronger unions?

Yes, the wage data for workers with less than a college degree, which are collected as part of the Current Population Survey conducted by the Census Bureau and the Bureau of Labor Statistics, are available by state.[2] Comparing wage changes across states can be difficult, given the many variables that affect wages.

3. Press reports that federal bank regulators have formed an interagency working group to consider increasing their coordination in assessing cybersecurity at large banks. Are these press accounts accurate? What do the bank regulators plan to do to assess cybersecurity at large banks?

The acceleration of cybersecurity risk management is a top supervisory priority for federal regulatory agencies, as it has implications for the safe and sound operations of financial institutions as well as financial stability. To that end, an interagency goal is to improve regulatory harmonization and the supervision of cybersecurity through better coordination of examinations at large financial institutions and to be more efficient with the use of resources. As such, a joint interagency cybersecurity examination is being planned. The Federal Reserve is currently working with the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC), and we are in early stages of developing an approach for a joint risk-based assessment of cybersecurity at large financial institutions.

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[2] See https://www.census.gov/programs-surveys/cps/data-detail.html.

4. The Federal Reserve Board has said it would consider on a case-by-case basis whether to allow a recipient of the OCC fintech charter to obtain direct access to the Federal Reserve payment systems. But the Federal Reserve Act requires national banks to become members of the Federal Reserve System and to become insured by the FDIC. Given that the recipient of a fintech charter would not be eligible for and could not obtain FDIC insurance, why would the decision as to whether to allow a fintech charter recipient to obtain a master account be made on a case-by-case basis?

As Governor Brainard has indicated in prior remarks,[3] the OCC's proposal raises interpretive legal and policy issues for the Federal Reserve regarding whether charter recipients would become Federal Reserve members or have access to Federal Reserve accounts and services. As you note, the Federal Reserve Act does require national banks to become members of the Federal Reserve System and to be insured by the FDIC. Currently, however, certain types of national banks that do not accept insurable deposits, such as trust banks, are members. Given the breadth of potential applicants for the OCC's special purpose charter, each applicant receiving such a charter would require the Board to determine, as a threshold question, whether the facts and circumstances of that particular applicant should cause the applicant to be eligible for membership or Reserve Bank services under the Federal Reserve Act.

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[3] See, e.g., Lael Brainard, Where do Banks Fit in the Fintech Stack (April 28, 2017), https://www.federalreserve.gov/newsevents/speech/files/brainard20170428a.pdf; Lael Brainard, Where do Consumers Fit in the Fintech Stack (Nov. 16, 2017), https://www.federalreserve.gov/newsevents/speech/files/brainard20171116a.pdf.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Doug Jones:</u>

1) A reality of our economic system is that unemployment rates for African-Americans are stubbornly and consistently higher than for white workers.

There are innumerable structural and historical reasons for this reality, but the fact is that it is true, and it is persistent.

A. Knowing this, do you believe it is appropriate for the Federal Reserve to consider this disparity when developing monetary policy and especially when determining proper metrics for "full employment," especially at a time when inflation risk has waned?

B. Do you believe the Federal Reserve possesses the monetary policy tools available to continue to lower unemployment in communities that have been historically left behind in our labor markets?

2) I believe an important question with critical importance to my constituents is if the nature of inflation has in any way changed in our modern economy.

I understand there may be no perfect measure of inflation, but for millions of people, young and old, official inflation measures do not seem to align with their view of the economy.

Inflation, officially, is low and steady.

But for three of the largest expenses in a modern family's budget – housing, health care, and education – there have been year after year of cost growth that outpace our official inflation measures.

A. I know that policymakers at the Federal Reserve are aware of these trends, but do you believe our current inflation measurements are accurately capturing cost increases in these critical areas?

B. And what are the consequences in the long term of these core items continually outpacing overall inflation?

3) In the bipartisan Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155), one of the provisions directed at relieving regulatory burden for community institutions allowed for small depository institutions to file streamlined Call Reports.

As the Federal Reserve and other prudential regulators have worked to finalize these rules, we have heard concerns from Alabama institutions that the final rules do not ultimately streamline the reports in a meaningful manner – and many of the reporting requirements that were removed had little impact on small institutions.

A. What input from community institutions did the Federal Reserve take while finalizing the rule, and does the Federal Reserve have plans to revisit and further streamline the call reports, consistent with S. 2155?

4) As you know, the Federal Reserve has begun the process of reviewing and fine-tuning the regulation of the U.S. operations of international banks. I believe the Federal Reserve's initial efforts are largely positive, and in many aspects, show an appropriate understanding of the importance of international banks to our domestic economy, while balancing the need to effectively regulate these institutions based on their individual risks.

However, there are certain aspects of the proposed rules which I believe deserve further attention.

A. First, when considering whether to include inter-affiliate transactions as part of the risk-based factors that the Federal Reserve considers for international institutions, given that these transactions are conducted wholly within the bank, what are the risk factors that led Federal Reserve to the decision to exempt these transactions for domestic institutions, but not international institutions?

B. Second, when considering the proper measure of a U.S. Intermediate Holding Company's (IHC) overall domestic profile, what factors led the Federal Reserve to determine that both the IHC's assets, as well as the assets of the international institution's U.S. branch, should be combined for purposes of applying liquidity requirements? As you know, IHC's are purposefully structured as a legal entity that is separate than the U.S. branch.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 5, 2019

The Honorable Doug Jones
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

[1] Questions for the record related to this hearing were received on July 22, 2019.

<u>Questions for The Honorable Jerome Powell, Chair, Board of Governors of the Federal Reserve System from Senator Doug Jones:</u>

1. A reality of our economic system is that unemployment rates for African-Americans are stubbornly and consistently higher than for white workers.

There are innumerable structural and historical reasons for this reality, but the fact is that it is true, and it is persistent.

A. Knowing this, do you believe it is appropriate for the Federal Reserve to consider this disparity when developing monetary policy and especially when determining proper metrics for "full employment," especially at a time when inflation risk has waned?

The benefits of the current economic expansion have been broadly shared, and the long expansion in economic activity has also lessened the employment disparities across demographic groups. For example, the unemployment rate for African Americans, although still above the rate for other groups, has noticeably narrowed its gap with the white unemployment rate and is now near the lowest readings since the Bureau of Labor Statistics began publishing this data series in the early 1970s. That said, there are long-standing disparities in unemployment rates across different segments of the population that the Federal Reserve does not have the tools or the mandate from Congress to address. Progress to further narrow these long-standing disparities in labor market outcomes by race and ethnicity are more likely to be found in structural policies that promote education, training, and equality of opportunity across all segments of our society. Monetary policy can best help by focusing on our dual mandate of fostering full employment and low inflation.

In setting monetary policy, the Federal Reserve has a statutory goal to promote maximum employment and stable prices. Because the Federal Reserve's policy actions affect the economy as a whole, it cannot directly target particular groups of workers. However, by fulfilling the maximum employment component of our dual mandate, the Federal Reserve can ensure that the conditions are in place to keep labor demand high and stable for as many workers as possible, which in turn allows workers to more easily find jobs that best match their abilities and that provide them with the greatest opportunity to increase their skills, productivity, and earnings. Indeed, a highlight for me of our "Fed Listens" events have been the panels focusing on the real world experiences of diverse groups in labor markets and in accessing credit. These panels underscore the importance of looking beyond the traditional macro-economic statistics in gauging the effects of monetary policy and make clear what the Federal Reserve's mandate to promote maximum employment and stable prices really means in people's lives.

B. Do you believe the Federal Reserve possesses the monetary policy tools available to continue to lower unemployment in communities that have been historically left behind in our labor markets?

In setting monetary policy, to be consistent with the dual mandate of maximum employment and price stability for the economy as a whole, the Federal Open Market Committee (FOMC) considers a range of experiences and economic outcomes across the country. For example, prior to every meeting, Reserve Banks prepare summaries of economic conditions in their districts that are compiled and published in the Federal Reserve's "Beige Book."[2] In addition, at every FOMC meeting, Reserve Bank presidents regularly describe economic conditions in their Districts. That said, monetary policy is a broad tool that cannot directly target particular communities. Despite that limitation and as stated above, the Federal Reserve, through our maximum employment mandate, can ensure that the conditions are in place to keep labor demand high and stable for as many workers as possible, which in turn helps workers in lower-income communities to more easily find employment. In addition to our monetary policy tools, we regularly work with an array of partners—from nonprofits, bankers and academics to practitioners and policymakers—to help strengthen and revitalize communities through housing and other place-based strategies.

2. I believe an important question with critical importance to my constituents is if the nature of inflation has in any way changed in our modern economy.

I understand there may be no perfect measure of inflation, but for millions of people, young and old, official inflation measures do not seem to align with their view of the economy.

Inflation, officially, is low and steady.

But for three of the largest expenses in a modern family's budget – housing, health care, and education – there have been year after year of cost growth that outpace our official inflation measures.

A. I know that policymakers at the Federal Reserve are aware of these trends, but do you believe our current inflation measurements are accurately capturing cost increases in these critical areas?

The measurement of inflation is challenging, but U.S. statistical agencies do a good job and I think our measures of inflation are reasonably accurate. One of the greatest challenges in price measurement is capturing the effect of changes in product quality. New or improved varieties of goods and services can give consumers more (or less) for their money, in a way that is often quite hard to measure —though our statistical agencies do attempt to do so. This challenge is particularly acute for health care, where it is very difficult to quantify the benefits that come from advances in treating disease.

Notwithstanding the issue of quality change, it is true that prices of housing, health care, and education have all risen faster than overall inflation. Those faster-than-average price increases have been offset by other prices, such as for apparel, cars, and televisions and other electronics, which have risen more slowly than overall inflation.

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[2] See https://www.federalreserve.gov/monetarypolicy/beige-book-default.htm.

B. And what are the consequences in the long term of these core items continually outpacing overall inflation?

Some households, especially lower-income households, likely spend an above-average share of their income on necessities. If the prices of necessities rise faster than average, one would want to take this fact into account when assessing the economic situation of these households.

3. In the bipartisan Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155), one of the provisions directed at relieving regulatory burden for community institutions allowed for small depository institutions to file streamlined Call Reports.

As the Federal Reserve and other prudential regulators have worked to finalize these rules, we have heard concerns from Alabama institutions that the final rules do not ultimately streamline the reports in a meaningful manner – and many of the reporting requirements that were removed had little impact on small institutions.

A. What input from community institutions did the Federal Reserve take while finalizing the rule, and does the Federal Reserve have plans to revisit and further streamline the call reports, consistent with S. 2155?

The Board of Governors (Board), Office of Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (the agencies) considered all comments received on the proposal to implement section 205 of S.2155 and streamline regulatory reporting requirements for small institutions. Finalizing the proposal was one step in the agencies' efforts to meaningfully streamline reporting requirements. The agencies are committed to actively exploring additional revisions to Call Reports in an effort to further reduce any unduly reporting requirements.

4. As you know, the Federal Reserve has begun the process of reviewing and fine-tuning the regulation of the U.S. operations of international banks. I believe the Federal Reserve's initial efforts are largely positive, and in many aspects, show an appropriate understanding of the importance of international banks to our domestic economy, while balancing the need to effectively regulate these institutions based on their individual risks.

However, there are certain aspects of the proposed rules which I believe deserve further attention.

A. First, when considering whether to include inter-affiliate transactions as part of the risk-based factors that the Federal Reserve considers for international institutions, given that these transactions are conducted wholly within the bank, what are the risk factors that led Federal Reserve to the decision to exempt these transactions for domestic institutions, but not international institutions?

The tailoring proposals issued by the Board, along with the OCC and the FDIC (the agencies), would apply prudential requirements to large domestic and foreign firms based on the risk profile of the firms using risk-based indicators.

Under the proposals, standards would be applied and calibrated to U.S. firms at the global parent, where inter-affiliate transactions are eliminated in consolidation. Standards applied to foreign banks would be tailored based on the foreign bank's operations in the United States, rather than the global parent. As a result, transactions between the U.S. operations and the foreign parent generally would be included in the calculation of the risk-based indicators for foreign banks. To address the structural differences between foreign and domestic firms, the proposal would exclude inter-affiliate liabilities and certain collateralized claims with affiliates from the measure of cross-jurisdictional activity.

The agencies requested comment on the treatment of inter-affiliate transactions and the methodology for computing the risk-based indicators under the tailoring proposals, and are currently evaluating those comments.

B. Second, when considering the proper measure of a U.S. Intermediate Holding Company's (IHC) overall domestic profile, what factors led the Federal Reserve to determine that both the IHC's assets, as well as the assets of the international institution's U.S. branch, should be combined for purposes of applying liquidity requirements? As you know, IHC's are purposefully structured as a legal entity that is separate than the U.S. branch.

The foreign bank tailoring proposals would generally apply the same framework to foreign banks as would apply to domestic firms, with certain adjustments to reflect the structure of foreign banks' operations in the United States. Most significantly, the proposals would determine regulatory requirements for a foreign bank based on the risk profile of the foreign bank's U.S. operations, rather than on the risk profile of the global consolidated firm. For liquidity, the proposals would assign a foreign bank a category of standards based on the risk profile of the firms' combined U.S. operations, including any U.S. subsidiaries (such as a U.S. intermediate holding company) and any U.S. branches.

The proposed approach for the calibration of liquidity requirements reflects the fact that a foreign bank's U.S. intermediate holding company and U.S. branch network are both part of a single firm, and is consistent with the Board's current enhanced prudential standards framework for liquidity risk management, stress testing, and buffer requirements. The Board is carefully considering all comments on the proposals, including with respect to tailoring of liquidity standards, as we work to develop a final rule.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Elizabeth Warren:</u>

1) Over the past year, we have discussed the risks to the financial system from leveragesd lending several times. In your press conference following the June 19, 2019 Federal Open Markets Committee meeting, you said that you "feel like" the safety and soundness risk from leveraged lending to the banks is "in a good place," and that the paper "is pretty stably funded, in the sense that there's no run risk, but there's still macroeconomic risk.2"

A. Does the 2013 leveraged lending guidance still reflect the Fed's thinking about the prudent levels of debt, understanding that guidance by definition does not have the force of law?

B. In 2018, the DC Circuit overturned 2014 rules mandate by Dodd-Frank that exempted collateralized loan obligations from risk retention rules that apply to other asset classes. Have the rules been successful in aligning the incentives of the managers and investors with respect to asset classes where they're in effect?

C. Would the reimposition of risk retention requirements with respect to CLOs improve their quality and lessen the macroeconomic risk you cited?

D. According to the industry's trade group, private equity-owned companies employ 5.8 workers in the United States. Are these jobs more vulnerable to a recession than jobs in an industry less reliant on debt?

2) I continue to be concerned with the lack of a real-time payments system operated by the Federal Reserve – in my view, it's not question of whether the United States will have a real time payments system, it's a question of whether it will be operated by the Fed, the big banks or big tech. In my view, it's imperative that the Fed provide a competitive system, quickly.

A. Last fall the Fed released a plan to establish a real-time payments system for comment. The comment period closed more than seven months ago. When does the Fed intend to announce its next steps toward establishing a real-time system?

B. When does it expect a real-time system to be operational?

C. Have market developments, including the announcement by Facebook and other companies that they intend to launch a digital currency for payment, expedited the Fed's timeframe.

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[2] The Federal Reserve, "Chairman Powell's Press Conference," June 19, 2019, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190619.pdf.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 20, 2019

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Elizabeth Warren:

1. Over the past year, we have discussed the risks to the financial system from leveraged lending several times. In your press conference following the June 19, 2019 Federal Open Markets Committee meeting, you said that you "feel like" the safety and soundness risk from leveraged lending to the banks is "in a good place," and that the paper "is pretty stably funded, in the sense that there's no run risk, but there's still macroeconomic risk.[1]"

A. Does the 2013 leveraged lending guidance still reflect the Fed's thinking about the prudent levels of debt, understanding that guidance by definition does not have the force of law?

[1] The Federal Reserve, "Chairman Powell's Press Conference," June 19, 2019, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190619.pdf.

The leveraged loan market continues to warrant attention. We are closely monitoring how risks are evolving and the potential impact of these risks on the broader financial system, as well as assessing the adequacy of bank risk management and controls. The 2013 guidance remains in effect, but, as you note, it does not have the force and effect of law. Supervised banks can continue to participate in leveraged lending activities, provided such activities, as with all lending activities, are conducted in a prudent manner, consistent with safety and soundness standards.

Although banks originate the majority of leveraged loans, a large percentage of leveraged loans are sold to investors outside the regulated banking system. While these loan sales allow the risks to be shared more broadly, we continue to evaluate whether some of that risk diversification is being diluted by banks increasing their exposure to collateralized loan obligations (CLOs) and other holding vehicles to which the loans are sold. We will continue to monitor the evolution of the nature and risk profile of these holding vehicles.

B. In 2018, the DC Circuit overturned 2014 rules mandate by Dodd-Frank that exempted collateralized loan obligations from risk retention rules that apply to other asset classes. Have the rules been successful in aligning the incentives of the managers and investors with respect to asset classes where they're in effect?

[1] The Federal Reserve, "Chairman Powell's Press Conference," June 19, 2019, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190619.pdf.

The credit risk retention rule for securitization, introduced in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act and finalized by regulators in 2014, is designed to curtail risky lending and securitization practices. The rule has had the biggest impact on commercial mortgage-backed securities (CMBS) and CLOs, where the lowest equity tranche of a deal (the riskiest part of the security) was historically held by a party other than the issuer. In contrast, issuers historically took the first-loss risk in many other types of asset-backed securities, including by retaining risk in excess of the requirement.

CMBS deals issued after the rules took effect generally have better credit characteristics than deals issued before the effective date of the rules.[2] Investors and industry professionals have also relayed anecdotally that risk retention has been among the factors that has contributed to the improvement in CMBS underwriting, and that they believe risk retention aligns the interests of securitization sponsors and investors.[3]

Meanwhile, the private-label residential mortgage backed securities new-issue market remains relatively small, and so discerning the longer-term effects of risk retention is more difficult.

C. Would the reimposition of risk retention requirements with respect to CLOs improve their quality and lessen the macroeconomic risk you cited?

[1] The Federal Reserve, "Chairman Powell's Press Conference," June 19, 2019, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190619.pdf.

The decision in the U.S. Appeals Court in February 2018 exempted open-market CLOs—the most common type of CLOs, which acquire their assets from arms-length negotiations and trading on the open market—from adhering to risk retention.[4] Because the rule was changed early in 2018, it is instructive to compare some statistics from 2017 and 2018 to glean evidence of effects. For instance, overall issuance of new CLOs was robust in 2017 and increased only slightly from that amount in 2018. Looking at pricing, the spreads on highly rated CLO debt increased in mid-2017 and remained about at that level in 2018, hence investors do not seem to have priced in additional risk as a result of the change in risk retention rules.

D. According to the industry's trade group, private equity-owned companies employ 5.8 workers in the United States. Are these jobs more vulnerable to a recession than jobs in an industry less reliant on debt?

[1] The Federal Reserve, "Chairman Powell's Press Conference," June 19, 2019, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190619.pdf.

We are not aware of research that has systematically studied the employment sensitivity to downturns for private equity-owned firms. There is, however, ample theoretical and empirical evidence that employment at more highly leveraged firms is more sensitive to macroeconomic fluctuations and to changes in financial-market conditions.[5] The typical business model

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[2] See "Credit Metrics Comparison: Risk Retention versus Non-Risk Retention," DBRS, June 13, 2017, and Sean Flynn, Andra Ghent, and Alexei Tchistyi, "Informational Efficiency in Securitization after Dodd-Frank," May 21, 2019.

[3] See Paul Fiorilla, "No Joke. It Really Is Different This Time... Right?" Commercial Property Executive, January 15, 2018.

[4] Balance-sheet CLOs, which are less common, are created by originators of loans to transfer the loans off their balance sheets and into a securitization vehicle. They are still subject to risk retention as per the Agencies' rule.

[5] See Steven Sharpe (1994), "Financial Market Imperfections, Firm Leverage, and the Cyclicality of Employment," *American Economic Review*, Vol. 83, No. 4, pp. 1060-1074. Recent corroborating empirical evidence is also provided by Xavier Giroud and Holger Mueller (2017), "Firm Leverage, Consumer Demand, and Employment Losses During the Great Recession," *Quarterly Journal of Economics*, Vol. 132, No. 1, pp. 271-316. Using micro-level data from the U.S. Census Bureau, Giroud and Mueller find that establishments of more highly levered firms experienced significantly larger employment losses in response to declines in local consumer demand.

followed by private equity firms tends to involve leveraged buyouts.[6] Other things equal, higher leverage could drive greater employment variability. Nonetheless, leverage is not the only characteristic relevant for assessing employment sensitivity to business cycle fluctuations. For instance, recent research that has attempted to measure the quality of management practices has highlighted that private equity-owned firms tend to have very strong management practices relative to other ownership groups. Although this research has not scrutinized the effect of management practices on employment variability, it seems plausible that better management practices could influence the sensitivity of employment to business cycle fluctuations. Moreover, private equity-owned firms may be better positioned to obtain external funding during credit market disruptions.[7] Accordingly, absent further study of private equity owned firms, it is unclear whether better management or other characteristics could more than offset the effects of leverage on employment sensitivity to a recession.

2. I continue to be concerned with the lack of a real-time payments system operated by the Federal Reserve – in my view, it's not question of whether the United States will have a real time payments system, it's a question of whether it will be operated by the Fed, the big banks or big tech. In my view, it's imperative that the Fed provide a competitive system, quickly.

A. Last fall the Fed released a plan to establish a real-time payments system for comment. The comment period closed more than seven months ago. When does the Fed intend to announce its next steps toward establishing a real-time system?

The Federal Reserve Board (Board) announced on August 5, 2019, that the Reserve Banks will develop a new real-time payment and settlement service, called the FedNow^{SM} Service, to support faster payments in the United States.[8] In making this decision, the Board adhered to the requirements of the Federal Reserve Act, the Monetary Control Act (MCA), and longstanding Federal Reserve policies and processes.[9]

The Board's assessment of the planned FedNow Service pursuant to the requirements of the MCA and the Board's criteria for new services and major service enhancements, proposed features and functionality for the service, and initial competitive impact analysis of the service can be found in our August 2019 *Federal Register* Notice.[10]

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[6] See Steven Davis, John Haltiwanger, Kyle Handley, Ron Jarmin, Josh Lerner, and Javier Miranda (2014), "Private Equity, Jobs, and Productivity," American Economic Review, Vol. 104, No (12), pp. 3956-3990.

[7] A recent a study of firms based in the United Kingdom found that during the 2008 crisis, firms backed by private equity investors decreased investments less than did their peers and experienced greater equity and debt inflows, higher asset growth, and increased market share. See Shai Bernstein, Josh Lerner, and Filippo Mezzanotti (2019), "Private Equity and Financial Fragility during the Crisis," The Review of Financial Studies, Vol. 32, No. 4, pp. 1309-1373.

[8] https://www.federalreserve.gov/newsevents/pressreleases/other20190805a.htm.

[9] See the Federal Reserve Act, https://www.federalreserve.gov/aboutthefed/fract.htm; Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221 (Mar. 31, 1980), https://fraser.stlouisfed.org/title/1032; Board of Governors of the Federal Reserve System, "The Federal Reserve in the Payments System," (Issued 1984; revised 1990), https://www.federalreserve.gov/paymentsystems/pfs_frpaysys.htm.

[10] https://www.federalreserve.gov/newsevents/pressreleases/files/other20190805a1.pdf.

B. When does it expect a real-time system to be operational?

The Federal Reserve recognizes that establishing FedNow Service would need to be carried out as soon as practicably possible and that time-to-market is an important consideration for many industry participants. However, the achievement of true nationwide reach, as opposed to initial availability of a service, is a critical measure of success for faster payments. Pending engagement between the Federal Reserve and the industry to inform the final service design, the FedNow Service is expected to be available in 2023 or 2024. However, it will likely take longer for any service, whether the FedNow Service or a private-sector service, to achieve nationwide reach regardless of when the service is initially available. In advance of the service's availability, the Federal Reserve will work closely with banks and their technology partners to prepare for expeditious onboarding.

C. Have market developments, including the announcement by Facebook and other companies that they intend to launch a digital currency for payment, expedited the Fed's timeframe.

See question 2B.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Jerry Moran:

1) As you mentioned, our economic expansion continues, as evident in the 3.7% unemployment rate and average of 172,000 jobs added to the economy each month. But we aren't seeing the economic boom to the same degree in rural areas.

Farmers have seen their net income plummet by half since 2013 and are now expected to hold nearly $427 billion in debt this year—the most since the farm crisis in the 1980s—while many segments of the ag industry continue struggling to fill jobs.

A. Aside from trade, where does the Federal Reserve's incoming data indicate Congress should focus its efforts on to avoid another farm crisis, and what are the Fed's future considerations for providing support to this segment of the economy?

2) It is disappointing to see final rules implementing 2155 provisions that are no different than the rule proposals despite input from this body after the initial proposal; with the short form call report final rule being a prime example after hearing from a significant portion of the Senate.

A. Can you provide me with any vote of confidence that the same thing won't happen with the final rule of the Community Bank Leverage Ratio?

3) I understand that the Federal Reserve buys the majority of the GSE's debt.

A. As the largest creditor for Fannie Mae and Freddie Mac, are you concerned that the GSEs have not been designated as SIFIs by FSOC—and wouldn't at least going through the SIFI designation process help ensure that the GSEs have a strong prudential framework?

B. How important do you think it is for Congress to reform the housing finance market and take action to end the conservatorship of Fannie Mae and Freddie Mac?

4) One of the most common sentiments I have heard from farmers over the years is that whether the rest of the economy is booming or struggling, the opposite occurs in the ag economy.

A. Do you and the Federal Reserve have an explanation for these disparities, and where do we need to focus our efforts to ensure our economic expansion benefits the ag economy and the economy as a whole?

B. Does the Federal Reserve have any monetary policy tools to help offset the disparities between the benefits of an expanding economy as a whole and the ag economy specifically?

5) In its report last year on nonbank financials, fintech and innovation, the Department of the Treasury made specific policy recommendations to the financial regulatory agencies, including the Federal Reserve, that were designed to ensure that the U.S. financial system keeps pace with financial systems abroad. One of the key areas of focus was the need to assure consumers and small businesses that they own their own financial data and should have the ability to grant permission to third parties to provide products or services that rely on customer data.

A. What steps has the Federal Reserve taken since the Treasury report was published last July to meaningfully improve consumer and small businesses digital financial data access?

6) As you know, the United Kingdom began deploying its Open Banking regime – designed to empower consumers and small businesses to choose any financial services provider they like, be they an incumbent or challenger– in January of last year. Since then, a number of other countries, including Australia, New Zealand, Canada, Singapore, Hong Kong, Mexico, and South Africa – just to name a few – have signaled their intentions to implement similar regimes.

A. Is there a risk that the U.S. falls behind if we don't start considering what a U.S. version of Open Banking should look like?

7) Should a financial institution retain the ability to restrict the ability of one of its customers to permission access to their data for any reason other than an imminent security threat?

8) The proliferation of bilateral contractual agreements between large financial institutions and data aggregators has been heralded by some policymakers as a positive development for innovation

A. But isn't this model of disparate, opaque agreements between financial institutions and the facilitators of technology-powered tools on which millions of American consumers and small businesses rely likely to lead to a markedly uneven playing field, with outcomes for end users dependent entirely on with which institutions they conduct their banking business?

B. Is the Federal Reserve concerned about this outcome?

C. What is the Federal Reserve doing to facilitate a more level playing field across the industry for financial institution customers?

9) The OCC is working diligently to modernize the Community Reinvestment Act, and I understand that FDIC Chairman McWilliams is also working jointly with Comptroller Otting.

A. Is the Federal Reserve engaged in this process and will you be part of any coordinated joint rulemaking effort?

B. If the Federal Reserve does not engage in a joint rulemaking with the OCC & FDIC, will you undertake a separate rulemaking and what are the key aspects of the Community Reinvestment Act would you like to address?

10) Technological advancements within banking are helping to transform the industry to suit the needs of customers in the digital space. What are the Federal Reserve's thoughts regarding what changes are needed to modernize the Community Reinvestment Act since customers are less reliant on branches?

11) I have heard a number of concerns from commercial end users about the notice of proposed rulemaking published by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, which would implement the standardized approach for counterparty credit risk in derivative contracts (SA-CCR). One area of particular concern is the proposed 1.4 calibration of the alpha factor applied to transactions with commercial end users.

A. Is there empirical analysis or justification for this alpha factor which conflicts with policy objectives of ensuring commercial end users can use derivatives to hedge and mitigate their commercial risk?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 15, 2019

The Honorable Jerry Moran
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1, 3, 4-7, and 9-11 that you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. Responses to your remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Jerry Moran:

1. As you mentioned, our economic expansion continues, as evident in the 3.7% unemployment rate and average of 172,000 jobs added to the economy each month. But we aren't seeing the economic boom to the same degree in rural areas. Farmers have seen their net income plummet by half since 2013 and are now expected to hold nearly $427 billion in debt this year—the most since the farm crisis in the 1980s—while many segments of the ag industry continue struggling to fill jobs.

A. Aside from trade, where does the Federal Reserve's incomiug data indicate Congress should focus its efforts on to avoid another farm crisis, and what are the Fed's future considerations for providing support to this segment of the economy?

Federal Reserve data suggest that the U.S. farm economy has weakened since 2013 and is expected to remain relatively weak in the coming months. Farm income declined sharply from 2013 to 2015 and has remained relatively flat in the years since. The decline in farm income primarily has been due to persistently low agricultural commodity prices and elevated input costs. The weakness in farm income has led to gradual but persistent declines in working capital due to ongoing cash flow shortages. This has, in turn, led to increased financing needs and a modest increase in financial stress in recent years in the U.S. farm sector.

The root cause of the suppressed U.S. farm economy has been persistently low farm income due to an ongoing environment of low agricultural commodity prices. The weakness in agricultural commodity prices has come about primarily from slower growth in the global demand for U.S. agricultural commodities and an increase in supply relative to previous years. The supply of agricultural products from one year to the next tends to respond to the broad undercurrent of global demand.

The Federal Reserve monitors all aspects of the U.S. economy and incorporates developments in each segment of the economy into its key mission areas. When evaluating the appropriate stance of monetary policy, for example, developments in the agricultural economy are regularly included in its deliberations, in addition to an evaluation of conditions in other areas of the U.S. economy. The Federal Reserve also works to ensure that commercial banks are evaluated properly in the provision of credit to the agricultural sector. Finally, the Federal Reserve also interacts regularly with the public, including agricultural stakeholders, to share insights on the farm sector and gather information in an effort to enhance decision making on matters related to agriculture.

3. I understand that the Federal Reserve buys the majority of the GSE's debt.

A. As the largest creditor for Fannie Mae and Freddie Mac, are you concerned that the GSEs have not been designated as SIFIs by FSOC—and wouldn't at least going through the SIFI designation process help ensure that the GSEs have a strong prudential framework?

Both the direct obligations issued by, and the mortgage-backed securities (MBS) guaranteed by, Fannie Mae and Freddie Mac are eligible for purchase by the Federal Reserve because they are fully guaranteed as to principal and interest by Fannie Mae and Freddie Mac. During the financial crisis and subsequent recession, the Federal Reserve purchased agency debt and agency MBS to help reduce the cost and increase the availability of credit for the purchase of houses.

In late 2014, the Federal Open Market Committee (Committee) stopped increasing its holdings of MBS and in late 2017 announced plans for the gradual reduction of the Federal Reserve's securities holdings. Moreover, as part of its 2014 statement on policy normalization principles and plans, the Committee stated that "it will hold primarily Treasury securities, thereby minimizing the effect of Federal Reserve holdings on the allocation of credit across sectors in the economy." As of August 2019, Federal Reserve holdings of agency securities are approximately $1.5 trillion, down from their October 2017 level of $1.8 trillion.

The Federal Reserve Board (Board) recognizes that the government-sponsored enterprises (GSEs) are important entities in the mortgage markets and in the financial system generally. Whether or not the Financial Stability Oversight Council (FSOC) should designate the GSEs would depend on the FSOC's consideration of the required statutory factors to determine whether the GSEs are systemically important.

It is important to note that the GSEs already have a consolidated prudential regulator with substantial regulatory authorities. Indeed, following enactment of the Housing and Economic Recovery Act of 2008 (HERA), the Federal Housing Finance Agency (FHFA) came into existence with an enhanced array of supervisory tools. These tools include explicit authority to

- impose and enforce prudential standards, including capital standards;
- conduct targeted and full scope examinations;
- obtain reports from parties on a regular and on an as-requested basis;
- oversee executive compensation, including incentive compensation and golden parachutes;
- require remedial actions; and
- undertake a full range of enforcement actions.

In addition, as part of HERA, Congress granted the Director of FHFA the discretionary authority to appoint FHFA as conservator or receiver of Fannie Mae, Freddie Mac, or any of the Federal Home Loan Banks upon determining that specified criteria had been met. This authority was used in September 2008 to avoid mortgage financing and financial market disruptions that may have resulted from the failure of Fannie Mae or Freddie Mac at that time.

B. How important do you think it is for Congress to reform the housing finance market and take action to end the conservatorship of Fannie Mae and Freddie Mac?

A robust, well-capitalized, well-regulated housing finance system is vital to the stability of the financial system and to the long-run health of our economy. We need a system that provides mortgage credit in good times and bad to a broad range of creditworthy borrowers. While reforms have addressed some of the problems of the pre-crisis system, there is broad agreement that the job is far from done. Today, the federal government's role in housing finance is even greater than it was before the crisis. The overwhelming majority of new mortgages are issued with government backing in a highly concentrated securitization market. That leaves us with both potential taxpayer liability and systemic risk. It is important to learn the right lessons from the failure of the old system. Above all, we need to move to a system that attracts ample amounts of private capital to stand between housing sector credit risk and taxpayers. We should also use market forces to increase competition and help to drive innovation.

4. One of the most common sentiments I have heard from farmers over the years is that whether the rest of the economy is booming or struggling, the opposite occurs in the ag economy.

A. Do you and the Federal Reserve have an explanation for these disparities, and where do we need to focus our efforts to ensure our economic expansion benefits the ag economy and the economy as a whole?

Cycles in the agricultural economy may differ from those of the broader U.S. economy due, in part, to differences in the time required for production to fully respond to underlying changes in demand. The strength of the U.S. farm sector depends crucially on the price of agricultural commodities, which is significantly determined by global supply and demand conditions. As global demand for agricultural products strengthens, the price of agricultural commodities tends to increase, which boosts farm income. Agricultural producers, both in the U.S. and globally, tend to respond to these higher prices by increasing production. However, unlike other economic sectors, history has shown that it often takes a number of years for agricultural production to fully adjust to the increase in demand. Likewise, as global demand growth slows, it may take a number of years for agricultural production to adjust, resulting in persistently low agricultural commodity prices.

In the mid-2000s, two primary drivers of demand for agricultural commodities were economic growth in China and growth in U.S. biofuels (i.e., ethanol). This increase in demand for agricultural products caused agricultural commodity prices to increase significantly from 2006 to 2013. Although agricultural production responded to the increase in prices, it took several years for supply to meet the increased demand. Since 2013, the pace of growth in these components of demand appears to have slowed. In general, however, the production of agricultural commodities, has remained relatively high. The slower demand growth, coupled with elevated supplies of agricultural commodities, has been a primary factor in keeping agricultural commodity prices relatively low.

B. Does the Federal Reserve have any monetary policy tools to help offset the disparities between the benefits of an expanding economy as a whole and the ag economy specifically?

In conducting monetary policy, the Federal Reserve incorporates information on all aspects of the U.S. economy into its regular policy deliberations. These deliberations take into account the strengths and weaknesses of various sectors, including agriculture. The Federal Reserve's monetary policy tools are powerful, but blunt, and not intended to address individual sectors of the economy. Rather, the Federal Reserve sets policy to achieve its overall aggregate goals of maximum employment and stable prices.

5. In its report last year on nonbank financials, finteeh and innovation, the Department of the Treasury made specific policy recommendations to the financial regulatory agencies, including the Federal Reserve, that were designed to ensure that the U.S. financial system keeps pace with financial systems abroad. One of the key areas of focus was the need to assure consumers and small businesses that they own their own financial data and should have the ability to grant permission to third parties to provide products or services that rely on customer data.

A. What steps has the Federal Reserve taken since the Treasury report was published last July to meaningfully improve consumer and small businesses digital financial data access?

As the Department of Treasury recently highlighted, "[t]he only express statutory provision regarding access to a consumer's own financial account and transaction data is Section 1033 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)."[1] Section 1033 provides the Consumer Financial Protection Bureau (CFPB) with the authority to prescribe rules regarding consumer rights in data related to financial products and services obtained from a financial institution. The CFPB identifies policy work related to this authority in its Spring 2019 release of "Long-Term Actions."[2]

As the Department of Treasury also indicated, other regulators have a role to play as well. Fintech innovators generally rely on connections to banks for access to consumer deposits or related account data, access to the payment system, or credit origination. Accordingly, as banks explore advances in fintech products and services, the Federal Reserve has a responsibility to ensure that institutions we supervise operate in a safe and sound manner and that they comply with applicable statutes and regulations, including consumer protection laws.

The Federal Reserve coordinates our activities on digital financial access with those of other regulators in a number of fora, including the Federal Financial Institutions Examination Council (FFIEC) Task Force on Supervision and the FFIEC Task Force on Consumer Compliance.

This calendar year, the Federal Reserve has also organized a number of meetings with industry actors, trade associations, and consumer advocates in a variety of fintech areas, including financial account aggregation, which have included joint participation from a number of relevant regulators, including the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), CFPB, the Federal Trade Commission, and the Conference of

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[1] U.S. Department of the Treasury (U.S. Treasury), A Financial System That Creates Economic Opportunities - Nonbank Financials, Fintech, and Innovation (July 2018), https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation.pdf. As described by the U.S. Treasury, the statute states that, subject to rules prescribed by the CFPB, "financial services companies subject to the Bureau's jurisdiction as covered persons are required to make available to a consumer, upon request, certain financial account and transaction data concerning any product or service obtained by the consumer from that financial services company."

[2] See https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=3170-AA78 (Consumer Access to Financial Records [as described in section 1033 of the Dodd-Frank Act]). Other consumer laws and regulations might also be relevant to the CFPB's policy response to issues involving account aggregation. See, e.g., https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=3170-AA79 (Regulation E Modernization).

State Bank Supervisors. We will continue to facilitate and to engage in collaborative discussions with other relevant financial regulators in these and other settings.

We also are reviewing how our guidance relates to expectations regarding the way banks should engage with fintech firms, including data-sharing agreements between banks and data aggregators. For example, the Federal Reserve often receives questions about the applicability of our vendor risk management guidance. Staff are reviewing this guidance to determine whether any adjustments or clarifications would be helpful to promote responsible innovation.

6. As you know, the United Kingdom began deploying its Open Banking regime – designed to empower consumers and small businesses to choose any financial services provider they like, be they an incumbent or challenger– in January of last year. Since then, a number of other countries, including Australia, New Zealand, Canada, Singapore, Hong Kong, Mexico, and South Africa – just to name a few – have signaled their intentions to implement similar regimes.

A. Is there a risk that the U.S. falls behind if we don't start considering what a U.S. version of Open Banking should look like?

As regulators, we have a responsibility to ensure that the institutions subject to our supervision are operated in a safe and sound manner and that they comply with applicable statutes and regulations, including consumer protection laws. We have a strong interest in permitting responsible innovations to flourish, but first must ensure the risks that they may present are appropriately managed, consistent with relevant legal requirements. With regard to open banking, the Federal Reserve has continued to monitor closely developments in other jurisdictions and analyze potential opportunities and challenges posed by the adoption of open banking models in the United States.[1]

From our study of these overseas directives, several important considerations for adopting a United States' version of open banking via regulation have emerged. For example, certain approaches in other jurisdictions to address attendant data-security and consumer-protection risks, by and large, are not readily available policy options to federal banking regulators in the United States. Moreover, third parties that access bank accounts are often subject to licensing and registration requirements, as well as associated capital and insurance requirements. Likewise, overseas directives may also require that electronic payments (both bank and non-bank) be authorized by two-factor authentication.

Perhaps most importantly, the jurisdictions that have moved forward with open banking requirements have less diverse banking systems materially, where the rules may impact fewer than ten very large institutions. In contrast, a U.S. version of open banking would impact a more diverse set of financial institutions, including thousands of small and community financial

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[1] For example, Board members have spoken about some of these issues. See, e.g., Lael Brainard, Where do Banks Fit in the Fintech Stack (April 28, 2017), https://www.federalreserve.gov/newsevents/speech/files/brainard20170428a.pdf. See also Lael Brainard, Where do Consumers Fit in the Fintech Stack (Nov. 16, 2017), https://www.federalreserve.gov/newsevents/speech/files/brainard20171116a.pdf.

institutions. For institutions with limited resources, the necessary investments in application programming interface technology and in negotiating and overseeing data-sharing agreements with data aggregators and third-party providers may be beyond their reach, especially as they usually rely on service providers for their core technology.

Accordingly, U.S. efforts to craft approaches that enhance the connectivity of banks with non-banks have benefited from the engagement of multiple agencies, along with input from the private sector and other stakeholders. In that regard, the private sector is continuing to experiment actively with a variety of different approaches to the connectivity issue and may itself move toward one or more widely accepted standards.

We support ensuring that connectivity issues are appropriately addressed in a way that allows community banks to participate in innovative platforms, and that this should be an important priority.

7. Should a financial institution retain the ability to restrict the ability of one of its customers to permission access to their data for any reason other than an imminent security threat?

In light of the CFPB's authority in this area (see response to Question 5A), the Board has not articulated an independent position regarding consumer-permissioned data access. Board members have, however, articulated general concerns about appropriate risk management relating to safety and soundness and consumer protection, as described in the response to Question 6A.

9. The OCC is working diligently to modernize the Community Reinvestment Act, and I understand that FDIC Chairman McWilliams is also working jointly with Comptroller Otting.

A. Is the Federal Reserve engaged in this process and will you be part of any coordinated joint rulemaking effort?

We are working closely and diligently with the FDIC and the OCC to determine how best to modernize the regulations implementing the Community Reinvestment Act (CRA). While the timing of a proposal is uncertain, we continue to discuss important aspects of reform with them and are committed to actively engaging in interagency discussions. We agree on the goals of improving the regulations by establishing more clarity about where and how CRA activities will be considered. We continue to discuss various ideas about how best to accomplish those goals.

B. If the Federal Reserve does not engage in a joint rulemaking with the OCC & FDIC, will you undertake a separate rulemaking and what are the key aspects of the Community Reinvestment Act would you like to address?

Given our significant engagement in the interagency rulemaking process, I will refrain from speculating on what would happen if the Federal Reserve does not sign on to a joint rulemaking with the OCC and FDIC.

10. Technological advancements within banking are helping to transform the industry to suit the needs of customers in the digital space. What are the Federal Reserve's thoughts regarding what changes are needed to modernize the Community Reinvestment Act since customers are less reliant on branches?

The Board understands the need to update the CRA regulations' approach to delineating assessment areas in order to reflect how technology and other advancements have significantly changed the manner in which financial services are accessed and delivered. Industry consolidation and adoption of new technologies have resulted in an increasing provision of banking services beyond geographic areas where banks have branches.

No matter how the agencies define a bank's assessment area in the future, a modernized CRA regulatory framework needs to be designed and implemented in a way that encourages banks to help meet the credit needs of all the communities that they serve, including those areas that are not major markets for the bank.

11. I have heard a number of concerns from commercial end users about the notice of proposed rulemaking published by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, which would implement the standardized approach for counterparty credit risk in derivative contracts (SA-CCR). One area of particular concern is the proposed 1.4 calibration of the alpha factor applied to transactions with commercial end users.

Is there empirical analysis or justification for this alpha factor which conflicts with policy objectives of ensuring commercial end users can use derivatives to hedge and mitigate their commercial risk?

The alpha factor was included in the proposal to implement the standardized approach for counterparty credit risk (SA-CCR) to ensure that SA-CCR, a standardized approach for determining capital requirements for the counterparty credit risk of derivative contracts, does not produce lower exposure amounts than the existing internal models methodology (IMM). IMM is a models-based approach that certain large and internationally active banking organizations may use to calculate their risk-weighted assets under the capital rule. In particular, IMM includes an alpha factor of 1.4 to add a level of conservatism to the model-based calculation and to address certain risks, such as wrong-way risk (meaning the exposure amount of the derivative contract increases as the counterparty's probability of default increases). As part of the SA-CCR rulemaking process, the Board is carefully considering commenters' concerns regarding the effect the application of the alpha factor will have on commercial end-user counterparties.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

November 5, 2019

The Honorable Jerry Moran
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2 and 8 you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. This concludes all responses to your questions.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Moran:

2. It is disappointing to see final rules implementing 2155 provisions that are no different than the rule proposals despite input from this body after the initial proposal; with the short form call report final rule being a prime example after hearing from a significant portion of the Senate.

A. Can you provide me with any vote of confidence that the same thing won't happen with the final rule of the Community Bank Leverage Ratio?

The Federal Reserve Board of Governors, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the agencies) recently adopted a community bank leverage ratio (CBLR) framework that is consistent with the Economic Growth, Regulatory Relief, and Consumer Protection Act's objective of reducing the regulatory burden on community banking organizations while maintaining safety and soundness. The agencies carefully considered the public comments on the proposal and actively consulted with state bank supervisors in developing the final rule.[1] Relative to the proposal, the final rule incorporates a number of changes advocated by commenters, notably including a "grace period" for firms which temporarily fail to meet certain qualifying criteria and removal of the proposal's separate prompt corrective action framework specific to the CBLR framework.

8. The proliferation of bilateral contractual agreements between large financial institutions and data aggregators has been heralded by some policymakers as a positive development for innovation.

A. But isn't this model of disparate, opaque agreements between financial institutions and the facilitators of technology-powered tools on which millions of American consumers and small businesses rely likely to lead to a markedly uneven playing field, with outcomes for end users dependent entirely on with which institutions they conduct their banking business?

We are aware that large data aggregators and financial institutions are seeking to negotiate the appropriate balance of trade-offs for various issues relating to consumer data access, including data security and other prudential concerns, in bilateral contractual agreements. We are monitoring these and other collaborative efforts involving data aggregators and financial institutions that seek to establish industry-wide norms that could be used by a broader array of participants.

The Federal Reserve regularly organizes meetings with industry actors, trade associations, and consumer advocates in a variety of fintech areas, including financial account aggregation to track developments. These meetings include joint participation from a number of relevant regulators, including the OCC, FDIC, CFPB, the Federal Trade Commission, and the Conference of State

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[1] See: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191029a.htm.

Bank Supervisors to ensure information sharing and maximize the opportunity for regulatory cooperation on these issues.

Throughout these discussions, we have consistently stressed the importance of involving relevant stakeholders, including smaller financial institutions and consumer advocates. We will continue to facilitate and engage in collaborative discussions with other relevant financial regulators in these and other settings.

B. Is the Federal Reserve concerned about this outcome?

Please see the response to question 8A.

C. What is the Federal Reserve doing to facilitate a more level playing field across the industry for financial institution customers?

Please see the response to question 8A.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Kyrsten Sinema:

1) According to the Fed's 2019 Consumer & Community Context report, from 2005 to 2014 over 400,000 young Americans were unable to buy a home due to the rise in student loan debt. According to Freddie Mac's June 2019 survey, 89% of millennials made different housing choices specifically to afford student loan payments, including postponing the purchase of a home. This survey also found that majorities of renters and homeowners in the West feel homeownership has become less accessible. Many Arizonans plan on selling their homes to retire. Are you concerned about the implications that a decline in homeownership by younger Americans will have on existing homeowners? Are you concerned about the implications of this trend for the housing market more broadly?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

August 20, 2019

The Honorable Kyrsten Sinema
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the question you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Kyrsten Sinema:

1. According to the Fed's 2019 Consumer & Community Context report, from 2005 to 2014 over 400,000 young Americans were unable to buy a home due to the rise in student loan debt. According to Freddie Mac's June 2019 survey, 89% of millennials made different housing choices specifically to afford student loan payments, including postponing the purchase of a home. This survey also found that majorities of renters and homeowners in the West feel homeownership has become less accessible. Many Arizonans plan on selling their homes to retire. Are you concerned about the implications that a decline in homeownership by younger Americans will have on existing homeowners? Are you concerned about the implications of this trend for the housing market more broadly?

It is true that young Americans today have a notably lower home ownership rate than previous generations did at the same stage of life. This could reflect a variety of factors including changing preferences and demographic trends, reduced credit access for some borrowers, and insufficient income or savings for down payments given the cost of renting, house prices, and student loan debt. Federal Reserve Board researchers have specifically examined the potential role of student loans and found it could only explain a small portion of the decline in homeownership.[1]

It is too soon to say for certain whether the low homeownership rate among millennials reflects a permanent shift or a delay in first home purchases. For instance, a recent survey by Fannie Mae suggests that most millennials plan to become homeowners eventually.[2] Moreover, the current environment of relatively low mortgage rates, a strong labor market, a return to more accessible mortgage credit, and generally healthy household balance sheets should encourage home ownership going forward and support the housing market more broadly. Another promising sign is that household formation rates have recovered since the depths of the recession.

If the homeownership rate of millennials were to remain low, the implications for existing home owners are unclear. The future value of existing homes will be determined not only by the demand for housing by younger generations but also by the housing supply, which will depend in large part on construction of new homes.

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[1] Mezza, Alvaro, Daniel Ringo, and Kamila Sommer (January 2019). "Can Student Loan Debt Explain Low Homeownership Rates for Young Adults?" Consumer & Community Context, Board of Governors of the Federal Reserve System, Vol 1., No.1.

[2] Betancourt, Kim, Steven Deggendorf, and Sarah Shahdad (September 2018). "Myth Busting: The Truth About Multifamily Renters," Fannie Mae, available at https://www.fanniemae.com/resources/file/research/emma/pdf/MF_Market_Commentary_091718.pdf.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Mike Rounds:

1) At our hearing, a number of my colleagues had the opportunity to ask you about the future path for interest rates and I appreciate your thoughts on that issue. I concur that the Fed shouldn't exhaust all of the tools in its toolbox and leave our economy unprepared for a response from the central bank in a future downturn.

I'd like to ask a related question about the Fed's balance sheet. You announced earlier this year that the Fed will end its balance sheet runoff at some point in 2019. One point that you have yet to address is what kind of Treasury securities that the Federal Reserve will hold once the runoff is complete. I understand that holding short-term notes will give the Fed more flexibility in the event you need to respond to a downturn in the economy.

A. What kind of Treasury securities will the Fed hold in the future? If you can't say for certain at this point, what will factor into your thinking on that front?

2) I would also like to understand your views on the yield curve for Treasury securities and what that means for the potential for a recession in the future. At an event for Congressional staff in March, the Fed's Director of the Division of Monetary Affairs, Thomas Laubauch, said that he, quote, "would not draw too much" from an inverted yield curve for a few reasons.

Among the reasons that Dr. Laubach cited were asset purchases from central banks in the US, EU, and Japan that have caused a decrease in return premiums. In years past, when monetary policy was tighter, an inverted yield curve would indicate that a recession was ahead. Now, thanks to those asset purchases, the yield curve is more indicative of where the market sees interest rates remaining in the short term.

A. Do you share Dr. Laubach's thinking? In your opinion, is the inverted yield curve still cause for concern?

3) The Coalition for Derivatives End Users pointed out that the rule implementing SA-CCR – as it is proposed – disproportionately burdens bank counterparties by increasing the capital they have to hold with respect to transactions with end-user counterparties.

Those end-user counterparties are currently exempt from posting margin, so if the proposed rule moved forward, bank counterparties would have to reset the imbalance by passing through the cost of capital fees to the end-user counterparties in the form of higher transaction fees or by dropping out of market making activities. This means that our markets would become less liquid and that farmers and Main Street consumers would pay more for simple commodities like corn, wheat, or gas.

A. Can you tell me more about why the Fed designed the SA-CCR rule this way and what impact you believe this will have on everyday Americans?

4) Wire fraud through e-mail poses tremendous risks to our constituents, especially homebuyers, and their confidence in our payment system's ability to safely transfer large amounts of money as part of the homebuying process.

A. How is the Federal Reserve addressing criminal exploitation of weaknesses in the U.S. wire system?

B. Which federal agencies has the Federal Reserve coordinated with on the issue of wire fraud?

5) An effort by the Federal Reserve to develop a real time payments (RTP) system would not be an easy undertaking. An existing RTP infrastructure already exists and is operated in the United States today. On its face, this would conflict with provisions in the Monetary Control Act that prohibit the Federal Reserve from competing with the private sector. In addition, should the Fed move forward, it would transmit and hold a tremendous amount of sensitive data.

Please tell me more about what the Fed is planning for real time payments.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

October 31, 2019

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 3-5 that you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. A response to your remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Rounds:

3. The Coalition for Derivatives End Users pointed out that the rule implementing SA-CCR – as it is proposed – disproportionately burdens bank counterparties by increasing the capital they have to hold with respect to transactions with end-user counterparties.

Those end-user counterparties are currently exempt from posting margin, so if the proposed rule moved forward, bank counterparties would have to reset the imbalance by passing through the cost of capital fees to the end-user counterparties in the form of higher transaction fees or by dropping out of market making activities. This means that our markets would become less liquid and that farmers and Main Street consumers would pay more for simple commodities like corn, wheat, or gas.

A. Can you tell me more about why the Fed designed the SA-CCR rule this way and what impact you believe this will have on everyday Americans?

The Federal Reserve Board (Board) proposed the implementation of standardized approach for counterparty credit risk (SA-CCR) to provide important improvements to risk sensitivity and calibration relative to the current exposure methodology (CEM), a standardized approach that uses supervisory-provided formulas to determine capital requirements for the counterparty credit risk of derivative contracts. In particular, the implementation of SA-CCR is responsive to concerns that CEM, developed a few decades ago, has not kept pace with certain market practices used predominantly by large and sophisticated banking organizations. The agencies anticipated that the proposal would not materially change the amount of capital in the banking system. Rather, any change in a particular banking organization's capital requirements, through either an increase or a decrease in regulatory capital, would reflect the banking organization's own derivative portfolio, the enhanced risk sensitivity of SA-CCR relative to CEM, and market conditions. Commenters have raised concerns regarding how SA-CCR could affect commercial end-users' ability to access the derivatives market, and the Board is considering carefully these comments, along with all other comments submitted, in formulating a final rulemaking that would implement SA-CCR.

4. Wire fraud through e-mail poses tremendous risks to our constituents, especially homebuyers, and their confidence in our payment system's ability to safely transfer large amounts of money as part of the homebuying process.

A. How is the Federal Reserve addressing criminal exploitation of weaknesses in the U.S. wire system?
B. Which federal agencies has the Federal Reserve coordinated with on the issue of wire fraud?

The Federal Reserve has taken a number of steps to address criminal exploitation of the U.S. wire system. The Board, jointly with the Financial Crimes Enforcement Network, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Administration, promulgated the Customer Identification Program (CIP) rule. The

CIP rule requires banks to obtain sufficient information from their customers in order to form a reasonable belief regarding the identity of each customer.[1] The CIP rule requires verification procedures designed to ensure that financial institutions know their customers and to assist in identifying potential bad actors. Such procedures are important in combatting wire fraud related to real estate, and other transactions.

Additionally, the Federal Reserve has been engaged in efforts to reduce fraud more broadly in wire payments. We have worked collaboratively with other central banks as part of the efforts by the Bank for International Settlement's Committee on Payments and Market Infrastructures (CPMI) to reduce the risk of wholesale payments fraud related to endpoint security with the broader objective of supporting financial stability.[2] As a result, the Federal Reserve and CPMI member central banks have developed a strategy to encourage and focus industry efforts to reduce the risk of fraud related to endpoint security.[3] The strategy includes key elements that payment system and messaging operators should consider as part of their efforts to mitigate payments fraud, and it encourages a holistic approach to address all areas relevant to preventing, detecting, responding to and communicating about fraud. Domestically, the Federal Reserve has collaborated with payment system stakeholders through its Secure Payments Task Force (Task Force) to advance information sharing for the mitigation of payment fraud.[4] In 2018, the Task Force published a number of recommendations aimed at standardizing fraud definitions, setting requirements for fraud data collection and formatting, implementing a framework for sharing fraud information domestically, and facilitating fraud information sharing internationally.

5. An effort by the Federal Reserve to develop a real time payments (RTP) system would not be an easy undertaking. An existing RTP infrastructure already exists and is operated in the United States today. On its face, this would conflict with provisions in the Monetary Control Act that prohibit the Federal Reserve from competing with the private sector. In addition, should the Fed move forward, it would transmit and hold a tremendous amount of sensitive data.

Please tell me more about what the Fed is planning for real time payments.

The Board announced on August 5, 2019, that the Reserve Banks will develop a new real-time payment and settlement service, called the FedNow℠ Service, to support faster payments in the United States.[5] In making this decision, the Board adhered to the requirements of the Monetary Control Act of 1980 (MCA) and long-standing Federal Reserve policies and processes.[6] The FedNow Service would operate alongside private-sector real-time gross settlement (RTGS) services for faster payments. This service is consistent with the operations of most other payment systems in the United States, such as funds transfers, checks, and automated clearinghouse payments, whereby the Reserve Banks operate payment and settlement services alongside and in support of similar private-sector services.

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[1] See 31 C.F.R. § 1020.220.

[2] See https://www.federalreserve.gov/newsevents/pressreleases/other20180508a.htm.

[3] See https://www.bis.org/cpmi/publ/d178.pdf.

[4] See https://fedpaymentsimprovement.org/payments-security/secure-payments-task-force-archive/.

[5] See https://www.federalreserve.gov/newsevents/pressreleases/other20190805a.htm.

[6] Board of Governors of the Federal Reserve System, "The Federal Reserve in the Payments System" (Issued 1984; Revised 1990).

The MCA requires that Federal Reserve services be priced competitively and made available equitably to depository institutions. The MCA encourages competition between the Reserve Banks and the private sector through an expectation that the Reserve Banks will recover costs of services, both actual expenses associated with providing the services as well as certain imputed costs, including the taxes and cost of capital that would be paid by a private-sector competitor.

The Board also adheres to internal policy criteria established in 1984 and revised in 1990[7] for the provision of new or enhanced payment services that specify the Federal Reserve must expect to (1) achieve full cost recovery over the long run, (2) provide services that yield a public benefit, and (3) provide services that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity. The Board's August 2019 *Federal Register* Notice provides a full analysis of how the FedNow Service meets the requirements of the MCA as well as the Board's policy criteria for the provision of new or enhanced services.

Also in support of real-time payments, the Federal Reserve announced its intention to explore the expansion of hours for the Fedwire® Funds Service and the National Settlement Service, up to 24x7x365, to support a wide range of payment activities, including liquidity management in private-sector services for faster payments. Subject to the outcome of additional risk, operational, and policy analysis, the Board will seek public comment separately on plans to expand Fedwire Funds Service and National Settlement Service hours.

[7] See https://www.federalreserve.gov/paymentsystems/pfs_frpaysys.htm.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

November 5, 2019

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1-2 that you submitted following the July 11, 2019, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. A response to your remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Rounds:

1. At our hearing, a number of my colleagues had the opportunity to ask you about the future path for interest rates and I appreciate your thoughts on that issue. I concur that the Fed shouldn't exhaust all of the tools in its toolbox and leave our economy unprepared for a response from the central bank in a future downturn.

I'd like to ask a related question about the Fed's balance sheet. You announced earlier this year that the Fed will end its balance sheet runoff at some point in 2019. One point that you have yet to address is what kind of Treasury securities that the Federal Reserve will hold once the runoff is complete. I understand that holding short-term notes will give the Fed more flexibility in the event you need to respond to a downturn in the economy.

What kind of Treasury securities will the Fed hold in the future? If you can't say for certain at this point, what will factor into your thinking on that front?

Since the Federal Open Market Committee (FOMC) ended balance sheet runoff in August 2019, the Federal Reserve has begun purchasing Treasury securities across the maturity spectrum. As a result, the Federal Reserve is holding Treasury securities with maturities from a few days to 30 years.

These purchases reflect two factors. First, at the conclusion of its July 2019 meeting, the FOMC announced that it intended to cease the runoff of its securities portfolio, noting that beginning in August 2019, principal payments received from agency debt and agency mortgage-backed securities (MBS) up to $20 billion per month would be reinvested in Treasury securities to roughly match the maturity composition of Treasury securities outstanding; principal payments in excess of $20 billion per month would continue to be reinvested in agency MBS. Also beginning in August, all maturing Treasury securities in the Federal Reserve's portfolio would be rolled over at Treasury auctions following usual practices; maturing and prepaying securities are reinvested. Second, in light of increases in the Federal Reserve's non-reserve liabilities, in early October, the FOMC determined it would purchase Treasury bills at least into the second quarter of next year in order to maintain over time an ample level of reserve balances at or above the level that prevailed in early September. This action is consistent with the FOMC's intention to implement monetary policy in a regime in which an ample supply of reserves ensures that control over the level of the federal funds rate, and other short-term interest rates, is exercised primarily through the setting of the Federal Reserve's administered rates, and in which active management of the supply of reserves is not required. These recent purchases are purely technical measures to support the effective implementation of the FOMC's monetary policy, and do not represent a change in the stance of monetary policy.

The FOMC has also begun discussions about the longer-run composition of the Federal Reserve's holdings of Treasury securities, but has not made any decisions. The FOMC is considering numerous factors that will influence its deliberations. Some factors include how the portfolio composition would interact with the setting of the target range for the federal funds rate, how the portfolio composition could allow the FOMC to use balance sheet policy in a future economic downturn, and how the portfolio composition would interact with the Treasury and broader financial markets. Any decision the FOMC ultimately reaches will be implemented with considerable advance notice to the public and in a manner that allows for smooth adjustment in financial markets.

2. I would also like to understand your views on the yield curve for Treasury securities and what that means for the potential for a recession in the future. At an event for Congressional staff in March, the Fed's Director of the Division of Monetary Affairs, Thomas Laubauch, said that he, quote, "would not draw too much" from an inverted yield curve for a few reasons.

Among the reasons that Dr. Laubach cited were asset purchases from central banks in the US, EU, and Japan that have caused a decrease in return premiums. In years past, when monetary policy was tighter, an inverted yield curve would indicate that a recession was ahead. Now, thanks to those asset purchases, the yield curve is more indicative of where the market sees interest rates remaining in the short term.

Do you share Dr. Laubach's thinking? In your opinion, is the inverted yield curve still cause for concern?

Measures of long-term yield spreads, such as the difference between the yield on a 10-year Treasury note and the yield on a 3-month Treasury bill were negative in recent months. Some academic research has documented that, in the past, such inversions have often preceded recessions. Some of these studies have further speculated that this pattern arises because long-term yields tend to fall, inverting the curve, precisely when market participants have come to believe that that risk of recession is elevated and that the central bank will soon reduce interest rates to support economic activity.

However, there are reasons to suspect that long-term rates may be lower now than in years past for reasons that are unrelated to expectations of a recession. For instance, strong demand among investors around the world for long-term risk-free assets likely has depressed long-term yields. In addition, purchases of long-term sovereign bonds by central banks have lowered long-term yields around the world, making inversions of the yield curve more likely.

For these and other reasons, inversions of the yield curve are by no means flawless predictors of recessions. In evaluating the outlook for economic activity and inflation in order to achieve its goals as mandated by Congress, the yield curve is just one of many indicators that the FOMC considers. The Committee expects that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Robert Menendez:

1) In a speech earlier this year, you stated that any revision to the Community Reinvestment Act (CRA) should "more effectively encourage banks to seek opportunities in underserved areas." Recently, the Urban Institute found that 60 percent of CRA-qualifying loans in low-and moderate-income census tracts are made to middle- and upper-income borrowers, including 29 percent to higher income borrowers. While lending to middle- and upper-income borrowers in low-and moderate-income communities can encourage community diversity, it should not be the predominant form of CRA lending.

A. Chair Powell, how is the Federal Reserve planning to ensure that the majority of CRA-qualifying loans are being made to low-and moderate-income borrowers?

B. What other steps is the Fed taking to ensure banks "seek opportunities in underserved areas?"

2) Our country's affordable housing crisis is making it increasingly hard for working families to find an affordable place to live anywhere near economic opportunity. The percentage of housing stock available for rent or sale has fallen sharply since the financial crisis and is now as low as it has been in more than 30 years. The current annual supply of new housing units is running an estimated 370,000 units below the trend for new housing demand.

A. Chair Powell, are you concerned that the affordable housing crisis is reducing labor mobility? What impact does reduced labor mobility have on the broader economy?

B. If the affordable housing crisis reduces labor mobility, affecting the entire economy, what role does the Federal Reserve have in addressing the affordable housing crisis in the U.S.?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 27, 2019

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Robert Menendez:

1. In a speech earlier this year, you stated that any revision to the Community Reinvestment Act (CRA) should "more effectively encourage banks to seek opportunities in underserved areas." Recently, the Urban Institute found that 60 percent of CRA-qualifying loans in low-and moderate-income census tracts are made to middle- and upper-income borrowers, including 29 percent to higher income borrowers. While lending to middle- and upper-income borrowers in low-and moderate-income communities can encourage community diversity, it should not be the predominant form of CRA lending.

A. Chair Powell, how is the Federal Reserve planning to ensure that the majority of CRA-qualifying loans are being made to low-and moderate-income borrowers?

The Federal Reserve currently is working with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) to consider improvements to modernize the existing Community Reinvestment Act (CRA) regulatory framework. As part of that review, we are considering evaluation approaches that would ensure that banks are meeting the credit needs of both low- and moderate-income households and low- and moderate-income communities.

B. What other steps is the Fed taking to ensure banks "seek opportunities in underserved areas?"

There are several options that the Federal Reserve staff have discussed with the FDIC and the OCC to encourage banks to seek opportunities in underserved areas. In our outreach with banks, community organizations, and other stakeholders, the Federal Reserve has heard support for updating the CRA regulations as they relate to a bank's assessment area(s) so there is more clarity regarding where banks may get CRA consideration for activities. Specifically, we are considering an approach that would retain assessment areas around a bank's branches in order to keep the CRA's focus on nearby local communities, including low- and moderate-income neighborhoods, while adding assessment areas where banks conduct significant activity apart from branches.

In addition, we are considering whether to more clearly define a separate, larger assessment area for the purposes of evaluating a bank's community development activities. A larger, more clearly defined area for community development activities could mitigate the artificial competition for investments in areas served by many banks and benefit perennially underserved rural areas or small metropolitan areas. We are also exploring ways to adjust the definition of low- and moderate-income in high-poverty rural areas where incomes overall may be low, relative to federal benchmarks. This type of adjustment could be helpful in encouraging more CRA activity in underserved rural areas.

2. Our country's affordable housing crisis is making it increasingly hard for working families to find an affordable place to live anywhere near economic opportunity. The percentage of housing stock available for rent or sale has fallen sharply since the financial crisis and is now as low as it has been in more than 30 years. The current annual supply of new housing units is running an estimated 370,000 units below the trend for new housing demand.

A. Chair Powell, are you concerned that the affordable housing crisis is reducing labor mobility? What impact does reduced labor mobility have on the broader economy?

Housing has indeed been a growing share of household budgets in recent years. Between 2000 and 2017, the share of households spending more than 30 percent of their income on rent increased from 39 percent to 49 percent. Families with lower incomes tend to spend much larger shares of their incomes on housing, and their share of income spent on rent has risen by an even larger amount.[1] Increases in rent expenditure shares have been widespread across the country, with four out of five metropolitan areas experiencing an increase of at least five percentage points since 2000.

Migration across states and metropolitan areas has trended down over the past several decades across all segments of the population.[2] Additionally, migration rates continue to be lower among people without a college degree, and highly educated workers have become more geographically concentrated. Furthermore, there was little migration out of the hardest-hit areas after the Great Recession.[3] Many have raised concerns that a lack of affordable housing in areas with the strongest employment opportunities has impeded labor mobility and prevented migration from workers who would benefit from moving to these areas—particularly workers without a college education.

Economic theory can predict very large effects of a lack of affordable housing on aggregate productivity, by preventing workers from moving to locations where skills would be most productive.[4] However, evidence on the connection between housing affordability and migration has not been clear-cut. Some research has found that high house prices reduce migration,[5] but

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[1] Jeff Larrimore and Jenny Schuetz, "Assessing the Severity of Rent Burden on Low-Income Families," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, December 22, 2017), https://www.federalreserve.gov/econres/notes/feds-notes/assessing-the-severity-of-rent-burden-on-low-income-families-20171222.htm.

[2] Raven Molloy, Christopher L. Smith, and Abigail Wozniak, "Internal Migration in the United States," *Journal of Economic Perspectives* 25, no. 3 (2011): 173–96.

[3] See the following studies for more information on these phenomena: Abigail Wozniak "Are College Graduates More Responsive to Distant Labor Market Opportunities?" *Journal of Human Resources*, 45, no. 4 (2010): 944–70; Enrico Moretti, "Real Wage Inequality," *American Economic Journal: Applied Economics* 5, no. 1 (2013); and Danny Yagan, "Employment Hysteresis from the Great Recession," NBER Working Paper No. 23844 (Cambridge, MA: September 2017).

[4] Chang-Tai Hsieh and Enrico Moretti "Housing Constraints and Spatial Misallocation," *American Economic Journal: Macroeconomics* 11, no. 2 (2019): 1–39; and Peter Ganong and Daniel Shoag, "Why Has Regional Income Convergence in the U.S. Declined?" *Journal of Urban Economics* 102 (2017): 76–90.

[5] Relevant studies finding an effect of house prices on migration include: Jelle Barkema and Tam Bayoumi, "Stranded! How Rising Inequality Suppressed U.S. Migration and Hurt Those Left Behind," IMF Working Paper No. 19/122 (2019); Matthew Notowidigdo, "The Incidence of Local Labor Demand Shocks," NBER Working Paper No. 17167 (Cambridge, MA: 2011); Andrew Plantinga, Cécile Détang-Dessendre, Gary Hunt, and Virginie Piguet, "Housing Prices and Inter-urban Migration," *Regional Science and Urban Economics* 43, no. 2 (2013), 296–306.

other research has found little effect.[6]

Other factors outside of a lack of affordable housing also are likely responsible, in part, for the decline in migration. Research has suggested that the decline in migration may reflect a decline in labor market dynamism more generally, since fewer workers change employers each year even when they do not move. There is also some evidence that there are fewer opportunities in large cities for workers without a college degree, and that part of the decline in migration also reflects workers staying longer in central cities into middle age.[7] And, consistent with the possibility that the lack of affordable housing is not driving low-income households out of expensive cities, lower income workers in areas with high rents are about equally satisfied with the quality of their housing as lower income workers in other areas.[8]

Ultimately, the impact of declining migration depends on its cause. If declining migration is due to a lack of affordable housing, then we might expect reduced economic output and increased economic inequality as fewer people move to economic opportunities. If declining migration is due to lower fluidity in the labor market more generally, then declining migration could be a symptom, not a cause, of other difficulties in the labor market. And, if declining migration is due to workers increasingly believing that their current job best matches their skills and interests—reducing the need to move elsewhere for employment—then it could be a positive development.

B. If the affordable housing crisis reduces labor mobility, affecting the entire economy, what role does the Federal Reserve have in addressing the affordable housing crisis in the U.S.?

A wide range of factors and policies outside of the purview of the Federal Reserve affect the availability and affordability of housing in the United States. The Federal Reserve monitors developments in housing and labor markets to assist in our understanding of the broader economy. With respect to our regulatory and supervisory responsibilities, we are committed to promoting a fair and transparent consumer financial services marketplace and effective community development, including for traditionally underserved and economically vulnerable households and neighborhoods. As discussed in my response to Question 1, the Federal Reserve is actively engaged in an interagency effort to modernize the CRA to encourage lending in low- and moderate-income communities. Access to credit by households and businesses is certainly a factor that contributes to the availability and affordability of housing.

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[6] Studies finding limited effects include Molloy, Smith, and Wozniak, "Internal Migration in the United States"; and Jeffrey Zabel, "Migration, Housing Market, and Labor Market Responses to Employment Shocks," *Journal of Urban Economics* 72 (2012): 267–84.

[7] David Autor, "Work of the Past, Work of the Future" American Economic Association Richard T. Ely Lecture (2019).

[8] See https://www.federalreserve.gov/consumerscommunities/shed.htm.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Ranking Member Sherrod Brown:

Capital

1) You have said that capital levels at the largest banks are much higher than they were before the financial crisis. Do you think that using capital levels during the financial crisis is the correct benchmark from which to analyze what is the appropriate level of capital? Do you agree that we should not lower capital levels for the largest banks?

Stress Capital Buffer

2) At the Fed's recent stress test conference, Vice Chair for Supervision Randal Quarles indicated that the Fed would soon finalize the stress capital buffer proposal. You have said that the overall level of capital, particularly at the largest firms, is about right."[1] If this proposal leads to lower capital levels at the largest banks, however, will the Fed adjust the supervisory and CCAR stress tests to offset that reduction and how?

Stress Tests – Qualitative Objection

3) The Fed recently eased the qualitative portion of the stress test regime and removed the qualitative objection, which allowed the Fed to prevent banks from making capital distributions based on the quality of their risk management and internal controls.

A. Without a strong qualitative component and qualitative objection, what incentive does a bank have to understand how capital distributions would reduce the amount of capital needed to survive another financial crisis? Before the 2008 financial crisis, existing examination and supervision tools were not enough to identify and correct mismanagement of capital risk. Please explain how the Fed will address these risks without the qualitative objection.

Distributional Financial Accounts

4) The Federal Reserve recently introduced distributional financial accounts, a new set of statistics on the distribution of wealth in the United States. These estimates once again confirm the clear increase in wealth inequality in recent decades. I want to express my appreciation to the Board for your attention to this issue and for the hard work of the team that put this together.

A. Tell us, what do you see as the key findings from this new research?

[1] *Monetary Policy and the State of the Economy Before the Hous. Comm. on Fin. Servs.*, 116th Cong. (Feb. 27, 2019).

B. How does this research, coupled with low interest rates, guide your efforts to push for both job and wage growth?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 19, 2019

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 22, 2019.

<u>Questions for The Honorable Jerome Powell, Chair, Board of Governors of the Federal Reserve System from Ranking Member Sherrod Brown:</u>

Capital

1. You have said that capital levels at the largest banks are much higher than they were before the financial crisis. Do you think that using capital levels during the financial crisis is the correct benchmark from which to analyze what is the appropriate level of capital? Do you agree that we should not lower capital levels for the largest banks?

The Federal Reserve Board considers a number of factors in assessing current capital levels, including the findings of researchers and studies since the financial crisis on optimal capital levels. I believe that the current overall level of bank capital is about right. Maintaining the safety and soundness of the largest banking firms is fundamental to maintaining the stability of the U.S. financial system and the broader economy. The banking agencies have substantially strengthened regulatory capital and liquidity requirements for large banking firms. The increase in requirements has significantly increased the financial resiliency of these firms. At the same time, regulation and supervision should be tailored according to banking firms' size, complexity, and risks posed to the financial system. I do not expect that refinements to the post-crisis regulatory regime will result in meaningful changes to capital levels, particularly for the largest, most systemically important banks.

Stress Capital Buffer

2. At the Fed's recent stress test conference, Vice Chair for Supervision Randal Quarles indicated that the Fed would soon finalize the stress capital buffer proposal. Yon have said that the overall level of capital, particularly at the largest firms, is about right."[1] If this proposal leads to lower capital levels at the largest banks, however, will the Fed adjust the supervisory and CCAR stress tests to offset that reduction and how?

[1] *Monetary Policy and the State of the Economy Before the Hous. Comm. on Fin. Servs.*, 116th Cong. (Feb. 27, 2019).

As noted in the response to question 1, I believe that the current overall level of bank capital is about right, and I do not expect that refinements to the post-crisis regulatory regime will result in meaningful changes to capital levels, particularly for the largest, most systemically important banks.

Stress Tests – Qualitative Objection

3. The Fed recently eased the qualitative portion of the stress test regime and removed the qualitative objection, which allowed the Fed to prevent banks from making capital distributions based on the quality of their risk management and internal controls.

A. Without a strong qualitative component and qualitative objection, what incentive does a bank have to understand how capital distributions would reduce the amount of capital needed to survive another financial crisis? Before the 2008 financial crisis, existing

examination and supervision tools were not enough to identify and correct mismanagement of capital risk. Please explain how the Fed will address these risks without the qualitative objection.

Given the importance of effective capital planning to safety and soundness, we will continue to assess annually the largest firms' capital planning practices through the rigorous, horizontal Comprehensive Capital Analysis and Review's exercise, as we have done since the last financial crisis. To the extent a firm exhibits capital planning deficiencies that call into question their ability to determine their capital needs under normal or stressed financial conditions, the Federal Reserve will use its full complement of supervisory tools – including deficient capital ratings, enforcement actions, and capital directives – to ensure prompt and thorough remediation of identified weaknesses by the firm.

Distributional Financial Accounts

4. The Federal Reserve recently introduced distributional financial accounts, a new set of statistics on the distribution of wealth in the United States. These estimates once again confirm the clear increase in wealth inequality in recent decades. I want to express my appreciation to the Board for your attention to this issue and for the hard work of the team that put this together.

A. Tell us, what do you see as the key findings from this new research?

The distributional financial accounts (DFAs) provide a new tool for monitoring quarterly changes in the distribution of wealth in the U.S. Like other studies of the wealth distribution, the DFAs show a substantial difference between the amount of wealth held by the top of the distribution and the bottom. For example, the wealth of the top 1 percent is considerably larger than that of the bottom 50 percent, with this difference increasing significantly over the last 30 years. In terms of shares, the top 1 percent owned about 31 percent of total wealth in the first quarter of 2019, while the bottom half owned about 1 percent.

Looking at the components of wealth in DFAs, another key finding is that business equity, which includes both corporate stock and unincorporated business ownership, is an important driver of increasing wealth concentration. Business equity as a share of total wealth has increased, on net, over the last 30 years, and the share of business wealth held by the top of the wealth distribution also has increased.

B. How does this research, coupled with low interest rates, guide your efforts to push for both job and wage growth?

The DFAs show that the bottom half of the wealth distribution holds a very small slice of aggregate U.S. wealth. This suggests that, for many of these households, good jobs are crucial to their well-being and their ability to save for the future. Our goal is to sustain the current expansion, with a strong labor market and stable prices, for the benefit of all households.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

<u>Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Thom Tillis:</u>

1) Traditionally, the Federal Reserve Board (Fed) has not been subject to audit, for fear of the audit undermining the independence of its monetary policy function. There appears to be no similar justification with respect to a business run by the Fed in competition with the private sector, and where budgets need to be reviewed for compliance with the Monetary Control Act. Assuming the Fed proceeds in this area, would you relax your traditional opposition to Fed audits if all monetary policy functions were exempt?

2) You have indicated that the Fed is considering a new business of providing a real-time payments service in competition with the existing RTP system operated by The Clearing House, and potentially other private sector actors. The Monetary Control Act requires the Fed to establish a fee schedule for Reserve Bank payment services that are based on the basis of all direct and indirect costs actually incurred in providing the priced services, including imputed costs (including taxes) that would be incurred by a private-sector provider.

3) What is the Fed's estimate of how much it would cost to build such a system, and operate it annually?

4) How would the Fed fund the initial outlay – for example, would you increase prices on your existing payments system products to fund it? Would these outlays reduce Fed remittances to the Treasury in the years they are made?

5) Can you commit that before incurring any start-up costs, you would have in place a business plan that envisioned pricing consistent with the Monetary Control Act, and share that plan with this Committee prior to any decision to move ahead?

6) My understanding is that with regard to the existing ACH services provided by the Fed, small banks are charged more than large banks. The discount is used in order to attract the greater volume provided by the large banks. Will you commit, and construct your business plan on the assumption that the Fed will never do volume discount pricing for any real-time payment service?

7) The Clearing House is owned by the nation's largest banks, which are already participating in the RTP system, and have built all the necessary connections to it. It seems exceedingly unlikely therefore – whether with volume discounts or without them – that those banks will abandon the RTP system to join any Fed system in the future. Is part of the Fed plan to require the largest banks to join the Fed System – in effect, outlawing a private sector option? If not, please explain (and include in your business plan an explanation of) how the Fed could price in compliance with the Monetary Control Act when its system does not process the volume of any of the large banks. What would pricing have to look like in order to recoup start-up and operating costs if only small banks, representing a fraction of total volume, were participating in the Fed system?

8) How many Fed employees (at the Board and the Reserve Banks) are employed to operate the ACH network? How many employees do you roughly estimate would be employed to operate a real-time network? Would Reserve Banks need to add staff or would they be transitioned from ACH (as the move towards real-time could lead to fewer employees devoted to ACH)?

9) If the Fed offers real-time payments, why should it continue to also be the regulator of the payments system? Should that responsibility be conferred to another agency who could more dispassionately assess the Fed's compliance with the provisions of the Monetary Control Act and all other applicable laws?

10) In January 2015, the Fed stated in its Strategies for Improving the U.S. Payment System that they "would not consider expanding its service provider role unless it determines that doing so is necessary to bring about significant improvements to the payment system and that actions of the private sector alone will likely not achieve the desired outcomes for speed, efficiency and safety in a timely manner." While you have stated that no final decisions have been made, the request for comments issued clearly states that the Fed is in fact considering expanding its role, despite the significant improvements made by the private sector. In the future, how can you expect the private sector to respond to the Fed's calls for innovation, when the Fed fails to hold itself to its commitments?

11) The FHFA has currently proposed a Conservatorship Capital Framework that provides capital credit for Enterprise Credit Risk Transfer (CRT) transactions in strong structures and/or with strong counterparties which seems appropriate at a high level. In a speech in July 2017 you expressed support for the GSEs' credit risk transfer efforts, and I believe there is a fair amount of consensus that these transactions have helped reduce taxpayer risks and introduce more private capital in support of the U.S. housing market. Among the often-cited objectives of housing finance reform is to level the playing field for private capital willing to price and invest in mortgage credit risk. Also, one of the overarching principals of the post-crisis regulatory environment has been that similarly situated companies should be regulated similarly regardless of charter-type. With those objectives in mind, it seems appropriate to me that banks should have a similar opportunity to receive capital relief for CRT transactions that are fully collateralized and/or insured by strong counterparties. This could expand mortgage options for consumers, allowing banks to retain the AAA risk on a mortgage, maintain the consumer relationship, and sell off the credit risk to entities better equipped to hold that risk given the duration mismatch for banking institutions.

A) Would you commit to taking a fresh look with your fellow banking regulators at the circumstances under which banks should be allowed capital credit for bona fide credit risk transfer transactions that involve sound structures and counterparties?

12) What are you doing to ensure that examiners are not downgrading ratings, issuing enforcement actions, or imposing Matters Requiring Attention and Immediate Attention (MRAs and MRIAs) based on guidance or informal standards? Banks are probably going to be reluctant

to raise these issues publically, so given the lack of transparency, how do we know that examiners are really basing their ratings and findings on rules and not guidance?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

November 15, 2019

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to question 11 that you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. This concludes all responses to your questions.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Tillis:

11. The FHFA has currently proposed a Conservatorship Capital Framework that provides capital credit for Enterprise Credit Risk Transfer (CRT) transactions in strong structures and/or with strong counterparties which seems appropriate at a high level. In a speech in July 2017 you expressed support for the GSEs' credit risk transfer efforts, and I believe there is a fair amount of consensus that these transactions have helped reduce taxpayer risks and introduce more private capital in support of the U.S. housing market. Among the often-cited objectives of housing finance reform is to level the playing field for private capital willing to price and invest in mortgage credit risk. Also, one of the overarching principals of the post-crisis regulatory environment has been that similarly situated companies should be regulated similarly regardless of charter-type. With those objectives in mind, it seems appropriate to me that banks should have a similar opportunity to receive capital relief for CRT transactions that are fully collateralized and/or insured by strong counterparties. This could expand mortgage options for consumers, allowing banks to retain the AAA risk on a mortgage, maintain the consumer relationship, and sell off the credit risk to entities better equipped to hold that risk given the duration mismatch for banking institutions.

Would you commit to taking a fresh look with your fellow banking regulators at the circumstances under which banks should be allowed capital credit for bona fide credit risk transfer transactions that involve sound structures and counterparties?

The Federal Housing Financing Agency's (FHFA) proposal on "Enterprise Capital Requirements" is specifically designed for Fannie Mae and Freddie Mac and their specialized lending niche. The FHFA has calibrated its proposed capital requirements and tailored its credit risk mitigation rules to two specific categories of exposures: single-family home loan and multifamily loan portfolios. These products have standardized characteristics that are incorporated in the FHFA's proposed approach for risk weighting these exposures.

Banks have a wider variety of exposures than Fannie Mae and Freddie Mac. Thus, banks require a different calibration of capital requirements and a more general set of rules governing the recognition of credit risk mitigation.

The banking agencies' approach for recognizing credit risk transfer through a securitization needs to be flexible enough to accommodate a wide variety of securitized asset classes without standardized characteristics. The approach may require more capital on a transaction-wide basis than would be required if the underlying assets had not been securitized, in order to account for the complexity introduced by the securitization structure. Furthermore, the agencies' capital rule requires banking organizations to meet certain operational requirements. An inability by a banking organization to meet these operational requirements may lead to higher risk weighting, relative to the FHFA's proposed approach. That said, you raise a number of important considerations, and we are reviewing policies related to credit risk transfers.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

November 5, 2019

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1-10 and 12 that you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. A response to your remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Thom Tillis:

1. Traditionally, the Federal Reserve Board (Fed) has not been subject to audit, for fear of the audit undermining the independence of its monetary policy function. There appears to be no similar justification with respect to a business run by the Fed in competition with the private sector, and where budgets need to be reviewed for compliance with the Monetary Control Act. Assuming the Fed proceeds in this area, would you relax your traditional opposition to Fed audits if all monetary policy functions were exempt?

Currently, the Federal Reserve is subject to several levels of audit and review. Under existing law, the financial statements of the Federal Reserve Board (Board) and the Reserve Banks are audited annually by an independent accounting firm (under the supervision of the Office of the Inspector General of the Board and the Board's Division of Reserve Bank Operations and Payment Systems, respectively). Our audited financial statements are made publicly available and provided to Congress annually.

In addition, the Congress and the Government Accountability Office (GAO) may conduct financial and operational audits of the Federal Reserve and have done so on many occasions. In particular, for non-monetary policy activities undertaken by the Federal Reserve, such as banking supervision and regulation, the GAO already has full audit review authority. As of the end of June 2019, nearly 170 audits have been conducted since the financial crisis.

The GAO also has reviewed specifically the Federal Reserve's role in providing payment services such as check, automated clearinghouse (ACH) transactions, and wire, and concluded that the payment system and its users have benefited over the long run from the Federal Reserve's operational involvement and competition with other providers.[1]

2. You have indicated that the Fed is considering a new business of providing a real-time payments service in competition with the existing RTP system operated by The Clearing House, and potentially other private sector actors. The Monetary Control Act requires the Fed to establish a fee schedule for Reserve Bank payment services that are based on the basis of all direct and indirect costs actually incurred in providing the priced services, including imputed costs (including taxes) that would be incurred by a private-sector provider.

Please see the responses to questions 4 and 5.

3. What is the Fed's estimate of how much it would cost to build such a system, and operate it annually?

Based on what we have learned from central banks in other countries and our own experience with building and modernizing our existing Federal Reserve payment services, we expect the

[1] See GAO-16-614, "Federal Reserve's Competition with Other Providers Benefits Customers, but Additional Reviews Could Increase Assurance of Cost Accuracy" (2016), https://www.gao.gov/products/GAO-16-614.

costs to be within a range that would allow us to achieve cost recovery over the long run.

The exact costs of building the FedNow℠ Service would be predicated on its specific features and functionality, which we will specify after receiving and considering public comment as part of our normal process for new services or major service enhancements, and other factors, such as technical architecture and build-versus-buy decisions.

4. How would the Fed fund the initial outlay – for example, would you increase prices on your existing payments system products to fund it? Would these outlays reduce Fed remittances to the Treasury in the years they are made?

FedNow Service outlays would be funded in a similar manner as all Reserve Bank outlays. Our practice is to recover development costs over the long run much like a private-sector firm. This includes imputing capital and certain other costs, for example taxes, to priced services as required by the MCA.

As with any Federal Reserve service, remittances to the Treasury may fluctuate based on the Federal Reserve's cost recovery.

5. Can you commit that before incurring any start-up costs, you would have in place a business plan that envisioned pricing consistent with the Monetary Control Act, and share that plan with this Committee prior to any decision to move ahead?

The MCA requires that "(o)ver the long run, fees shall be established on the basis of all direct and indirect costs actually incurred in providing the Federal Reserve services."[2] In addition, the MCA requires the Federal Reserve to "give due regard to competitive factors and the provision of an adequate level of such services nationwide."

Reflecting the MCA requirement also to give due regard to both competitive factors and the provision of an adequate level of services nationwide, the Board's longstanding policy (since 1980) recognizes that, during an initial start-up period, new operational requirements and variations in volume may temporarily change unit costs for a service. Our intention is to match revenues and costs as soon as possible and monitor progress in meeting this goal. We would be happy to discuss the progress on the FedNow Service with the committee.

6. My understanding is that with regard to the existing ACH services provided by the Fed, small banks are charged more than large banks. The discount is used in order to attract the greater volume provided by the large banks. Will you commit, and construct your business plan on the assumption that the Fed will never do volume discount pricing for any real-time payment service?

The Federal Reserve has not yet determined the pricing structures or levels that will be applicable to the FedNow Service. Before the FedNow Service is launched, the Board will announce the service's fee structure and fee schedule. Based on prevailing market practices, the Board expects that the fee structure would include a combination of per-item fees, charged to sending banks and potentially, to receiving banks, and fixed participation fees. The ultimate fee

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[2] 12 U.S.C. 226.

structure and schedule would be informed by the Board's assessment of market practices at the time of implementation, which could evolve from today's practices. Separate per-item fees could also be charged for other message types that may be offered in the future. This approach is consistent with the approach currently taken with respect to other priced services provided by the Federal Reserve.

7. The Clearing House is owned by the nation's largest banks, which are already participating in the RTP system, and have built all the necessary connections to it. It seems exceedingly unlikely therefore – whether with volume discounts or without them – that those banks will abandon the RTP system to join any Fed system in the future. Is part of the Fed plan to require the largest banks to join the Fed System – in effect, outlawing a private sector option? If not, please explain (and include in your business plan an explanation of) how the Fed could price in compliance with the Monetary Control Act when its system does not process the volume of any of the large banks. What would pricing have to look like in order to recoup start-up and operating costs if only small banks, representing a fraction of total volume, were participating in the Fed system?

Many banks today, particularly large ones, have signed up for Federal Reserve and private-sector services in other payment systems. We expect large banks would benefit from joining the FedNow Service both from a business perspective, in order to extend reach to a broader array of banks, and from a resiliency perspective to have a back-up option. We expect these benefits would outweigh the costs of joining two services, as is the case today for other payment services.

8. How many Fed employees (at the Board and the Reserve Banks) are employed to operate the ACH network? How many employees do you roughly estimate would be employed to operate a real-time network? Would Reserve Banks need to add staff or would they be transitioned from ACH (as the move towards real-time could lead to fewer employees devoted to ACH)?

Approximately 70 employees work on day-to-day operations of the Federal Reserve's FedACH service in order to support the service's approximately 10,000 financial institution customers. Staff from across the Federal Reserve System provide additional support functions for various Federal Reserve services, including FedACH, such as technology development.

The FedNow Service is a priority for the Federal Reserve, and as such we will devote the necessary resources required to deliver the highest quality service in a timely manner. Resources will likely come both from existing staff within the Federal Reserve as well as new staff. Staff will not be drawn exclusively from any single service or other Reserve Bank function.
The Board requires all Federal Reserve services, including FedACH and FedNow Service, to recover the actual and imputed long-run costs, which includes staffing costs, associated with operating the service.

9. If the Fed offers real-time payments, why should it continue to also be the regulator of the payments system? Should that responsibility be conferred to another agency who could more dispassionately assess the Fed's compliance with the provisions of the Monetary Control Act and all other applicable laws?

The Board does not have plenary regulatory or supervisory authority over the U.S. payment system. Rather, the Board has limited authority to influence private-sector payment systems in specific circumstances. For example, the Bank Service Company Act grants the Board (and the other federal banking agencies) the authority to regulate and examine third party service providers, but only for the performance of certain covered services and only when services are performed for depository institutions under the agency's supervision.

Under the Federal Reserve Act, the Board supervises the activities of the Reserve Banks through rules, policies, and examinations. The decision to build the FedNow Service adheres to the MCA and the longstanding Federal Reserve policies and processes.[3]

10. In January 2015, the Fed stated in its Strategies for Improving the U.S. Payment System that they "would not consider expanding its service provider role unless it determines that doing so is necessary to bring about significant improvements to the payment system and that actions of the private sector alone will likely not achieve the desired outcomes for speed, efficiency and safety in a timely manner." While you have stated that no final decisions have been made, the request for comments issued clearly states that the Fed is in fact considering expanding its role, despite the significant improvements made by the private sector. In the future, how can you expect the private sector to respond to the Fed's calls for innovation, when the Fed fails to hold itself to its commitments?

The decision to build the FedNow Service is responsive to requests from the Faster Payments Task Force (FPTF) and a recommendation from the U.S. Department of the Treasury (U.S. Treasury). Through the Strategies for Improving the U.S. Payment System (SIPS) initiative, the Federal Reserve and industry stakeholders worked together to identify desirable improvements to the U.S. payment system and the most effective way to achieve those improvements.

The FPTF, a diverse group of more than 300 industry stakeholders convened as part of the SIPS initiative, issued in 2017 a final report with 10 consensus recommendations intended to advance the goal of ubiquitous, safe faster payments in the United States.[4] Among those recommendations was a request for the Federal Reserve to provide a 24x7x365 settlement service for faster payments. The request was intended to "enable a needed infrastructure to support faster payments." At that time, the members of the FPTF were aware of and anticipated the launch of the private-sector service.

The U.S. Treasury made a similar recommendation in its 2018 report on financial innovation: "Treasury recommends that the Federal Reserve move quickly to facilitate a faster retail payments system, such as through the development of a real-time settlement service."[5] The FPTF request and U.S. Treasury recommendation reflect the foundational role that the Federal Reserve, as the nation's central bank, has served since its inception in providing payment and settlement services to banks.

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[3] See https://www.federalreserve.gov/paymentsystems/pfs_policies.htm.

[4] See https://fasterpaymentstaskforce.org/.

[5] See https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation_0.pdf.

12. What are you doing to ensure that examiners are not downgrading ratings, issuing enforcement actions, or imposing Matters Requiring Attention and Immediate Attention (MRAs and MRIAs) based on guidance or informal standards? Banks are probably going to be reluctant to raise these issues publically, so given the lack of transparency, how do we know that examiners are really basing their ratings and findings on rules and not guidance?

In September 2018, the federal financial regulatory agencies issued an Interagency Statement Clarifying the Role of Supervisory Guidance (Interagency Statement). The Interagency Statement reaffirmed that supervisory guidance, unlike laws and regulations, is not legally enforceable, and therefore supervisory actions cannot be based on supervisory guidance.

Where appropriate and helpful to explain the identified issue and possible remediation steps to the firm, examiners may, as the statement indicates, refer to guidance. The Board issues guidance to increase the transparency of our supervisory expectations. We have reminded our examiners to be clear when communicating with financial institutions in order to minimize possible confusion between the principles and sound practices described in guidance and the requirements of regulations.

Since the issuance of the Interagency Statement, the Federal Reserve has taken several steps to ensure that System supervisory staff understand its content and are acting consistent with it. These steps include:

- Issuing internal talking points, FAQs, and training materials after publication of the Interagency Statement;
- Conducting a mandatory training session for all supervisory staff on the Interagency Statement, with examples of acceptable language for supervisory communications, as well as additional, more targeted training sessions with staff;
- Instituting a greater use of templates for supervisory communications to firms to ensure consistency in messages, including related to guidance;
- Confirming with all Reserve Bank supervisory staff and staff of all portfolio management groups that they have implemented the Interagency Statement in their respective Districts and portfolios;
- Coordinating with the other federal banking agencies so that any interagency guidance is consistently applied; and
- Indicating to firms that if they have concerns about how supervisory guidance is being applied, they should feel free to reach out to Federal Reserve staff, either at their local Reserve Bank or to Board staff directly.

In addition, an appeals process exists for firms who wish to challenge supervisory findings, including MRAs and MRIAs.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
July 11, 2019

Questions for The Honorable Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System, from Senator Tina Smith:

1) On July 10, the New York Times reported that Deutsche Bank private banking managers retained notorious child predator Jeffrey Epstein as a client, even after Deutsche Bank's compliance officers recommended that the bank drop him as a client because of reputational risks to the bank.

A. In general, what type of customer presents reputational risks to a bank? How does the Fed assess a bank's reputational risks, and how does the Fed account for reputational risks in its supervision of banks?

B. Could having Jeffrey Epstein – one of the most well-known sex offenders in the world – present a reputational risk to a bank?

C. If a bank doesn't think Jeffrey Epstein presents a reputational risk, then what sort of customer would be notorious enough that a bank should be concerned about reputational risk?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 11, 2019

The Honorable Tina Smith
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you submitted following the July 11, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

[1] Questions for the record related to this hearing were received on July 22, 2019.

Questions for The Honorable Jerome H. Powell, Board of Governors of the Federal Reserve System from Senator Tina Smith:

1. On July 10, the New York Times reported that Deutsche Bank private banking managers retained notorious child predator Jeffrey Epstein as a client, even after Deutsche Bank's compliance officers recommended that the bank drop him as a client because of reputational risks to the bank.

A. In general, what type of customer presents reputational risks to a bank? How does the Fed assess a bank's reputational risks, and how does the Fed account for reputational risks in its supervision of banks?

The Federal Reserve expects firms to consider reputational risks in their interactions with potential and existing clients. In the examination process, supervisors assess whether firms have adequate processes in place to detect and address reputational risks.

In general, the Federal Reserve will focus on whether any risks, including reputational risks, present safety and soundness concerns for the firm or present a risk of noncompliance with a law or regulation.

B. Could having Jeffrey Epstein – one of the most well-known sex offenders in the world – present a reputational risk to a bank?

Any individual client engaging in illegal or unethical behavior potentially could present reputational risks for an institution depending on the severity of the infraction or behavior. The Federal Reserve does not comment on specific individuals.

C. If a bank doesn't think Jeffrey Epstein presents a reputational risk, then what sort of customer would be notorious enough that a bank should be concerned about reputational risk?

Please see response to Question 1B.

Congressman David Scott- Questions for the Record:

Monetary Policy and the State of the Economy: July 10, 2019

Chairman Powell,

As a follow-up to our discussion during the hearing, could you please provide some additional information:

- Can you tell me the approximate number and scope of current LIBOR contracts that do not have fall back provisions?
- Are contracts still being made that are based on LIBOR and do not have fall back provisions? If so, under what circumstances?
- Additionally, can you please discuss the alternative reference rates being contemplated, such as SOFR (Secured Overnight Financing Rate) and Treasury's CMT (Constant Maturity Treasury Rate) and their application to both fixed and adjustable rate mortgages?
- What other issues must be considered during the transition away from LIBOR and how might it impact consumers who may be party to LIBOR based financial contracts?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 27, 2019

The Honorable David Scott
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the questions you submitted following the July 10, 2019,[1] hearing before the House Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative David Scott:</u>

As a follow-up to our discussion during the hearing, could you please provide some additional information:

- **Can you tell me the approximate number and scope of current LIBOR contracts that do not have fall back provisions?**

The Alternative Reference Rates Committee (ARRC) has estimated that contracts referencing U.S. London Interbank Offered Rate (LIBOR) totaled approximately $200 trillion as of year-end 2016 in gross notional exposure (which includes contracts both with and without fallback language).[2]

To the best of our knowledge, almost all of these contracts have some form of fallback language and examples of contracts with absolutely no fallback provision are rare. However, most legacy contracts referencing LIBOR have fallback provisions that were not designed for the kind of permanent stop or disruption to LIBOR that is likely to occur after 2021. The ARRC has developed and recommended use of more robust fallback provisions in floating rate debt, business loans, and securitizations that address these problems and the ARRC is currently consulting on fallback language for adjustable rate mortgages. For derivatives, which are the largest source of LIBOR exposures, the International Swaps and Derivatives Association (ISDA) will be offering a protocol that addresses these problems.

- **Are contracts still being made that are based on LIBOR and do not have fall back provisions? If so, under what circumstances?**

LIBOR contracts are still being written. As previously noted, there are relatively few LIBOR contracts that have no fallback provision whatsoever, however use of robust fallback language varies by financial institution and product. The use of more robust fallback language now appears to be fairly prevalent in new contracts for floating-rate debt and syndicated loans, but it is less prevalent in other types of business loans and securitizations. While circumstances differ for each firm and it is difficult to generalize, we understand that some firms are still working to evaluate whether to use ARRC recommended fallback language, which is still in process, or to develop company specific fallback language. In this context, it should be noted that the ARRC and industry trade groups (e.g. ISDA) are still deliberating on recommended fallback language for some products.

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[2] See https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

- **Additionally, can you please discuss the alternative reference rates being contemplated, such as SOFR (Secured Overnight Financing Rate) and Treasury's CMT (Constant Maturity Treasury Rate) and their application to both fixed and adjustable rate mortgages?**

Other reference rates, like the Second Oversight Financing Rate (SOFR) and the Constant Maturity Treasury Rate (CMT), can be or already are used for adjustable rate mortgages. Some banks already offer adjustable rate mortgages[3] based on the CMT rates. The potential for offering adjustable rate mortgages based on SOFR is discussed in the ARRC Consumer Products Working Group white paper "Options for Using SOFR in Adjustable-Rate Mortgages" issued on July 11, 2019, and Fannie Mae and Freddie Mac have indicated that they will build their systems in order to be able to accept these kinds of mortgages. Fixed rate mortgages do not use LIBOR as a reference rate, because the interest rate for those products is fixed at origination.

- **What other issues must be considered during the transition away from LIBOR and how might it impact consumers who may be party to LIBOR based financial contracts?**

Consumers may have a limited understanding of LIBOR, the chosen replacement reference rate, and how their payments on affected variable rate products (such as adjustable-rate residential mortgages) could change. Firms (including creditors and servicers) must ensure any transition complies with applicable consumer protection laws and regulations, such as the Truth in Lending Act and the Federal Trade Commission Act prohibition against unfair and deceptive acts or practices. Relevant elements of a firm's transition strategy may include, as appropriate:

- Identifying affected consumer loan contracts and plans for addressing them;
- Preparing clear and timely disclosures about any change in terms, including any regulatory-required advance notice of interest rate changes to borrowers;
- Developing transparent communications plans, which may include guidelines for operational practices and employee training; and clear, understandable, and consistent messaging about the choice of the replacement reference rate, spread adjustment, timing, and other mechanics;
- Implementing system changes required to carry out the transition to the new rate, including any operational considerations for billing cycles.

The ARRC Consumer Product Working Group has developed a set of guiding principles for consumer loan products and has actively worked with consumer groups and the Consumer Financial Protection Bureau and other agencies in developing both its whitepaper on the potential for SOFR-based adjustable rate mortgages and on its consultation on more robust fallback provisions of LIBOR-based adjustable rate mortgages. The ARRC will likewise work closely with consumer groups in developing a recommended spread adjustment and spread adjusted rate that lenders could choose to move to as a replacement to LIBOR in consumer loan products.

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[3] See http://sec.gov/spotlight/fixed-income-advisory-committee/arrc-second-report-041519.pdf.

Full Committee
Question for the Record
Monetary Policy and the State of the Economy
July 10, 2019

Federal Reserve Balance Sheet Size

Chairman Powell, you have testified over the past few years about the reduction of the Fed's balance sheet. You discussed the need for liquid reserves and the changing composition of the Fed's balance sheet since the great recession.

At its peak, the balance sheet was 25% of GDP which is significantly larger than its pre-crisis level of approximately 6% of GDP.

Many indications, plus your own testimony on February 27th, 2019, indicated that the resulting balance sheet is in the range of 16-17% of GDP. And, as of the Q1 2019, the board of governors has suggested that you will stop decreasing the size of the balance sheet effective September 30th.

From all appearances the 8% decline in the balance sheet over the past 9 months has, in no way, tightened monetary conditions and appears to have been taken in stride by the broader market. In fact, there is very little academic proof that QE1 or QE2 contributed any measurable easing or benefit to the economy post-crisis. Therefore, I find it not at all surprising, that there is no appreciable impact in the market from reversing these ill-conceived experiments during the post-crisis environment.

Mr. Powell, I don't believe that the board has provided sufficient detailed thought backed up by analytical presentation as to why the Fed's balance sheet should stay disproportionately large. Just because other central banks are doing it doesn't make it the proper course of action for the world's largest, most sophisticated, most global central bank.

Will you commit to a public forum led by Fed economists where outside parties can engage on the size and composition of the Fed's balance sheet?

Federal Reserve Balance Sheet Composition

As you know, I believe that the Fed's balance sheet should be composed of treasuries only, and for the most part, only short-term treasuries.

Given this sudden affection for a large balance sheet, will you advocate with your colleagues at the board of governors for a swap of the remaining agency mortgage-backed securities portfolio to the treasury for short-term treasury bills as mortgage-backed securities have consistently made up about 40% of the balance sheet since, at least, October 2018?

In my view, it's important that the fiscal authority take the responsibility for the balance sheet and resulting profit or loss from extraordinary asset purchases during the crisis be they mortgage-backed-securities, Maiden Lane assets, or any other asset taken as a part of the crisis intervention.

By emphasizing short-term treasury bills, this is more in line with the board of governors' current policy of setting a policy rate. This will keep the Fed's earnings more in line with their stated policy rate.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 17, 2019

The Honorable French Hill
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the questions you submitted following the July 10, 2019,[1] hearing before the House Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative French Hill:</u>

1. *Federal Reserve Balance Sheet Size*

Chairman Powell, you have testified over the past few years about the reduction of the Fed's balance sheet. You discussed the need for liquid reserves and the changing composition of the Fed's balance sheet since the great recession.

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Mr. Powell, I don' t believe that the board has provided sufficient detailed thought backed up by analytical presentation as to why the Fed's balance sheet should stay disproportionately large. Just because other central banks are doing it doesn't make it the proper course of action for the world's largest, most sophisticated, most global central bank.

Will you commit to a public forum led by Fed economists where outside parties can engage on the size and composition of the Fed's balance sheet?

There is a large and growing body of research on the impact of large-scale asset purchases on financial markets and economic growth. Results vary, but most authors find some positive effect of these purchases in easing financial conditions.

In terms of any decisions about the size and composition of the balance sheet, the Federal Reserve believes it is important to be transparent with the public on these issues. There are numerous ways the Federal Reserve communicates with the public about balance sheet issues. At least once a year, the Federal Reserve Bank of New York releases information on the Federal Reserve's balance sheet, with specific details about the evolution of the securities portfolio and projections for how these holdings will evolve.[1] Three weeks after each Federal Open Market Committee (FOMC) meeting, the minutes are released, which provide a summary

[1] https://www.newyorkfed.org/markets/annual_reports.

of any discussion the FOMC participants had on the balance sheet. And, when consensus decisions are reached, the FOMC shares this information with the public by releasing statements, such as in January 2019 when the FOMC participants decided to implement policy in the long-run in an ample reserves regime.

In terms of the current size of the Federal Reserve's balance sheet, it reflects the FOMC's decisions regarding monetary policy implementation as well as the Federal Reserve's statutory responsibilities that are independent of policy decisions. This point is seen in the three key liabilities on the Federal Reserve's balance sheet: currency in circulation, reserves and the U.S. Department of the Treasury (Treasury) General Account (TGA). Each of these liabilities helps provide social benefits to the economy and plays an important role as a safe and liquid asset for the public, the banking system, the U.S. government, or other institutions. And, each of these liabilities has grown both nominally and as a share of GDP over the past decade.

In terms of currency, the largest liability on the Federal Reserve's balance sheet, notes in circulation have more than doubled since the start of the financial crisis, with currency's share of GDP rising from about 5 percent at that time to 8 percent today. U.S. currency is an important medium of exchange and store of value, both domestically and abroad. Despite the increasing use of electronic means of payment, currency remains widely used in retail transactions in the United States. And, with heavy usage of U.S. currency overseas, changes in global growth as well as in financial and geopolitical stability can also materially affect the rate of currency growth.

Reserves are currently the second largest liability on the Federal Reserve's balance sheet. The FOMC has stated it will in the longer-run hold no more reserves than consistent with efficient and effective policy implementation. This determination will take into consideration the demand for reserves of depository institutions. Banks demand reserves for a variety of reasons. In part, banks determine their desired level to facilitate daily payment flows, both in ordinary times and in stress scenarios, without borrowing funds or selling assets. Banks also demand reserves for meeting regulatory restrictions, which have changed dramatically since the financial crisis, with large banks now maintaining substantial buffers of reserves, among other high-quality liquid assets, to comply with liquidity regulations. Reflecting these various demands, reserves have grown from their pre-crisis very small share of GDP to nearly 8 percent today.

The TGA reflects the fact that the Federal Reserve serves as the Treasury Department's fiscal agent. The size of the TGA is determined by the Treasury's rules. Before 2008, the Treasury targeted a steady, low balance of $5 billion in the TGA on most days. In May 2015, the Treasury announced its intention to hold in the TGA a level of cash generally sufficient to cover one week of outflows, subject to a minimum balance objective of roughly $150 billion. As of early October 2019, the TGA was about $335 billion, or nearly 2 percent of GDP.

Going forward, the Committee will continue its discussion on the composition of the balance sheet. In doing so, it will consider advantages of alternative compositions. As individuals outside the Fed have opined on the issue, these views are publically known and can be included in the discussion.

2. *Federal Reserve Balance Sheet Composition*

As you know, I believe that the Fed's balance sheet should be composed of treasuries only, and for the most part, only short-term treasuries.

Given this sudden affection for a large balance sheet, will you advocate with your colleagues at the board of governors for a swap of the remaining agency mortgage-backed securities portfolio to the treasury for short-term treasury bills as mortgage-backed securities have consistently made up about 40% of the balance sheet since, at least, October 2018?

In my view, it's important that the fiscal authority take the responsibility for the balance sheet and resulting profit or loss from extraordinary asset purchases during the crisis be they mortgage-backed- securities, Maiden Lane assets, or any other asset taken as a part of the crisis intervention.

By emphasizing short-term treasury bills, this is more in line with the board of governors' current policy of setting a policy rate. This will keep the Fed's earnings more in line with their stated policy rate.

The FOMC will be continuing its discussion of the longer-run composition of its balance sheet at future meetings. That said, the FOMC has already noted that it intends, in the longer run, to return to holding primarily Treasury securities. Over the past several years, the FOMC has taken steps to reduce the Federal Reserve's holdings of agency mortgage-backed securities (MBS). Currently, monthly principal payments from agency debt and agency MBS below the $20 billion are reinvested into Treasury securities, which is shifting the Federal Reserve's securities holdings toward Treasury securities.

At past FOMC meetings, participants began their discussion about the future composition of the Federal Reserve's Treasury securities holdings. Participants have discussed advantages of alternative compositions. For example, they noted that shorter maturities would provide flexibility to lengthen maturity if warranted by an economic downturn, whereas a portfolio with maturities that matched the outstanding Treasury market would have a more neutral effect on the market. These and other factors, including the point you raised, will be taken into consideration before any decision is made.

Question for the Record from Congressman Jim Himes for the Full Committee Hearing entitled "Monetary Policy and the State of the Economy"

Wednesday, July 10, 2019 10:00 AM

Jerome Powell, Chairman, Board of Governors of the Federal Reserve System:

Does the Federal Reserve Board view facilities, structured like narrow banks, as a way to provide competition in the interest rate environment? If not, why not?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

November 1, 2019

The Honorable Jim Himes
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to your question that you submitted following the July 10, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2019.

Questions for The Honorable Jerome H. Powell, Board of Governors of the Federal Reserve System from Representative Himes:

1. Does the Federal Reserve Board view facilities, structured like narrow banks, as a way to provide competition in the interest rate environment? If not, why not?

Depending on the prevailing constellation of short-term interest rates, facilities structured like narrow banks may foster competition by offering alternative, competitively priced deposit products to institutional investors. However, it is unclear that any benefits from improved competition will be passed through to retail depositors. In addition, the potential improvements to competition would need to be assessed against risks to financial intermediation, financial stability, and the implementation of monetary policy.

The Board has addressed these issues in greater detail in its March 12, 2019, advance notice of proposed rulemaking for its Regulation D (84 Fed. Reg. 8829).[1]

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[1] See https://www.govinfo.gov/content/pkg/FR-2019-03-12/pdf/2019-04348.pdf.

Congresswoman Joyce Beatty (OH-03)
Committee on Financial Services
"Monetary Policy and the State of the Economy"
July 10, 2019 at 10:00am – Rayburn 2128

Questions for the Record

Question #1

In the *105th Annual Report of the Board of Governors of the Federal Reserve System*, it states there are 9 savings and loan holding companies primarily engaged in insurance underwriting activities regulated by the Federal Reserve. I bring this to your attention because in a similar report produced for 2011, there were 26 savings and loan holding companies primarily engaged in insurance underwriting activities.

As you know, The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, P.L. 111-203, transferred the responsibility of supervision and regulation of these insurance companies to the Federal Reserve. In the nine short years since Congress gave this authority to the Federal Reserve, nearly 65% of these insurance companies have closed or sold their depository institution and exited Federal Reserve supervision and regulation. For example, in 2012 there were only 21 of these companies, in 2013 there were only 15, in 2015 only 12, in 2017 down to 11 and last year down to 9.

It is indisputable that there has been a steady decline in the number of these insurance companies under Federal Reserve supervision and regulation since the Federal Reserve took over this authority in 2010. This includes Nationwide Insurance from my district, who announced they were closing their depository institution last year.

I am urging you to create a working group within the Federal Reserve to take a closer look at how your institution can further tailor your existing regulations for these insurance companies before there are none left, unless it is your intention to ensure there are no savings and loan holding companies primarily engaged in insurance underwriting activities, in which case, I would ask you to provide your rational. Would you consider creating a working group? Why or why not?

Question #2

I am growing more concerned about the growing geographic and demographic diversity issues in the venture capital industry in this country and the potential effects of exacerbating the wealth gap and leaving whole communities behind. Roughly 80% of current venture capital investment is invested in four states – California, New York, Massachusetts and Texas – compared to 50% in 1995. Meanwhile, businesses co-founded by women and minorities continue to be left out of venture capital investment. In 2017, venture capital investment went to only 9% of businesses co-founded by women, only 1.9% of businesses co-founded by Latinos and only 1% of businesses co-founded by African Americans.

What are your thoughts on these figures? Do you believe venture capital, a growing source of private equity capital for businesses, has the potential or already has exasperated the wealth gap?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 15, 2019

The Honorable Joyce Beatty
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the questions you submitted following the July 10, 2019,[1] hearing before the House Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative Joyce Beatty:

1. In the 105th Annual Report of the Board of Governors of the Federal Reserve System, it states there are 9 savings and loan holding companies primarily engaged in insurance underwriting activities regulated by the Federal Reserve. I bring this to your attention beeause in a similar report produced for 2011, there were 26 savings and loan holding companies primarily engaged in insurance underwriting activities.

As you know, The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, P.L. 111-203, transferred the responsibility of supervision and regulation of these insurance companies to the Federal Reserve. In the nine short years since Congress gave this authority to the
Federal Reserve, nearly 65% of these insurance companies have closed or sold their depository institution and exited Federal Reserve supervision and regulation. For example, in 2012 there were only 21 of these companies, in 2013 there were only 15, in 2015 only 12, in 2017 down to 11 and last year down to 9.

It is indisputable that there has been a steady decline in the number of these insurance companies under Federal Reserve supervision and regulation since the Federal Reserve took over this authority in 2010. This includes Nationwide Insurance from my district, who announced they were closing their depository institution last year.

I am urging you to create a working group within the Federal Reserve to take a closer look at how your institution can further tailor your existing regulations for these insurance companies before there are none left, unless it is your intention to ensure there are no savings and loan holding companies primarily engaged in insurance underwriting activities, in which case, I would ask you to provide your rational. Would you consider creating a working group? Why or why not?

The Federal Reserve Board's (Board) principal supervisory objective for consolidated supervision of Insurance Savings and Loan Holding Companies (ISLHCs) is ensuring that they operate in a safe and sound manner so that the subsidiary insured depository institution is protected from risks related to nonbanking activities, including insurance. In applying our consolidated supervision, we work to ensure that regulations, supervisory guidance, and expectations are appropriately tailored to account for the unique complexities and characteristics of ISLHCs. We also continue to identify opportunities to improve coordination and cooperation with state insurance regulators in order to reduce regulatory burden on supervised firms while still fulfilling the Federal Reserve's supervisory mandate.

As required under the Economic Growth, Regulatory Relief, and Consumer Protection Act, the Board is in the process of establishing the Insurance Policy Advisory Committee (IPAC) and published an application for IPAC membership in the Federal Register on July 3, 2019. The IPAC will be comprised of a diverse group of up to 21 insurance experts to provide information, advice, and recommendations to the Board on both domestic and international insurance topics. The first IPAC meeting is scheduled for November 4, 2019. We hope the IPAC will provide an external view of the potential impact of any further revisions to our supervisory framework.

2. I am growing more concerned about the growing geographic and demographic diversity issues in the venture capital industry in this country and the potential effects of exacerbating the wealth gap and leaving whole communities behind. Roughly 80% of current venture capital investment is invested in four states - California, New York, Massachusetts and Texas- compared to 50% in 1995. Meanwhile, businesses co-founded by women and minorities continue to be left out of venture capital investment. In 2017, venture capital investment went to only 9% of businesses co-founded by women, only 1.9% of businesses co-founded by Latinos and only 1 % of businesses co-founded by African Americans.

What are your thoughts on these figures? Do you believe venture capital, a growing source of private equity capital for businesses, has the potential or already has exasperated the wealth gap?

The level of venture capital investment, as measured by dollar volume, has become more geographically concentrated over time, as statistics show large dollar investments being made in a small number of companies, many of which are headquartered in California, New York, Massachusetts and Texas. That said, given that the location of the venture capital investment is based on the headquarters of the company receiving funding, it is relevant to also consider that the investment funds may be disbursed over a broader geographic area, spreading the impact beyond the location of the company headquarters. Data on the number of venture capital investments per state show somewhat less concentration than the level of funding, with about 60 percent of investments occurring in the California, New York, Massachusetts and Texas in 2018.

The level of venture capital investment in business co-founded by women is low, but it has been increasing in recent years. In 2006, about 4 percent of investment was in companies with at least one female founder, but by 2018 about 12 percent of investment was in business co-founded by women. The number of venture capital investments going to businesses co-founded by women has also increased, from about 6 percent in 2006 to about 19 percent in 2018.

To better understand the factors that could affect the macro-economy, the Federal Reserve will continue to monitor trends related to business investment and its effect on the concentration of wealth.

Questions for the Record
Ranking Member Patrick McHenry
Subcommittee Hearing
"Monetary Policy and the State of the Economy"
July 10, 2019

- In your most recent Monetary Policy Report, the Fed suggests that modest wage growth may be linked to weak productivity growth. What do you believe is the most plausible explanation for slow productivity growth, and what kinds of policies would you recommend prioritizing in order to address it?

- At your January press conference, you were asked whether a $4 trillion balance sheet gave you sufficient firepower to handle a future recession. You answered yes. However, the Fed's balance sheet, as a share of GDP, is about where the Bank of Japan's balance sheet was prior to the financial crisis. Today, the Bank of Japan has ended up with a balance sheet as large as the Japanese economy, with mixed results on inflation and limited room to handle another downturn. Has Japan's experience affected your thinking on the appropriate size of the Fed's balance sheet, and how will the Fed work to ensure that the U.S. would avoid a similar fate?

- At your last hearing, the gentleman from New York, Mr. Zeldin, brought up the 2016 hack of Bangladesh's central bank, which led to the theft of $81 million by exploiting fraud detection vulnerabilities at the New York Fed. Since then, we had a hearing with major bank CEOs who identified cybersecurity as a profound risk to the financial sector. We've also recently witnessed ransomware attacks threaten essential government services in Maryland and Florida. I was hoping you could provide us with more details on the Fed's efforts to strengthen cybersecurity at both the operational and supervisory levels. In particular, who is accountable for overseeing these efforts at the Fed, including information sharing and the protection of your systems; and what kinds of contingency planning and stress tests is the Fed undertaking to improve our resilience against hacks in the future?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 25, 2019

The Honorable Patrick McHenry
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Ranking Member:

Enclosed is my response to question 1 that you submitted following the July 10, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record. A response to your remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Ranking Member Patrick McHenry:</u>

1. In your most recent Monetary Policy Report, the Fed suggests that modest wage growth may be linked to weak productivity growth. What do you believe is the most plausible explanation for slow productivity growth, and what kinds of policies would you recommend prioritizing in order to address it?

Labor productivity in the business sector rose at an annual rate of 1¼ percent from 2007 to 2018, about half its pace from 1991 to 2007. Many factors have likely contributed to the slowdown in productivity growth, most prominently lower business investment and slower capital accumulation during the current expansion compared with earlier expansions. Other possibilities include the absence of a new, economy-changing technology, whose adoption could spur another wave of strong productivity growth, or that recent technological advances are taking longer to percolate through the economy.

While the Federal Reserve can indirectly influence productivity growth by calibrating monetary policy to achieve stable macroeconomic conditions that are conducive to increasing business investment, prescriptions to increase productivity growth are more likely to be found in fiscal and regulatory policies than in monetary policy.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

October 17, 2019

The Honorable Patrick McHenry
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Ranking Member:

Enclosed are my remaining responses to questions 2 and 3 that you submitted following the July 10, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record. This concludes all responses to your questions.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Ranking Member Patrick McHenry:</u>

2. At your January press conference, you were asked whether a $4 trillion balance sheet gave you sufficient firepower to handle a future recession. You answered yes. However, the Fed's balance sheet, as a share of GDP, is about where the Bank of Japan's balance sheet was prior to the financial crisis. Today, the Bank of Japan has ended up with a balance sheet as large as the Japanese economy, with mixed results on inflation and limited room to handle another downturn.

Has Japan's experience affected your thinking on the appropriate size of the Fed's balance sheet, and how will the Fed work to ensure that the U.S. would avoid a similar fate?

The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment and stable prices. At each FOMC meeting the Committee evaluates data on the U.S. economy and chooses the appropriate stance of policy to continue to move the economy toward its mandated objectives. The current size of the Federal Reserve's balance sheet reflects the FOMC's decisions regarding monetary policy implementation as well as the Federal Reserve's statutory responsibilities that are independent of policy decisions.

Three key liabilities on the Federal Reserve's balance sheet are currency in circulation, reserves and the Treasury's General Account (TGA). Each of these liabilities helps provide social benefits to the economy and plays an important role as a safe and liquid asset for the public, the banking system, the U.S. government, or other institutions. And, each of these liabilities has grown both nominally and as a share of GDP over the past decade.

In terms of currency, the largest liability on the Fed's balance sheet, notes in circulation have more than doubled since the start of the financial crisis, with currency's share of GDP rising from about 5 percent of GDP to 8 percent today. U.S. currency is an important medium of exchange and store of value, both domestically and abroad. Despite the increasing use of electronic means of payment, currency remains widely used in retail transactions in the United States. And, with heavy usage of U.S. currency overseas, changes in global growth as well as in financial and geopolitical stability can also materially affect the rate of currency growth.

Reserves are currently the second largest liability on the Federal Reserve's balance sheet. The FOMC has stated it will in the longer-run hold no more reserves than consistent with efficient and effective policy implementation. This determination will take into consideration the demand for reserves of depository institutions. Banks demand reserves for a variety of reasons. In part, banks determine their desired level to facilitate daily payment flows, both in ordinary times and in stress scenarios, without borrowing funds or selling assets. Banks also demand reserves for meeting regulatory restrictions, which have changed dramatically since the financial crisis, with large banks now maintaining substantial buffers of reserves, among other high-quality liquid assets, to comply with liquidity regulations. Reflecting these various demands, reserves have grown from their pre-crisis very small share of GDP to nearly 8 percent today.

The TGA reflects the fact that the Federal Reserve serves as the Treasury Department's fiscal agent. The size of the TGA is determined by the Treasury's rules. Before 2008, the Treasury targeted a steady, low balance of $5 billion in the TGA on most days. In May 2015, the Treasury announced its intention to hold in the TGA a level of cash generally sufficient to cover one week of outflows, subject to a minimum balance objective of roughly $150 billion. As of early October 2019, the TGA was about $335 billion, or nearly 2 percent of GDP.

The experience of other countries including Japan suggests that it is important for central banks to act aggressively and preemptively to avoid protracted scenarios in which short-term interest rates are forced to the effective lower bound, and inflation and inflation expectations run chronically below desired levels. In Japan and in Europe, policymakers have found it very difficult to escape these conditions, in part because they may have delayed too long before taking strong actions. For its part, the FOMC has indicated that it is prepared to use all of its tools including forward guidance and asset purchases as necessary to promote its statutory objectives in a scenario in which the federal funds rate is at the effective lower bound. That posture is especially important now given the secular decline in the level of interest rates. The current low-interest rate environment suggests that central banks have less scope to ease policy now with their traditional tool of short-term interest rates and the probability of becoming constrained by the lower bound is thus higher than in the past. As a result, central banks around the world have been focusing on developing new tools and strategies to provide policy accommodation when needed to steer clear of the types of difficulties faced in Japan over recent decades. Indeed, the issue of how best to contend with the effective lower bound on short-term interest rates is one of the key areas of focus in the Federal Reserve's current review of its policy strategies, tools, and communications.

3. At your last hearing, the gentleman from New York, Mr. Zeldin, brought up the 2016 hack of Bangladesh's central bank, which led to the theft of $81 million by exploiting fraud detection vulnerabilities at the New York Fed. Since then, we had a hearing with major bank CEOs who identified cybersecurity as a profound risk to the financial sector. We've also recently witnessed ransomware attacks threaten essential government services in Maryland and Florida.

I was hoping you could provide us with more details on the Fed's efforts to strengthen cybersecurity at both the operational and supervisory levels.

In particular, who is accountable for overseeing these efforts at the Fed, including information sharing and the protection of your systems; and what kinds of contingency planning and stress tests is the Fed undertaking to improve our resilience against hacks in the future?

The Federal Reserve Board (Board) is aware of the risks and threats within cyberspace. The Board complies with the Federal Information Security Modernization Act and, among other requirements, National Institute of Standards and Technology (NIST) guidance as applicable, to manage its information security including cyber risks. Current areas of focus include ensuring that sensitive information, such as personally identifiable information (PII), is protected and handled appropriately, and protecting against advanced hacking techniques from nation states and other advanced actors, insider threats, and Distributed Denial of Service (DDOS) attacks.

To address these challenges, the Board has implemented and continues to enhance its Data Loss Protection program. The Board has taken steps to enhance information handling policies, encryption of data at rest, including databases containing PII, and incident response processes. The Board also is working to improve its continuous advanced persistent threat and DDOS protection and detection capabilities. In addition, the Board is in the process of implementing the Department of Homeland Security's (DHS) Einstein suite of advanced intrusion detection capabilities and enhancing the Board's continuous monitoring program through participation in DHS's Continuous Diagnostic and Mitigation program.

The Federal Reserve Banks also maintain an information security program based on NIST standards. The Board and the Reserve Banks (collectively, the Federal Reserve) use a comprehensive defense in-depth approach whereby multiple layers of security controls are implemented to protect sensitive information as well as vigilantly monitoring probes and attacks on an ongoing basis. It is important to acknowledge, however, that no defense is foolproof. Early detection of attacks is just as important as prevention through multiple layers of defense. Hence, we continually work to identify and remediate attacks before any damage occurs.

The Bank of Bangladesh incident in 2016 occurred due to lapses in security controls at the Bank of Bangladesh rather than the Federal Reserve Banks. Nevertheless, the Reserve Banks' financial services functions have taken actions to reduce the risk of wholesale payments fraud related to endpoint security. These actions include reminding customers of the importance of workstation controls, implementing overdraft account monitoring, and providing enhanced customer-account management tools (e.g., limiting payment values or only allowing payments during set time periods during the day). The Federal Reserve also contributed to the publication of an international strategy on reducing the risk of wholesale payments fraud related to endpoint security, and continues to engage with central banks and market participants to monitor efforts to reduce risk.[1]

The Federal Reserve also recognizes the systemic risk posed by cyber threats to the financial system. The global financial services sector has a heightened level of exposure to cyber risk due to its high degree of information technology activities and the increasing interconnection between firms in the sector. As such, cyber risk mitigation and cyber resiliency initiatives continue to be high priorities for the Federal Reserve. To strengthen risk management practices across the financial sector and reduce the impact of cyber-related incidents, the Federal Reserve coordinates with partners through the Financial and Banking Information Infrastructure Committee (FBIIC), the Financial Services Sector Coordinating Council (FSSCC), and the Financial Services Information Sharing and Analysis Center (FS-ISAC). The Board is a member of the FBIIC, which is chaired by the U.S. Department of the Treasury and is comprised of 17 federal and state financial services regulatory agencies or organizations that supervise banking, investment and insurance firms. The FBIIC coordinates and shares information with respect to homeland security issues as they pertain to FBIIC members and financial-sector participants. The FBIIC coordinates with the FSSCC, which is its private sector equivalent and comprised of approximately 70 private sector firms representing financial trade associations, financial market utilities, and the most critical sector firms. Finally, the Federal Reserve is a member, and supports the resilience efforts, of the FS-ISAC, the global financial industry's resource for cyber

[1] https://www.bis.org/cpmi/publ/d170.pdf.

and physical threat intelligence analysis and sharing. The Federal Reserve encourages the financial institutions that it supervises to incorporate threat monitoring programs and participate in information sharing organizations such as FS-ISAC.

Cybersecurity remains a top supervisory priority as it has implications for the safe and sound operations of financial institutions as well as financial stability. To that end, the Board (including through the Federal Reserve Banks acting on the Board's behalf) has undertaken significant supervisory work to assess cybersecurity risk management at financial institutions that it supervises. The Board is also working with other federal regulatory agencies to streamline and harmonize cybersecurity guidance across the financial sector in a manner that aligns with the NIST Cybersecurity Framework (CSF), which was developed in consultation with government and the private sector. For example, the Federal Financial Institutions Examination Council members released a joint statement on August 28, 2019, emphasizing the benefits of using a standardized approach, such as the NIST CSF or the FSSCC Cybersecurity Profile, to assess and improve cybersecurity preparedness. In addition, in an effort to reduce regulatory burden, the Board is working with the other prudential regulators to identify instances where we can better work together on examinations and concentrate appropriate resources to address cyber risk.

House Committee on Financial Services

Hearing: Monetary Policy and the State of the Economy

July 10, 2019

Questions for the Record from U.S. Representative Ted Budd (R-NC.)

Witness: The Honorable Jerome Powell, Chairman, Board of Governors of the Federal Reserve System

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-Chairman Powell: At a time when the Federal Reserve is contemplating in engaging in functions currently undertaken by the private sector, isn't it time that we take a look at the regulatory processes for independent agencies? In past Congresses, with bipartisan support, we have seen the introduction of legislation that authorizes the President to require that independent agencies apply the same cost benefit process that Presidents have required of other agencies for many years. Why should independent agencies such as the Federal Reserve issue major rules without a publicly available quantitative cost benefit analysis?

-With the creation of the Faster Payments Task Force and the Federal Reserve's goal of achieving ubiquity of a real-time settlements system amongst industry participants, would the Federal Reserve mandate industry compliance to achieve this goal? Why or why not?

-In the Request for Comment on the services, the Federal Reserve cited several examples of private sector faster payments services that have emerged in the United States in recent years. Have you concluded that the private sector cannot achieve the objectives that you seek to achieve with the services?

-Could the Federal Reserve achieve its objectives without offering the services but rather by making changes to its current infrastructure, for example by expanding the operating hours of the National Settlement Service or enhancing the Automated Clearing House's same-day payment capabilities?

-If the Federal Reserve decides to offer the real-time payment service, what role do you foresee the private sector having in the process, and how would the Federal Reserve collaborate with the private sector to ensure interoperability? Finally, as a regulator of depository institutions and their holding companies, how would you ensure that it does not exert undue influence over them to use the services?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

September 27, 2019

The Honorable Ted Budd
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the questions you submitted following the July 10, 2019,[1] hearing before the House Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on August 14, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative Ted Budd:</u>

1. Chairman Powell: At a time when the Federal Reserve is contemplating in engaging in functions currently undertaken by the private sector, isn't it time that we take a look at the regulatory processes for independent agencies?

In past Congresses, with bipartisan support, we have seen the introduction of legislation that authorizes the President to require that independent agencies apply the same cost benefit process that Presidents have required of other agencies for many years.

Why should independent agencies such as the Federal Reserve issue major rules without a publicly available quantitative cost benefit analysis?

The Federal Reserve Board (Board) takes seriously the importance of evaluating the costs and benefits of its rulemaking efforts. Under the Board's current practice, consideration of costs and benefits occurs at each stage of the rulemaking process. The Board's proposed and final rules include a discussion of the expected impact of the rule, and the Board seeks comment on its proposals, including on potential costs and benefits. In addition to seeking comment on its proposals, the Board generally collects information directly from parties that may be affected.

Recently, the Board has published quantitative analyses in connection with a number of rulemakings, i.e. the global systemically important banks surcharge rule, the single-counterparty credit limit rule, and the long-term debt rule. In addition, to further these efforts and to ensure consistency and rigor in analyzing the impact of its proposed and final rules, the Board's Division of Supervision and Regulation established a unit dedicated to analyzing the costs and benefits associated with rulemakings.

By considering both direct and indirect costs and benefits and qualitative considerations, the Board's current process supports the effective implementation of the Board's statutory responsibilities.

2. With the creation of the Faster Payments Task Force and the Federal Reserve's goal of achieving ubiquity of a real-time settlements system amongst industry participants, would the Federal Reserve mandate industry compliance to achieve this goal? Why or why not?

The Board does not have plenary regulatory or supervisory authority over the U.S. payment system. Instead, the Federal Reserve has historically exercised significant influence in the U.S. payment system through the Reserve Banks' provision of payment and settlement services to banks. This operational role has helped to promote payment systems in the United States that are ubiquitous, safe, and efficient.

3. In the Request for Comment on the services, the Federal Reserve cited several examples of private sector faster payments services that have emerged in the United States in recent years.

Have you concluded that the private sector cannot achieve the objectives that you seek to achieve with the services?

The Board's evaluation of Reserve Bank service proposals, such as the FedNow^{SM} Service, is subject to the requirements of the Monetary Control Act of 1980 (MCA) and longstanding Federal Reserve policies and processes. The Board's policy for evaluating new services was carefully tailored to consider factors that are most relevant in assessing the costs and benefits of the service. Specifically, the Board assesses whether the Federal Reserve will achieve full cost recovery over the long run, whether the service will yield a clear public benefit, and whether the service is one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity. In addition, the Board performs a competitive impact analysis when considering an operational or legal change to a Reserve Bank service or price that would have a direct and material adverse effect on the ability of others to compete with the Reserve Banks.

With respect to the FedNow Service, the Board has concluded that private-sector real-time gross settlement services (RTGS) for faster payments alone cannot be expected to provide an infrastructure for faster payments with reasonable effectiveness, scope, and equity. In particular, private-sector services are likely to face significant challenges in extending equitable access to the more than 10,000 diverse banks across the country. The Board also concluded that the development of the FedNow Service will likely yield clear and substantial benefits to the safety and efficiency of faster payments in the United States, as suggested by the majority of comments in response to the Board's previous request for comment. Additionally, the Board concluded that the Federal Reserve will achieve full cost recovery over the long run for the FedNow Service and, as required by the MCA for Federal Reserve services overall.

The Board's assessment of the planned FedNow Service pursuant to the requirements of the MCA and the Board's criteria for new services and major service enhancements, proposed features and functionality for the service, and initial competitive impact analysis of the service can be found in its August 2019 *Federal Register* Notice.[1]

4. Could the Federal Reserve achieve its objectives without offering the services but rather by making changes to its current infrastructure, for example by expanding the operating hours of the National Settlement Service or enhancing the Automated Clearing House's same-day payment capabilities?

In the August 2019 Federal Register notice announcing the Board's decision regarding the FedNow Service, the Board also expressed its intent to explore the expansion of hours for the Fedwire Funds Service and the National Settlement Service (NSS), up to 24x7x365, subject to further analysis of relevant operational, risk, and policy considerations. The expansion would support liquidity management in private-sector RTGS services for faster payments, as well as provide additional benefits to financial markets beyond faster payments. In May of this year, the

[1] https://www.federalreserve.gov/newsevents/pressreleases/files/other20190805a1.pdf.

Board also requested comment on expanding the hours of the Fedwire Funds Service (ACH) and NSS to accommodate an additional automated clearing house same-day settlement window.[2]

While expanded hours are expected to foster improvements to the broader U.S. payment system, the Board believes expanded hours alone will not accomplish the goal of safe, efficient and nationwide access to real-time payment services in the United States. The FedNow Service will be designed and built to achieve real-time payments anywhere and at any time.

5. If the Federal Reserve decides to offer the real-time payment service, what role do you foresee the private sector having in the process, and how would the Federal Reserve collaborate with the private sector to ensure interoperability?

Finally, as a regulator of depository institutions and their holding companies, how would you ensure that it does not exert undue influence over them to use the services?

During its engagement with the industry, the Federal Reserve fully intends to pursue interoperability and other paths to achieving the ultimate goal of nationwide reach for faster payments. Although direct exchange of payments between RTGS infrastructure operators may not be an initial element of the FedNow Service, the Federal Reserve would continue to pursue interoperability as a longer-term objective as standards, technology, and industry practices evolve.

Within the Federal Reserve, supervisory activities are internally segregated from payment services activities. Supervisory staff do not steer banks to specific payment service providers, Federal Reserve or otherwise. In addition, internal policy prevents payment services staff from having a competitive advantage through access to supervisory information.

Moreover, the MCA requires that Federal Reserve services must be priced competitively and encourages competition between the Reserve Banks and the private sector through an expectation that, over the long run, the Reserve Banks will recover their actual costs of services. The FedNow Service, operating alongside private-sector RTGS services would give banks the option of choosing a service or connecting to more than one service, a choice they have today for all existing payment services, including funds transfers, ACH, checks, and debit and credit cards.

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[2] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190509b.htm.

Committee on Banking, Housing, and Urban Affairs
"Developments in Global Insurance Regulatory and Supervisory Forums"
September 12, 2019

Questions from Mr. Thomas Sullivan, Associate Director, Board of Governors, Federal Reserve System, from Senator Ben Sasse:

1) I understand that the International Capital Standard (ICS) produced by the International Association of Insurance Supervisors (IAIS) is non-binding to U.S. insurers until it is either adopted by regulators or enacted into law by Congress.

A. Could you discuss the potential ramifications on U.S. insurers operating in markets abroad even if the standards produced through IAIS are non-binding on U.S. insurers?

B. What disadvantages or repercussions could our insurers at home in the U.S. face?

2) The U.S. represents over 40% of the world's insurance market and has one of the most robust, well-developed insurance regulatory systems in the world. One which both protects consumers and but also encourages competition and innovation. With this in mind, the Federal Reserve in January of this year at a roundtable stated that it would "continue to advocate for international insurance standards that promote a global level playing field and work well for the U.S. insurance market".

A. Is the U.S. insurance industry well-regulated and protecting consumers today?

B. If yes, what is ICS solving for since the ICS as proposed would disadvantage U.S. insurers?

3) In May of this year, a group of bipartisan Senators including myself sent a letter to Vice Chairman Quarles on this particular topic. In this letter we stated that we believe "the Financial Stability Board (FSB) should publicly state that aggregation approaches to group capital as well as other well-developed and proven jurisdictional capital regimes are acceptable methodologies for assessing group capital adequacy".

A. If the Fed and NAIC through their respective proposals, the Building Block Approach (BBA) and the Group Capital Calculation, are unsuccessful in having one of these accepted by the IAIS both of which are more compatible to the U.S. insurance structure, what are the next steps that Team USA need to take to ensure that our U.S. insurance companies are not placed on an uneven playing field?

4) You serve in the FSB and have inside knowledge about how the process for the ICS is being developed and where the IAIS's mindset is. Can you explain why they will not make this commitment to U.S.?

A. Why should U.S. insurers go through this process with a group that does not show sufficient consideration of U.S. interests?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

December 11, 2019

The Honorable Ben Sasse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of the questions that you submitted following the September 12, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 8, 2019.

Questions for Mr. Thomas Sullivan, Associate Director, Board of Governors of the Federal Reserve System from Senator Sasse:

1. I understand that the International Capital Standard (ICS) produced by the International Association of Insurance Supervisors (IAIS) is non-binding to U.S. insurers until it is either adopted by regulators or enacted into law by Congress.

A. Could you discuss the potential ramifications on U.S. insurers operating in markets abroad even if the standards produced through IAIS are non-binding on U.S. insurers?

B. What disadvantages or repercussions could our insurers at home in the U.S. face?

The International Capital Standard (ICS) is considered a group capital standard. U.S. insurers operating in foreign markets that have adopted the ICS would likely be expected by their foreign regulators to be capitalized at the group level based on the ICS. If the company is not using the ICS for the entire group (including its U.S. business), the local foreign regulators could potentially subject the firm to enhanced supervisory requirements.

The Federal Reserve, along with the U.S. Department of the Treasury, National Association of Insurance Commissioners, and the States remain committed to working with the International Association of Insurance Supervisors IAIS to develop an international standard that is appropriate for the U.S. insurance market.

An international standard like the ICS could limit regulatory arbitrage and could help provide a level playing field for global insurers. It could also help ensure that U.S. companies are not held to unsuitable or onerous regulations when they operate abroad.

2. The U.S. represents over 40% of the world's insurance market and has one of the most robust, well-developed insurance regulatory systems in the world. One which both protects consumers and but also encourages competition and innovation. With this in mind, the Federal Reserve in January of this year at a roundtable stated that it would "continue to advocate for international insurance standards that promote a global level playing field and work well for the U.S. insurance market".

A. Is the U.S. insurance industry well-regulated and protecting consumers today?

The U.S. has the largest insurance market in the world[2] and routinely receives high marks for supervision in assessments by third parties.

B. If yes, what is ICS solving for since the ICS as proposed would disadvantage U.S. insurers?

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[2] See https://www.treasury.gov/resource-center/international/Documents/cr1590.pdf and https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2019_FIO_Annual_Report.pdf.

An appropriate international standard could limit regulatory arbitrage and help provide a level playing field for internationally active insurance groups. An appropriate international standard could also help to ensure that internationally active U.S. companies are not held to unsuitable and onerous standards when they operate in foreign countries. Additionally, it could reduce risk to U.S. consumers by ensuring that foreign insurers operating within the United States are held to appropriate capital regulation by their foreign group-wide supervisor.

3. In May of this year, a group of bipartisan Senators including myself sent a letter to Vice Chairman Quarles on this particular topic. In this letter we stated that we believe "the Financial Stability Board (FSB) should publicly state that aggregation approaches to group capital as well as other well-developed and proven jurisdictional capital regimes are acceptable methodologies for assessing group capital adequacy".

A. If the Fed and NAIC through their respective proposals, the Building Block Approach (BBA) and the Group Capital Calculation, are unsuccessful in having one of these accepted by the IAIS both of which are more compatible to the U.S. insurance structure, what are the next steps that Team USA need to take to ensure that our U.S. insurance companies are not placed on an uneven playing field?

The Federal Reserve intends to continue to advocate internationally for the recognition of the Aggregation Method (AM) at the IAIS, which in its design will be foundationally similar to our domestic approach, the building block approach (BBA) and the NAIC's Group Capital Calculation. Because of the concerns regarding the current design of the ICS, U.S. members also support continued development of the ICS to accommodate design changes during the monitoring period.

4. You serve in the FSB and have inside knowledge about how the process for the ICS is being developed and where the IAIS's mindset is. Can you explain why they will not make this commitment to U.S.?

A. Why should U.S. insurers go through this process with a group that does not show sufficient consideration of U.S. interests?

The Federal Reserve believes that it is in our national interest to engage in the international insurance standards-development process so that it produces standards that are appropriate for the U.S. market and U.S. consumers when foreign insurers operate here and are suitable for U.S. companies operating abroad. Without engagement, even less consideration would be given to U.S. interests in the development of international standards. Furthermore, the ICS, or any standard produced by the IAIS, is a voluntary standard that is not binding and would need to be adopted voluntarily by each member jurisdiction in accordance with applicable domestic laws.

Committee on Banking, Housing, and Urban Affairs
"Developments in Global Insurance Regulatory and Supervisory Forums"
September 12, 2019

<u>Questions from Mr. Thomas Sullivan, Associate Director, Board of Governors, Federal Reserve System, from Senator Catherine Cortez Masto:</u>

1) How could insurance companies pose a threat to U.S. financial stability?

2) How frequently in the past fifteen years did property and casualty or life insurers become insolvent? How many of claims to insolvent firms were not covered? How many of claims to insolvent firms were covered by the Guarantee Associations?

3) Are there any insurance companies now – either from their nature, scope, size, scale, concentration, interconnectedness, or mix of activities – that could pose a threat to U.S. financial stability? If yes, what do you recommend we do about these potential threats?

4) The International Association of Insurance Supervisors (IAIS) approved its 2020-2024 Strategic Plan this summer. It also included cyber resilience and climate risk. Can you tell me more about the goals the IAIS has to reduce risks related to cyber-attacks and climate change?

5) What investment strategies are insurance carriers taking in relation to climate risk versus what new policies options or restrictions are becoming prevalent to address climate change?

6) How are different nations requiring insurance firms to consider the impacts of climate change?

7) The International Association of Insurance Supervisors (IAIS) is working to evaluate the use of financial technology and insurance. Can you tell me more about issues related to artificial intelligence, the use of algorithms, and data privacy?

8) How do you monitor the property and casualty insurance companies to ensure fintech and insurtech innovations do not lead to discrimination? How do you ensure compliance with the Fair Housing Act?

9) The Nevada Insurance Commissioner told me that the Covered Agreement standards were developed using banking capital standards, rather than insurance capital standards. Can you explain the difference between the controls that banks have in place versus the controls that insurers have in place? I'm specifically interested in the use of the reinsurance tools that insurance carriers have available to them that banking systems do not.

10) Do you think that the international insurance supervisors who focus on insurance capital standards are open to alter their oversight standards to be considered "substantially similar" to the U.S. standards?

11) The European Union established Solvency II. Can you describe how the Minimum Capital Requirements work? What is considered? What happens when an insurance company falls below the Minimum Capital Requirements?

12) Solvency II has three pillars. Pillar 3 requires insurers file annual reports with their regulator and make them available to the public. Have you had any feedback from the public based on one of those reports?

13) If the US did not agree to use the same Solvency II standards, and could not get the EU to agree to another type of solvency oversight convention, would U.S. carriers have to pay more for reinsurance products purchased from foreign companies? If so, would U.S. carriers be reluctant to buy foreign reinsurance products that could cost more?

14) Can you explain why some argue that the proposed Solvency II standards could place the U.S. insurance carriers at a disadvantage?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

December 11, 2019

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of the questions that you submitted following the September 12, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 8, 2019.

Questions for Mr. Thomas Sullivan, Associate Director, Board of Governors of the Federal Reserve System from Senator Cortez Masto:

1. How could insurance companies pose a threat to U.S. financial stability?

Many observers have argued that insurers do not pose systemic risks because such entities have longer-term liabilities than banks and are immune to a large influx of demands for funds over a short period of time or "runs." However, history shows that there are several examples of runs on large insurance companies that threatened the broader financial system and the U.S. economy.

Insurance products were run upon during the Great Depression, leading to withdrawals on certain products being suspended.[2] The runs on Executive Life in April 1991, followed by those on First Capital Life in May 1991 and Mutual Benefit in July 1991, were tied to products that offer protection and wealth accumulation that could be withdrawn at the discretion of the policyholder, such as Guaranteed Interest Contracts.[3]

More recently, the near-collapse of AIG during the financial crisis showed that the distress of a large and systemic insurance company could imperil the financial stability of the United States, ultimately putting the American economy at risk.

Insurance companies can also pose risks to the financial system through their role as intermediaries with other parts of the financial system. Among other things, they play a major role in lending to non-financial companies and in the market for commercial real estate financing. For this reason, liquidity problems at life insurance companies can have serious implications for financial markets and the broader economy.

2. How frequently in the past fifteen years did property and casualty or life insurers become insolvent? How many of claims to insolvent firms were not covered? How many of claims to insolvent firms were covered by the Guarantee Associations?

Over 200 licensed insurance companies became insolvent between 2000 and 2017. Guarantee associations covered most of the cost of these insolvencies, but these guarantees are restricted by policy type and coverage limit.

3. Are there any insurance companies now – either from their nature, scope, size, scale, concentration, interconnectedness, or mix of activities – that could pose a threat to U.S. financial stability? If yes, what do you recommend we do about these potential threats?

The financial crisis showed that the distress of large and systemic nonbank financial companies could imperil the financial stability of the United States, ultimately putting the American economy at risk, as noted above. The Dodd-Frank Wall Street Reform and Consumer Protection

[2] See "Insurance concerns tighten loan rules," New York Times, March 9, 1933, p. 6.

[3] Similar to bank CDs, the money invested in these life insurance contracts could generally be withdrawn at the option of the policyholder and was therefore subject to runs.

Act (Dodd-Frank Act) gave regulators new tools to address this problem and in 2013, the Financial Stability Oversight Council (FSOC) moved to designate AIG, Prudential, and MetLife for additional supervisory measures.

Since then, reflecting changes in size and business activities of AIG, and a re-evaluation of the risks posed by Prudential, FSOC has rescinded the designation of these firms.[4]

In March 2016, the U.S. District Court overturned the FSOC's determination that MetLife poses a threat to U.S. financial stability. The government subsequently appealed the District Court's decision. In January 2018, FSOC and MetLife filed a joint motion to dismiss FSOC's appeal, which was accepted by the U.S. Court of Appeals. It should be noted that, in the summer of 2017, MetLife shrank substantially by spinning off a portion of its U.S. retail life insurance and annuity segment into Brighthouse Financial.

It is important for the FSOC to continue to monitor large nonbank financial firms to ensure that, should such firms encounter distress, the functioning of the broader economy is not threatened. The possibility of de-designation provides an incentive for designated firms to significantly reduce their systemic footprint.

4. The International Association of Insurance Supervisors (IAIS) approved its 2020-2024 Strategic Plan this summer. It also included cyber resilience and climate risk. Can you tell me more about the goals the IAIS has to reduce risks related to cyber-attacks and climate change?

The International Association of Insurance Supervisors (IAIS) regards both cyber risk and risks from climate change as important emerging risks and has prioritized these, along with FinTech and other issues, in its strategic plan. The IAIS has set up high level groups on these topics. The groups will explore these risks, propose any needed revisions to IAIS standards, and produce materials that will help supervisors to mitigate these risks.

5. What investment strategies are insurance carriers taking in relation to climate risk versus what new policies options or restrictions are becoming prevalent to address climate change?

U.S. insurance companies have responded to climate risk in various ways, including by implementing policies that incorporate Environmental, Social, and Corporate Governance (ESG) factors into their investment strategies. Many large insurers also produce an annual sustainability report.

6. How are different nations requiring insurance firms to consider the impacts of climate change?

[4] The Financial Stability Oversight Council rescinded the designations on Prudential and AIG in October 2018 and September 2017 respectively (see https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx for additional detail).

Regulators in most jurisdictions have not introduced new requirements for insurance firms related to the impacts of climate change. However, as with any emerging risk, regulators expect firms to include risks related to climate change in their risk identification and risk management activities, and expect boards to question management about the firm's exposure to climate risk.

7. The International Association of Insurance Supervisors (IAIS) is working to evaluate the use of financial technology and insurance. Can you tell me more about issues related to artificial intelligence, the use of algorithms, and data privacy?

The IAIS formed a FinTech Forum (Forum) in 2018 to study the possible impact of new technology to the insurance sector. The Forum meets approximately six times per year to present on various topics including artificial intelligence, distributed ledger technology, and other possible emerging risks.

The Forum aggregates data from many jurisdictions to understand and assess how these risks are identified, monitored, reported, and controlled. If necessary, risks are escalated to the IAIS Executive Committee for better understanding of how the Insurance Core Principles may apply.

8. How do you monitor the property and casualty insurance companies to ensure fintech and insurtech innovations do not lead to discrimination? How do you ensure compliance with the Fair Housing Act?

The important aspects of the actual business of providing insurance are the province of the relevant state insurance supervisors. The Federal Reserve does not regulate the manner in which property and casualty insurance is provided by supervised institutions or the types of insurance that they provide.

The Federal Reserve does supervise all state member banks for compliance with the Fair Housing Act, which prohibits discrimination in residential real-estate-related transactions—including the making and purchasing of mortgage loans—on the basis of race, color, religion, sex, handicap, familial status, or national origin. Our fair lending supervision program includes review of fintech practices to ensure that the financial institutions under our jurisdiction fully comply with applicable federal consumer protection laws and regulations.

9. The Nevada Insurance Commissioner told me that the Covered Agreement standards were developed using banking capital standards, rather than insurance capital standards. Can you explain the difference between the controls that banks have in place versus the controls that insurers have in place? I'm specifically interested in the use of the reinsurance tools that insurance carriers have available to them that banking systems do not.

A Covered Agreement is an agreement authorized by the Title V of the Dodd-Frank Act related to the recognition of insurance prudential standards. The Secretary of the Treasury and U.S. Trade Representative must approve covered agreements, and these agencies led the negotiation of the U.S. – E.U. Covered Agreement.

The U.S. – E.U. Covered Agreement does not require applying banking capital standards to insurers. The U.S. – E.U. Covered Agreement was negotiated in consultation with state insurance regulators and reflects insurance-centric concepts.

10. Do you think that the international insurance supervisors who focus on insurance capital standards are open to alter their oversight standards to be considered "substantially similar" to the U.S. standards?

The U.S. has the largest insurance market in the world[5] and routinely receives high marks for supervision in assessments by third parties. Most other jurisdictions aspire to having substantially similar protections as the U.S. market. Many jurisdictions are, however, committed to their current approach to assessing insurance capital and would like to avoid significant changes.

11. The European Union established Solvency II. Can you describe how the Minimum Capital Requirements work? What is considered? What happens when an insurance company falls below the Minimum Capital Requirements?

Under Solvency II, the Minimum Capital Requirement (MCR) represents the capital needed to cover (based on an 85 percent confidence interval) the variation over one year in the company's "basic own funds" (roughly equivalent to shareholders' equity). The MCR considers variation that arises from insurance underwriting risk, market risk, counterparty default risk, and operational risk. If a company's capital position falls below the MCR, the supervisor may put the company into receivership, require it to stop selling new business, and/or revoke its insurance license. There is a higher level, called the Solvency Capital Requirement (SCR) which is calibrated to a 99.5 percent confidence level. Firms subject to Solvency II typically manage to a level above the SCR and supervisors typically view the SCR as the first point of supervisory intervention.

12. Solvency II has three pillars. Pillar 3 requires insurers file annual reports with their regulator and make them available to the public. Have you had any feedback from the public based on one of those reports?

At this time, we have not been contacted with feedback on Solvency II disclosures.

13. If the US did not agree to use the same Solvency II standards, and could not get the EU to agree to another type of solvency oversight convention, would U.S. carriers have to pay more for reinsurance products purchased from foreign companies? If so, would U.S. carriers be reluctant to buy foreign reinsurance products that could cost more?

This scenario would be a continuation of the status quo and, by itself, would not lead to an increase in reinsurance premiums.

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[5] See https://www.treasury.gov/resource-center/international/Documents/cr1590.pdf and https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2019_FIO_Annual_Report.pdf.

14. Can you explain why some argue that the proposed Solvency II standards could place the U.S. insurance carriers at a disadvantage?

Solvency II is the regulatory framework applied to insurers who operate in the European Union (EU). Foreign subsidiaries of U.S. insurance carriers operating in the EU are subject to Solvency II just as subsidiaries of foreign insurers operating in the U.S. are subject to the State Risk-Based Capital framework applicable in the U.S. Solvency II is a group capital standard. Since the U.S. does not currently have a group capital standard, it is possible that foreign regulators could subject the EU-based subsidiaries of U.S. insurance carriers to enhanced supervisory requirements unless the terms of the Covered Agreement are met.

Committee on Banking, Housing, and Urban Affairs
"Developments in Global Insurance Regulatory and Supervisory Forums"
September 12, 2019

Questions from Mr. Thomas Sullivan, Associate Director, Board of Governors, Federal Reserve System, from Senator Elizabeth Warren:

1) In you view, does the capital framework that exists as part of the U.S. state-based insurance regulatory regime provide similar protections as the proposed ICS Version 2.0 standard?

2) In response to questions from Senator Brown during your oral testimony, you indicated that supported FSOC's de-designation of insurance companies, meaning that you did not believe that any insurance companies in the U.S. today would pose a risk to the broader economy in the event they experienced material financial distress.

A. Do you believe that American International Group, Inc., Prudential Financial, Inc., and MetLife, Inc. have reduced their risk profiles sufficiently since the financial crisis?

B. Should an insurance company's overall risk profile, including their interconnectedness to other institutions and overall leverage exposure should no longer be considered when determining the appropriate regulatory tools?

C. Under an activities-based approach, how would regulators proactively identify activities that insurance companies engage in that are risky and prevent firms from restructuring or renaming those activities?

3) On September 6, 2019, the Federal Reserve issued a Notice of Proposed Rulemaking (NPR) that described a building block approach (BBA) that builds on existing state-based insurance standards. This approach would result in capital requirements for insurance companies that own a depository institution. 1 Does the Federal Reserve view the capital standard as a tool primarily for providing stability of the insurance industry within the financial system, providing protection to holders of insurance policies, or both?

[1]Board of Governors of the Federal Reserve System, "Federal Reserve Board invites public comment on proposal to establish capital requirements for certain insurance companies supervised by the Board", https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190906a.htm

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

December 11, 2019

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of the questions that you submitted following the September 12, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 8, 2019.

<u>Questions for M1r. Thomas Sullivan, Associate Director, Board of Governors of the Federal Reserve System from Senator Warren:</u>

1. In you view, does the capital framework that exists as part of the U.S. state-based insurance regulatory regime provide similar protections as the proposed ICS Version 2.0 standard?

Currently, the U.S. regulatory regime does not include group-level capital requirements. The Federal Reserve Board (Board) has proposed applying a building block approach (BBA) to the insurers we supervise domestically. We believe an approach like the BBA, domestically, in the form of the Aggregation Method (AM), internationally, will provide a comparable outcome to the protections in the International Capital Standards 2.0 for the groups to which it would be applied.

2. In response to questions from Senator Brown during your oral testimony, you indicated that supported FSOC's de-designation of insurance companies, meaning that you did not believe that any insurance companies in the U.S. today would pose a risk to the broader economy in the event they experienced material financial distress.

> **A. Do you believe that American International Group, Inc., Prudential Financial, Inc., and MetLife, Inc. have reduced their risk profiles sufficiently since the financial crisis?**

The financial crisis showed that the distress of large and systemic nonbank financial companies could imperil the financial stability of the United States, ultimately putting the American economy at risk. The Dodd-Frank Wall Street Reform and Consumer Protection Act gave regulators new tools to address this problem, and in 2013, the Financial Stability Oversight Council (FSOC) acted to designate AIG, Prudential, and MetLife for additional supervisory measures.

Since the financial crisis, AIG has largely sold off or wound down its capital markets businesses, and has become a smaller firm that poses less of a threat to financial stability. For example, it has reduced its assets by more than $350 billion, wound down its Financial Products division, and sold off its mortgage insurance company.

The October 2018 decision to rescind Prudential's designation was based upon the FSOC's reevaluation of the risks posed by the firm. The FSOC examined the potential for policyholders to withdraw cash or surrender their policies from Prudential in the event the company experienced material financial distress and concluded that a forced liquidation of assets by Prudential to account for policyholder withdrawals should not be large enough to impair overall market functioning or impact the macroeconomy, although it could pose challenges to certain market participants.

In March 2016, the U.S. District Court overturned the FSOC's determination that MetLife poses a threat to U.S. financial stability. The government subsequently appealed the District Court's decision. In January 2018, the FSOC and MetLife filed a joint motion to dismiss the FSOC's appeal, which was accepted by the U.S. Court of Appeals. It should be noted that, in the summer of 2017, MetLife shrank substantially by spinning off a portion of its U.S. retail life insurance and annuity segment into Brighthouse Financial.

It is important to continue to monitor large nonbank financial firms to ensure that, should they encounter distress, the functioning of the broader economy is not threatened. The possibility of de-designation provides an incentive for designated firms to significantly reduce their systemic footprint.

B. Should an insurance company's overall risk profile, including their interconnectedness to other institutions and overall leverage exposure should no longer be considered when determining the appropriate regulatory tools?

The Board is not the primary regulator for insurance companies and thus not responsible for establishing the regulations to which they are subject.

C. Under an activities-based approach, how would regulators proactively identify activities that insurance companies engage in that are risky and prevent firms from restructuring or renaming those activities?

FSOC's proposed non-bank guidance promotes an activities-based approach for identifying and mitigating risks to financial stability. However, it also maintains the tool of designating individual entities as systemically important in cases where the activities-based approach is either inappropriate or insufficient.

The guidance represents a framework that addresses financial stability risks that either would not be mitigated by designating the largest market participants or would be more efficiently mitigated by directly targeting the risky activity. FSOC's monitoring of activities will look for activities that may generate leverage, interconnectedness, or run risk and that can generate significant spillovers to the economy. In the case of insurance companies, for example, it will be important to focus on products that offer protection and wealth accumulation that could be withdrawn at the discretion of the policyholder, such as Guaranteed Interest Contracts that generated runs in the 1990s.[2]

It is important to note that we view the activities-based approach described in the proposed amended guidance as a complement to entity designations rather than as a substitute for the current entity-based approach of managing systemic risk. Individual non-bank entities can pose systemic risks, and we believe that it is critical that FSOC maintains the option to designate these firms when appropriate.

3. On September 6, 2019, the Federal Reserve issued a Notice of Proposed Rulemaking (NPR) that described a building block approach (BBA) that builds on existing state-based insurance standards. This approach would result in capital requirements for insurance

[2] Like bank CDs, the money invested in these life insurance contracts can generally be withdrawn at the option of the policyholder and is therefore subject to runs.

companies that own a depository institution. [1] Does the Federal Reserve view the capital standard as a tool primarily for providing stability of the insurance industry within the financial system, providing protection to holders of insurance policies, or both?

[1] Board of Governors of the Federal Reserve System, "Federal Reserve Board invites public comment on proposal to establish capital requirements for certain insurance companies supervised by the Board", https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190906a.htm

By helping to prevent insolvencies, the BBA would protect the U.S. system of deposit insurance and promote financial stability. This compliments the work of state insurance regulators to protect policyholders.

Committee on Banking, Housing, and Urban Affairs
"Developments in Global Insurance Regulatory and Supervisory Forums"
September 12, 2019

Questions from Mr. Thomas Sullivan, Associate Director, Board of Governors, Federal Reserve System, from Senator Kyrsten Sinema:

1) Under the new capital standard being developed by the International Association of Insurance Supervisors, insurance companies would be required to hold short-term assets more than, or instead of, long-term assets. If insurance companies are required to do so, will this new standard reduce the availability and affordability of annuities, which are longer-term products that provide retirement security for millions of Americans?

Board of Governors of the Federal Reserve System
Washington, DC 20551

December 11, 2019

The Honorable Kyrsten Sinema
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of the questions that you submitted following the September 12, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 8, 2019.

<u>Questions for Mr. Thomas Sullivan, Associate Director, Board of Governors of the Federal Reserve System from Senator Sinema:</u>

1. Under the new capital standard being developed by the International Association of Insurance Supervisors, insurance companies would be required to hold short-term assets more than, or instead of, long-term assets. If insurance companies are required to do so, will this new standard reduce the availability and affordability of annuities, which are longer-term products that provide retirement security for millions of Americans?

Under its current form, the International Capital Standard (ICS) is unfit for the U.S. insurance market, and the Federal Reserve is advocating at the International Association of Insurance Supervisors that the structure of the ICS should comport with the structure of the U.S. insurance market. Adopting the ICS as it is currently construed would result in capital requirements for longer duration products, like annuities, that are higher than current requirements. This would likely increase the cost of offering these products. The higher cost could result in reduced interest by companies in offering these products and/or higher costs for these products for consumers.

Committee on Banking, Housing, and Urban Affairs
"Developments in Global Insurance Regulatory and Supervisory Forums"
September 12, 2019

Questions from Mr. Thomas Sullivan, Associate Director, Board of Governors, Federal Reserve System, from Senator Patrick Toomey:

1) Should the IAIS adjust its International Capital Standards (ICS) to comport with the structure of the United States insurance market prior to adoption for monitoring?

2) How can the operational effectiveness of ICS be properly examined if it is has identified flaws from the outset?

3) Specifically, what adjustments to ICS would you like to see prior to its adoption?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

December 11, 2019

The Honorable Patrick Toomey
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of the questions that you submitted following the September 12, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 8, 2019.

Questions for Mr. Thomas Sullivan, Associate Director, Board of Governors of the Federal Reserve System from Senator Toomey:

1. Should the IAIS adjust its International Capital Standards (ICS) to comport with the structure of the United States insurance market prior to adoption for monitoring?

Yes, the Federal Reserve Board (Board) advocates at the International Association of Insurance Supervisors (IAIS) that the structure of the International Capital Standard (ICS) should comport with the structure of the U.S. insurance market.

2. How can the operational effectiveness of ICS be properly examined if it is has identified flaws from the outset?

Under its current form, the ICS is unfit for the U.S. market. Because of this, the Federal Reserve, Department of the Treasury, National Association of Insurance Commissioners (NAIC), and the States are pressing hard to structure the monitoring period so that further work and revisions will be made.

An international standard could limit regulatory arbitrage and could help provide a level playing field for global insurers. It also could help ensure that U.S. companies are not held to unsuitable or onerous regulations when they operate abroad. This is why we remain committed to working with the IAIS to develop an international standard that works for the U.S. insurance market.

3. Specifically, what adjustments to ICS would you like to see prior to its adoption?

We have concerns that the ICS currently includes a valuation method and other requirements that may not be optimal for the U.S. insurance market. Insurers generally operate with a buy-and-hold, long-term approach to investing, yet the ICS, as proposed, uses a market-based valuation method, whose volatility could ultimately reduce the availability of insurance products with long-term guarantees.

Because of these concerns, the Federal Reserve intends to continue to advocate internationally for the recognition of the Aggregation Method (AM) at the IAIS, which in its design will be foundationally similar to our domestic approach, the building block approach (BBA) and the NAIC's Group Capital Calculation. The IAIS should include a path to determine that the Aggregation Method (AM) is an outcome equivalent or "comparable" to the ICS.

Committee on Banking, Housing, and Urban Affairs
"Developments in Global Insurance Regulatory and Supervisory Forums"
September 12, 2019

Questions from Mr. Thomas Sullivan, Associate Director, Board of Governors, Federal Reserve System, from Senator Robert Menendez:

1) Before the International Association of Insurance Supervisors (IAIS) votes on adoption of the new international capital standards, there will be two meetings this month and next to lay the groundwork for the annual General Meeting in November.

A. How will each of you approach these meetings and what outcomes do you hope to achieve?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

December 11, 2019

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of the questions that you submitted following the September 12, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on October 8, 2019.

<u>Questions for Mr. Thomas Sullivan, Associate Director, Board of Governors of the Federal Reserve System from Senator Menendez:</u>

1. Before the International Association of Insurance Supervisors (IAIS) votes on adoption of the new international capital standards, there will be two meetings this month and next to lay the groundwork for the annual General Meeting in November.

A. How will each of you approach these meetings and what outcomes do you hope to achieve?

In each of these meetings, the Federal Reserve will collaborate with the States, National Association of Insurance Commissioners, and Federal Insurance Office to advocate for the best interests of the U.S. insurance market. Collectively, we have concerns with several aspects of the International Capital Standard (ICS), including the ICS's market-based valuation approach and the standard for assessing the comparability of the Aggregation Method. We plan to raise these issues at each meeting until there is agreement on how to proceed. It is our intention to achieve a suitable agreement that addresses our concerns and recognizes the U.S. regulatory system.

Committee on Banking, Housing, and Urban Affairs
"Facilitating Faster Payments in the U.S."
September 25, 2019

Questions for Ms. Esther George, President and Chief Executive Officer, Federal Reserve Bank of Kansas City, from Senator Elizabeth Warren:

1. What are the implementation challenges associated with FedNow? How does the Federal Reserve (the Fed) plan to resolve these challenges?

   A. In your testimony, you stated that the FedNow service would allow the Fed to "promote the development and implementation of industry-wide fraud mitigation standards." Can you provide more detail regarding the steps being taken to prevent consumer harm from fraud on FedNow?

   B. How will the Fed ensure that its system is fully interoperable with existing RTP systems and future ones that may develop?

2. In the Federal Register notice for the proposed FedNow Service, the Fed also announced plans to explore expanding the hours for the Fedwire Funds Service and the National Settlement Service.[1]

   A. Does the Federal Reserve have a timeline for implementing this proposed expansion?

   B. Please describe the ways in which this expansion will further support private sector initiatives to provide faster payments and more quickly settle transactions.

3. The Fed has stated that the ultimate pricing structure for FedNow "would be informed by the Board's assessment of market practices at the time of implementation."[2] Could you provide further detail as to what factors the Fed will be considering as it develops a fee structure and schedule, particularly with respect to whether the Fed will offer volume discounts to the largest banks?

[1] Federal Reserve System, Federal Register Notice, "Federal Reserve Actions to Support Interbank Settlement of Faster Payments", August 9, 2019, https://www.federalreserve.gov/newsevents/pressreleases/files/other20190805a1.pdf
[2] Ibid.

Joint Economic Committee Hearing – November 13, 2019
"The Economic Outlook"
Questions for the Record for Chair Powell
Submitted by Congresswoman Joyce Beatty (OH-03)

Question #1

According to the Federal Reserve of St. Louis, auto loan debt is at a record $1.2 trillion, up about a half a billion dollars over the last decade, meaning it is up roughly 63% over the last decade. We are also seeing the average length of an auto loan increase significantly with about a third of auto loans in the first half of 2019 for new vehicles with terms longer than 72 months - up from just 10% a decade ago.

What does the Federal Reserve make of this recent uptrend of debt in the auto market in the last decade and the lengthening of loan terms out more than 72 months? Does this say anything about the strength of the consumer in this economy? This does not seem to be sustainable, does it?

Question #2

At a recent meeting of the Financial Stability Oversight Council (FSOC), members of FSOC heard a presentation from staff of the Federal Reserve, Federal Housing Finance Agency, and Conference of State Bank Supervisors regarding the growth of non-bank mortgage origination and servicing and potential related risks. One of these risks related to the reliance of many non-bank lenders on short-run financing from banks that could dry up in a downturn. These non-bank lenders have increased their share of the mortgage lending market since the Financial Crisis of 2008, especially as it relates to FHA loans, which is where many low-income and minority borrowers receive financing to purchase a home.

Can you tell this Committee what you thought of that presentation? Is FSOC or the Federal Reserve taking any actions to address this concern?

Question #3

As you know, the Federal Reserve is currently developing capital requirements for insurance companies that own depository institutions, otherwise known as insurance savings and loan holding companies. In the notice of proposed rulemaking issued in September, the Board indicated that your intention under your proposed requirements, no company subject to the requirements would have to raise capital above what they hold today under state law. This also reflects the robust nature of existing state capital requirements.

If you found through further analysis and comment that healthy insurers that are well capitalized under state law would have to significantly increase capital to meet Board requirements and continue their current business operations, would you take that into account when finalizing your rule?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

December 20, 2019

The Honorable Joyce Beatty
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to all of the questions that you submitted following the November 13, 2019,[1] hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 19, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative Beatty:</u>

1. According to the Federal Reserve of St. Louis, auto loan debt is at a record $1.2 trillion, up about a half a billion dollars over the last decade, meaning it is up roughly 63% over the last decade. We are also seeing the average length of an auto loan increase significantly with about a third of auto loans in the first half of 2019 for new vehicles with terms longer than 72 months - up from just 10% a decade ago.

What does the Federal Reserve make of this recent uptrend of debt in the auto market in the last decade and the lengthening of loan terms out more than 72 months? Does this say anything about the strength of the consumer in this economy? This does not seem to be sustainable, does it?

Auto loan debt is at a record of near $1.2 trillion dollars as of 2019:Q3, about $460 billion higher in nominal terms than a decade ago—when auto loan balances were at the nadir in the midst of the Great Recession. That said, auto loan growth has been outpaced by nominal GDP growth over the past fifteen years. Among other factors, we expect auto loan nominal balances to continue to grow with the economy and inflation.

Terms of auto loans indeed have increased noticeably during the past decade. However, in a longer perspective, the maturity extension is comparable to what occurred over the past several decades. For example, the Federal Reserve Board's (Board) G. 20 Finance Companies Statistical Release indicates that the average term of auto loans originated by financing subsidiaries of auto makers (captive finance companies) increased from 35 months in early 1970s to 62 months in early 2010s, a pace of about 6 months per decade. The upward trend in auto loan terms reflect, in part, the improvement of vehicle durability.

Implications of longer auto loan terms on borrowers are mixed. On the one hand, other factors held constant, longer loan terms reduce monthly payments, which makes vehicles and loans more affordable for liquidity-constrained car buyers. On the other hand, increased auto loan terms may exacerbate consumers' vulnerabilities. For example, longer auto loan terms expose consumers to future income and expenditure shocks for a longer period, increasing the probability of default. Additionally, extended loan terms reduce equity accumulation and push up loan-to-value ratios. Currently, overall auto loan delinquencies remain stable at moderate levels.

2. At a recent meeting of the Financial Stability Oversight Council (FSOC), members of FSOC heard a presentation from staff of the Federal Reserve, Federal Housing Finance Agency, and Conference of State Bank Supervisors regarding the growth of non-bank mortgage origination and servicing and potential related risks. One of these risks related to the reliance of many non-bank lenders on short-run financing from banks that could dry up in a downturn. These non-bank lenders have increased their share of the mortgage lending market since the Financial Crisis of 2008, especially as it relates to FHA loans,

which is where many low-income and minority borrowers receive financing to purchase a home.

Can you tell this Committee what you thought of that presentation? Is FSOC or the Federal Reserve taking any actions to address this concern?

I share your concern about the vulnerabilities associated with the growth of nonbank mortgage originators and servicers. In its annual report, which was released on December 4, 2019, the Financial Stability Oversight Council (FSOC) highlighted these risks and recommended that federal and state regulators continue to coordinate closely to collect data, identify risks, and strengthen oversight of nonbank companies involved in the origination and servicing of residential mortgages. The Board does not have any direct regulatory authority over these nonbank institutions, but we share our technical expertise as appropriate with our partner agencies and remain committed to supporting work undertaken by FSOC. The Secretary of the Treasury, as Chair of the FSOC, is best able to answer questions regarding future actions.

3. As you know, the Federal Reserve is currently developing capital requirements for insurance companies that own depository institutions, otherwise known as insurance savings and loan holding companies. In the notice of proposed rulemaking issued in September, the Board indicated that your intention under your proposed requirements, no company subject to the requirements would have to raise capital above what they hold today under state law. This also reflects the robust nature of existing state capital requirements.

If you found through further analysis and comment that healthy insurers that are well capitalized under state law would have to significantly increase capital to meet Board requirements and continue their current business operations, would you take that into account when finalizing your rule?

The Board currently supervises eight institutions that are significantly engaged in insurance activities. These eight institutions would therefore be subject to the proposed capital requirement. In addition to publication of the Notice of Proposed Rulemaking (NPR) for comment, the Board conducted a Quantitative Impact Assessment (QIS) of the Building Block Approach (BBA) with supervised firms. The responses to the NPR as well as the feedback from supervised firms on the QIS and the data that will be received through the QIS will provide us with the ability to ensure appropriate calibration of the BBA capital requirement.

Joint Economic Committee Hearing – November 13, 2019
"The Economic Outlook"
Questions for the Record for Chair Powell
Submitted by Senator Hassan

1. A recent study by Xavier Jaravel that was highlighted by the Center on Poverty and Social Policy at Columbia University[1] found that, from 2004 to 2015, inflation for retail products was, on average, 0.44 percentage points higher for the bottom income quintile relative to the top income quintile. When adjusting inflation measures to account for this "inflation inequality," the number of people in poverty in 2018 was about 8 percent larger than under the official inflation measure. This translates to roughly 3.2 million more households classified as living in poverty than under official measures. **In pursuing its dual mandate, how does the Federal Reserve account for inflation inequality in setting policies – such as target interest rates – that are aimed at managing inflation? Further, does the Fed have plans to research inflation inequality and its implications for monetary policy?**

[1] Center on Poverty and Social Policy, Columbia University. 2019. "The Costs of being Poor: Inflation Inequality Leads to Three Million More People in Poverty." https://groundworkcollaborative.org/wp-content/uploads/2019/11/The-Costs-of-Being-Poor-Groundwork-Collaborative.pdf

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

December 20, 2019

The Honorable Maggie Hassan
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of the questions that you submitted following the November 13, 2019,[1] hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 19, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Hassan:

1. A recent study by Xavier Jaravel that was highlighted by the Center on Poverty and Social Policy at Columbia University[1] found that, from 2004 to 2015, inflation for retail products was, on average, 0.44 percentage points higher for the bottom income quintile relative to the top income quintile. When adjusting inflation measures to account for this "inflation inequality," the number of people in poverty in 2018 was about 8 percent larger than under the official inflation measure. This translates to roughly 3.2 million more households classified as living in poverty than under official measures. In pursuing its dual mandate, how does the Federal Reserve account for inflation inequality in setting policies – such as target interest rates – that are aimed at managing inflation? Further, does the Fed have plans to research inflation inequality and its implications for monetary policy?

[1] Center on Poverty and Social Policy, Columbia University. 2019. "The Costs of being Poor: Inflation Inequality Leads to Three Million More People in Poverty." https://groundworkcollaborative.org/wp-content/uploads/2019/11/The-Costs-of-Being-Poor-Groundwork-Collaborative.pdf

The research you cite finds evidence that inflation over the period studied was higher for low-income groups than for those with higher incomes. The paper argues that the differences may have been driven by product innovation that is targeted to products that relatively affluent people purchase. This research is interesting, and the issues it raises are clearly relevant for understanding changes in the standard of living for different income groups. Some related research has been conducted by individual staff at the Federal Reserve,[2] and it would indeed be useful to see more such work being done.

Knowing the implications of this work for monetary policy is challenging, however. My colleagues and I fully recognize that inflation is not the same for everyone. Different people purchase different things from different places, and the national price indexes are by necessity averages across the population. At the same time, monetary policy affects inflation broadly, and we interpret our price stability mandate to refer to overall inflation. Moreover, the study does not indicate that the observed inflation differentials across income groups were somehow related either to the overall level of inflation or to the state of the business cycle. Accordingly, it is not clear how the results might bear on the Federal Reserve's decisions regarding either the inflation or employment portions of our congressional mandate.

Economic policy should strive to achieve solid economic growth and rising standards of living not just on average but throughout the population. The policies to support these objectives are mostly outside the scope of monetary policy, but I believe the Federal Reserve can contribute by pursuing our mandate of maximum employment and price stability.

[2] Kaplan, G. and S. Schulhofer-Wohl. 2017. "Inflation at the Household Level." Journal of Monetary Economics vol. 91, November, pp. 19-38, https://doi.org/10.1016/j.jmoneco.2017.08.002.

Joint Economic Committee Hearing – November 13, 2019
"The Economic Outlook"
Questions for the Record for Chair Powell
Submitted by Senator Cotton

1. Chairman Powell, I understand that the CECL accounting standard was on the agenda of last week's FSOC meeting. A short time ago, a bipartisan letter from Congress was sent to Secretary Mnuchin, who serves as FSOC's Chairman, called for tasking the Office of Financial Research to study CECL and its likely impact on the economy. Is the FSOC planning to follow up on the recommendation in that letter and give that assignment to the OFR? What additional plans came out of last week's FSOC meeting?

2. Chairman Powell, a year ago the Fed was approaching finalizing its long-proposed rule creating a new Stress Capital Buffer (SCB). Started under the past administration, the SCB was designed integrate the forward-looking stress test results with the Board's non-stress capital requirements. The result would produce capital requirements for large banks that are firm-specific and risk-sensitive. Unfortunately, that effort was delayed and missed being applied for the 2019 evaluation year. Will the SCB be finalized this Fall so that it can be applied for 2020?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

December 20, 2019

The Honorable Tom Cotton
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all of the questions that you submitted following the November 13, 2019,[1] hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 19, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Cotton:</u>

1. Chairman Powell, I understand that the CECL accounting standard was on the agenda of last week's FSOC meeting. A short time ago, a bipartisan letter from Congress was sent to Secretary Mnuchin, who serves as FSOC's Chairman, called for tasking the Office of Financial Research to study CECL and its likely impact on the economy. Is the FSOC planning to follow up on the recommendation in that letter and give that assignment to the OFR? What additional plans came out of last week's FSOC meeting?

As described in the minutes of the November 2019 FSOC meeting,[1] members of the Financial Stability Oversight Council (FSOC) heard presentations by staff from member agencies describing issues around Current Expected Credit Losses (CECL). In terms of your question about plans coming out of the meeting, the minutes note that "[t]he Chairperson asked the Office of Financial Research to review existing research on CECL and to report back to FSOC with a summary of that literature." The Secretary of the Treasury, as Chair of the FSOC, is best able to answer questions regarding any additional work. The Federal Reserve Board (Board) remains committed to supporting the work undertaken by FSOC.

2. Chairman Powell, a year ago the Fed was approaching finalizing its long-proposed rule creating a new Stress Capital Buffer (SCB). Started under the past administration, the SCB was designed integrate the forward-looking stress test results with the Board's non-stress capital requirements. The result would produce capital requirements for large banks that are firm-specific and risk-sensitive. Unfortunately, that effort was delayed and missed being applied for the 2019 evaluation year. Will the SCB be finalized this Fall so that it can be applied for 2020?

The Board continues to consider the stress capital buffer proposal and to look for ways to improve the capital framework that maintain the resilience of the financial system, while increasing efficiency and transparency. I currently do not have a further update regarding rule finalization and implementation.

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[1] https://home.treasury.gov/system/files/261/November072019-minutes.pdf.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

January 16, 2020

The Honorable Ted Cruz
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 19 and 20 that you submitted following the November 13, 2019,[1] hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record. A response to your remaining questions will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 19, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Cruz:</u>

19. Chairman Powell, I understand that you are on the Financial Stability Oversight Council (FSOC) and that the current expected credit loss (CECL) accounting standard for loan losses was on the agenda of last week's FSOC meeting. On October 18, 2019, a bipartisan letter from Congress was sent to Secretary Mnuchin, who serves as FSOC's Chairman. The letter called for tasking the Office of Financial Research (OFR) to study CECL and its likely impact on the economy. Is the FSOC planning to follow up on the recommendation in that letter and give that assignment to the OFR? What additional plans came out of last week's FSOC meeting?

As described in the minutes of the November 2019 meeting,[2] my Financial Stability Oversight Council (FSOC) colleagues and I heard presentations by staff from banking agencies describing issues around current expected credit loss (CECL). After the presentation, the Chairperson asked the Office of Financial Research to review existing research on CECL and report back to the FSOC with a summary of that literature. The Federal Reserve remains committed to supporting any work undertaken by the FSOC.

20. Chairman Powell, a year ago the Federal Reserve was close to finalizing its long-proposed rule creating a new Stress Capital Buffer (SCB). Started under the past administration, the SCB was designed to integrate the forward-looking stress test results with the Fed's non-stress capital requirements. The result would produce capital requirements for large banks that are firm-specific and risk-sensitive. Unfortunately, that effort was delayed and missed being applied for the 2019 evaluation year. Here we are, a year later, quickly approaching 2020. Can we get the SCB finalized this year so that it can be applied for 2020?

The Federal Reserve Board continues to consider the stress capital buffer proposal and to look for ways to improve the capital framework that maintain the resilience of the financial system, while increasing efficiency and transparency. I currently do not have any update regarding rule finalization and implementation.

[2] See https://home.treasury.gov/system/files/261/November072019-minutes.pdf.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

February 28, 2020

The Honorable Ted Cruz
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1 to 18 that you submitted following the November 13, 2019,[1] hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record. This concludes all responses to your questions.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 19, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Cruz:</u>

1. During your confirmation hearing on November 28, 2017, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, you showed a willingness, to share your views on fiscal policy, as Federal Reserve Chairmen before you have previously done. For example, Senator Van Hollen asked if you agreed with former Chairman Yellen's statement that: "current spending and taxation decisions will lead to an unsustainable debt situation with rising interest rates and declining investment in the United States that will further harm productivity, growth, and living standards." You responded by discussing your views on fiscal policy and agreed with Chairman Yellen's statement.

Your willingness to discuss spending and taxation policies during your confirmation hearing appears to stand in stark contrast with your unwillingness to answer similar questions when testifying before the United States Joint Economic Committee on November 13, 2019. During that hearing, I expressed my concern that certain types of federal policies (i.e. tax policies) could discourage investment and slow down economic growth. I then asked you to opine on whether a massive tax increase would be good or bad for the economy. I specifically asked: "Would a massive tax increase be good or bad for the economy? In your judgement, would such policies decrease investment and slow down economic growth?"

Given your willingness to respond to taxation questions during your confirmation hearing, please respond to the following: Would a massive tax increase be good or bad for the economy? In your judgement, would such policies decrease investment and slow down economic growth?

2. In your opinion, would higher taxes on small-and medium-sized businesses potentially lower their disposable income?

3. If businesses have less disposable income, would they potentially reduce their investment in capital? If so, what impact would that have on the U.S. economy?

4. If Congress decided to levy an annual tax on taxpayers' entire net worth—what some are calling a "wealth tax"—what impact might that have on economic behavior?

5. Would a wealth tax reduce national saving, and if so, what ripple effects would that have across the economy, especially for working-class Americans?

6. The Tax Cuts and Jobs Act allowed for full and immediate expensing for most types of business investment. If Congress were to reverse this change and instead require firms to deduct the cost of an investment from their taxes over the life of the asset acquired, what would this do to business investment?

7. What effect does a decrease in business investment have on jobs and wages, particularly for middle- and working-class Americans?

8. Prior to the Tax Cuts and Jobs Act, the United States had the highest corporate tax rate amongst OECD nations. The 2017 tax reform law lowered the corporate tax rate in the United States to 21%, making our rate more competitive with other OECD countries. If the United States were to return its corporate rate to 35%, what consequences would that have on business investment in the United States and economic growth generally?

9. If Congress were to increase the corporate tax rate, would the burden of that tax fall only to wealthy corporations along with the nation's millionaires and billionaires, or would it fall on the shoulders of workers, shareholders, and consumers as well? To what extent would it impact various groups (e.g. corporations, shareholders, workers, consumers, etc.)?

10. During your confirmation hearing, Senator Tillis asked you whether reducing the tax and regulatory burden on certain businesses would lead to more or less investment in productivity. You responded: "I think there clearly are ways in the tax code to support different kinds of activity, and certainly, investment is one of these." What are some of the ways in which the tax code supports investment?

11. What are some of the ways in which the tax code now better supports business investment than it did prior to the enactment of the Tax Cuts and Jobs Act? Please be specific in terms of which changes to the code supported investment.

12. On December 13, 2017, in response to Congress passing the Tax Cuts and Jobs Act, former Chairman Janet Yellen stated, "My colleagues and I are in line with the general expectation among most economists that the type of tax changes that are likely to be enacted would tend to provide some modest lift to GDP growth in the coming years." Again, with the benefit of hindsight, has Chairman Yellen's prediction borne itself out over the last two years since passage of the Tax Cuts and Jobs Act? Do you agree that the tax changes have provided a lift to GDP?

13. On April 2, 2008, Chairman Ben Bernanke testified before the United States Joint Economic Committee. During the hearing, Representative Kevin Brady asked Chairman Bernanke if it was a bad time for Congress to consider significant new tax increases while the economy was experiencing job uncertainty, low consumer confidence, and a loss of net household worth. In response, Chairman Bernanke stated: "in the short term certainly I think new tax increases would reduce disposable income and consumption, and I think that would be a concern." Do you agree with Chairman Bernanke's statement? Please explain, and if you do agree, would you say the statement is still true today?

14. On November 8, 2007, Chairman Bernanke testified before the United States Joint Economic Committee. During the hearing Senator Brownback asked Chairman Bernanke if raising taxes would be harmful to long-term economic growth in the United States. In response, Chairman Bernanke stated: "A large increase in net taxes would tend to be a drag on consumer spending and on the economy through a number of different channels, I

should say. That would be an issue, I think, if that were to be the case, given what we expect to be a slower growth economy for the next couple of quarters." Do you agree with Bernanke's statement? In your view, is Chairman Bernanke's statement that "a large increase in net taxes would tend to be a drag on consumer spending and on the economy" still true today? Please explain.

15. During his June 15, 2004 confirmation hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, former Chairman Alan Greenspan stated: "I have always been strongly supportive of the elimination of the double taxation of dividends largely because I have always considered it a type of tax which probably impeded capital expansion and economic growth as a consequence. So, I was very strongly supportive and remained supportive of those types of tax cuts, including marginal tax-rate cuts." Do you agree with Chairman Greenspan's statement? Please explain.

16. Former Chairman Greenspan also stated during his 2004 confirmation hearing that for "ordinary workers", "a significant part of the increase in disposable income was the result of tax cuts." Do you agree with Chairman Greenspan's statement? Please explain.

17. During an interview with CNBC's "Squawk on the Street" on January 7, 2019, former Chairman Greenspan stated that the 2017 Tax Cuts and Jobs Act: "was an excellent tax cut." Do you agree with Chairman Greenspan's statement? Please explain.

18. From the first quarter of 2015 to the third quarter of 2016, net domestic investment declined to 437 billion. In the past three years, however, the nation has experienced unprecedented growth.

Earlier this year the unemployment rate fell to the lowest level since 1968. African-American unemployment is the lowest ever recorded at 5.4%, current poverty levels for African Americans and Hispanics are the lowest ever recorded, and the number of individuals on food stamps has dropped dramatically.

From August 2018 to August 2019, there were 1.7 million fewer Americans on food stamps. Additionally, approximately 243,000 Texans came off the supplemental nutrition assistance program, and in the first quarter of 2019, net domestic investment peaked at over $676 billion.

Chairman Powell, do you agree that our country experienced a slow recovery from the recession through 2016? If yes, what has been the biggest driver of the economic growth that our country has experienced since 2016?

Fiscal policy is properly the purview of Congress and the Administration, and therefore, it would not be appropriate for the Federal Reserve to comment on the specifics of fiscal policy proposals. In that spirit, I will highlight some important general considerations when assessing the effects of fiscal policy on the economy that relate to the questions you have posed.

As you noted, I have often stated that current fiscal policy is on an unsustainable path with rising deficits and debt as a share of gross domestic product (GDP). A large and growing federal debt, relative to the size of the economy, over coming decades would have negative effects on the economy. In particular, it would tend to reduce national saving, all else equal, and put upward pressure on longer-term interest rates, raising borrowing costs for households and businesses. Those effects would probably restrain private investment, which in turn, would reduce productivity and overall economic growth. Consequently, standards of living would improve more slowly.

As I wrote in my testimony, putting fiscal policy on a sustainable path over time would also help ensure that policymakers have the space to use fiscal policy to assist in stabilizing the economy if it weakens in the future. Despite the overall need for deficit reduction, the current low interest rate environment means that, in addition to monetary policy, it would be important for fiscal policy to help support the economy in a downturn.

Fiscal policy decisions can affect the productive capacity of the economy through additional channels besides the national saving channel described above. Notably, effective marginal tax rates can alter incentives to save, invest, and work, and spending on infrastructure and other public investments can influence the productive capacity of the economy as well.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

January 16, 2020

The Honorable Amy Klobuchar
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions that you submitted following the November 13, 2019,[1] hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 19, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Klobuchar:

A third of non-retirees have zero retirement savings, and a well-known Federal Reserve study found that four in ten adults do not have enough cash to pay for a $400 emergency expense.

- **How would enhanced financial security for older Americans help promote economic growth?**
- **The Federal Reserve's dual mandate requires careful consideration of the effect of monetary policy on both inflation and unemployment. We know that keeping the unemployment rate low is critical for working Americans while inflation can be particularly harmful for seniors who rely on a fixed income. Could policies that significantly increase retirement savings help mitigate the most painful effects of unforeseen inflation?**

In general, older Americans have more wealth than younger Americans. According to the Federal Reserve's Distributional Financial Accounts, households with heads older than age 55 hold almost 75 percent of overall wealth. However, these overall numbers mask major differences across older households in their financial resilience. For example, data from the Federal Reserve's Survey of Consumer Finances suggests that only about half of older households have enough money easily accessible to cover three months of their expenses.

Financial resilience is a particular concern for older households. It is likely harder for these households to address financial setbacks by working more hours or re-entering the labor force. Instead, in difficult times, these households may be forced to cut their spending significantly. These sudden drops in spending can amplify the effects of recessions. Enhanced financial security would reduce this drag on economic growth. Unforeseen inflation is among the financial setbacks that might occur to older households, and its effects would be less if households have greater retirement savings.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

February 14, 2020

The Honorable Denny Heck
House of Representatives
Washington, D.C. 20510

Dear Congressman:

Enclosed are my responses to the questions that you submitted following the November 13, 2019,[1] hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 19, 2019.

Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative Heck:

1. Five years ago, as unemployment crossed below 6%, the first members of the FOMC said "full employment" was at hand. In the years since, as unemployment dropped below 5% and below 4%, more and more members of the FOMC said the Fed had reached its goal. We know now that those estimates of full employment were far too early, as you've acknowledged this in previous Congressional hearings. How is the Committee reckoning with this? Is there an open discussion about what caused those premature estimates or how to better measure of full employment in the future?

A great deal of uncertainty surrounds estimates of the level of full employment. This uncertainty stems from the fact that full employment is not observable. Instead, we must infer it from the behavior of observable variables. But these observable variables are influenced by many other factors, not just full employment, making the estimation of full employment extremely challenging. Adding to the challenge is the fact that the structure of the economy is constantly changing. For example, the Phillips curve relationship between inflation and the distance to full employment, has weakened over time, making estimates of full employment even more uncertain.

The Federal Reserve has responded to this uncertainty by gathering as much information as possible on full employment, including, but not limited to, extensive economic data on the labor market, inflation, and many other aspects of the economy, as well as estimates and forecasts from state-of-the-art statistical and structural models of the economy. We also consult research outside of the Federal Reserve System and benefit from conversations with economists, businesses, non-profits and individuals at events such as our "Fed Listens" series. In addition, each member of the Federal Open Market Committee (FOMC) uses their own experience and expertise to interpret the relevant economic data and analysis. The exposure to these different perspectives benefits all FOMC members.

We also regularly examine our forecast errors of important macro variables, such as inflation and unemployment, to see what we got wrong and why. We then use this information to inform our estimate of full employment and our current forecasts. Because the structure of the economy is constantly changing in ways that are difficult to recognize and understand in real time, we must guard against anchoring our understanding of the economy too much in the past. Finally, realizing that we will not always be right about full employment and other structural aspects of the economy, we use alternative simulations of economic activity to examine what the consequences for activity and employment would be if we are wrong. We then take these risks into account in deciding current policy.

2. Can you explain how you measure full employment? In the economic projections, the FOMC members estimate that the sustainable unemployment rate is 4.0-4.3%, which suggests that, at our current level of 3.6%, we're well beyond full employment, but other measures like monthly job gains show there's still slack in the labor market. What should regular citizens and policymakers look at to gauge how close the FOMC believes we are to meeting the full-employment mandate?

As noted in the previous response, the level of full, or maximum, employment is not observable. Accordingly, estimates of the level of full employment and assessments of labor market slack are subject to considerable uncertainty and re-evaluation. FOMC members consider a range of indicators when evaluating the strength of the labor market, including direct measures of labor market utilization such as the unemployment rate, the labor force participation rate, and the share of employed individuals working part time but preferring full-time employment. Members also consider the pace of job gains, indicators of how hard or easy it is for people to find jobs and for employers to find qualified workers, how quickly wages and broader measures of hourly compensation are increasing, and the inflation rate for the personal consumption expenditure (PCE) price index (as well as other measures of price inflation).

The unemployment rate in January 2020 was 3.6 percent, and since December 2017 it has remained at or below 4.1 percent—the median of participants' estimates of the sustainable unemployment rate in the December 2019 Summary of Economic Projections. As you noted, on the basis of the unemployment rate alone, it would appear that the labor market is operating above its full-employment level. However, both PCE price inflation and core PCE inflation, which excludes the volatile food and energy components, have remained below 2 percent—the rate of price inflation that the FOMC judges to be most consistent with achievement of both parts of the dual mandate—and the pace of wage gains has remained modest. Indeed, the coincidence of inflation running below 2 percent and a low and declining unemployment rate has led FOMC participants to revise down their estimates of the long-run sustainable unemployment rate, with the median estimate declining by 0.5 percentage point since the December 2017 FOMC meeting.

Other indicators of labor market activity seem to support the view that we have not yet reached full employment and that the unemployment rate may be overstating the strength in the labor market. In particular, the continuing solid pace of job gains and the sustained increases in the labor force participation rate for 25 to 54 year olds both suggest that there is further room for employment to increase.

It is not unusual for these various indicators to be sending divergent signals about labor market slack, so congressional policymakers and the public should look at a variety of measures of labor market activity, as well as for signs of a pickup in the pace of wage gains and PCE inflation rising towards 2 percent, to get a broad sense of how close FOMC members think we are to full employment.

FOMC participants convey their assessments of the maximum level of employment and discuss the information they use to inform those assessments in various public communications, including speeches, testimony, post-meeting statements, and FOMC meeting minutes. The Board's biannual Monetary Policy Report to Congress also includes a detailed analysis of the labor market.

3. As the Fed conducts its framework review, most of the focus has been on the price-stability mandate. For example, you've discussed switching to average inflation targeting. Are there framework changes being considered with respect to the full-employment mandate? And if so, what are those changes?

The Federal Reserve conducts monetary policy to pursue maximum employment and price stability. Unlike the inflation rate, the maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors cannot be directly observed and may change over time. Consequently, the FOMC's policy decisions are informed by assessments of the maximum level of employment based on a wide range of data, recognizing that such assessments are necessarily uncertain and subject to revision. In recent years, declines in the unemployment rate have not been associated with a significant acceleration in wages or a pickup in overall inflation, suggesting that the labor market was not at tight as would have been suggested by earlier estimates of the so-called natural rate of unemployment. Accordingly, many forecasters have revised down estimates of the natural rate of unemployment in recent years. FOMC participants have also revised down their individual estimates of the unemployment rate that is expected to prevail in the longer run.

The Federal Reserve is taking a broad and open-minded look at the monetary policy strategy, tools, and communications practices it uses to pursue its goals of maximum employment and price stability. While this review is broad in scope, it takes as given the Federal Reserve's congressionally assigned dual mandate goals, including maximum employment.

The review includes a series of "Fed Listens" events around the country to hear perspectives from representatives of business and industry, labor leaders, community and economic development officials, academics, nonprofit organizations, and others. The feedback from these events has underscored the positive implications of strong labor markets and high rates of employment for various communities.

4. Business investment has been slowing for six straight quarters despite the passage of the tax cut in 2017, the economy getting closer to full employment, and interest rates remaining very low. How has the experience of weak business investment in the aftermath of the tax changes been reflected in updates to the Federal Reserve's economic forecasting model? How do you expect business investment to trend going forward?

The U.S. economy is now in the 11th year of this expansion, with gross domestic product on pace for a moderate gain for 2019 as a whole. Household consumption remains a bright spot, supported by a healthy job market, rising incomes, and favorable levels of consumer confidence. Reflecting the decline in mortgage rates since late 2018, residential investment turned up in the third quarter following an extended period of weakness.

In contrast to the continued strength in household spending, investment spending by businesses decelerated sharply in 2019, following strong gains in 2018. The softness in business investment has been widespread, with all three major sub-sectors—equipment, structures, and intellectual property products—making sizable contributions to the deceleration. Sluggish growth abroad, trade developments, and heightened uncertainty all appear to be weighing on investment. In addition, the suspension of deliveries and production at a major commercial aircraft manufacturer has reduced transportation equipment investment, and sliding energy prices have contributed to ongoing declines in drilling and mining investment that began in mid-2018. Investment in non-drilling structures has also declined, with commercial construction—particularly shopping malls—accounting for much of the decrease. If it were sustained, the recent diminished pace of business investment could meaningfully reduce the contribution of capital deepening (capital services per trend employee hour) to the growth rate of trend labor productivity and thus to the longer-run growth rate of the U.S. economy as a whole.

Looking ahead, business output growth and the cost of capital are both fundamental determinants of business investment. As such, the sustained expansion in economic growth that we anticipate, which partly reflects the policy adjustments we have made this past year, should encourage a sustained pickup in business investment. Moreover, corporate financing conditions as well as financing conditions for small businesses have remained generally accommodative on the whole. At the same time, while some of the uncertainties around trade have diminished recently, uncertainty over global economic prospects pose ongoing risks. In the longer term, another risk is that high and rising federal debt could restrain business investment and thereby reduce productivity and overall economic growth.

Forward-looking indicators of business spending, such as orders of nondefense capital goods, surveys of business conditions and sentiment, capital spending plans, and profit expectations from industry analysts, all appear to have stabilized in recent months after having deteriorated markedly earlier in 2019. These indicators are consistent with continued soft investment growth in the months ahead, but likely not material declines.

5. As we have discussed before, I believe that reaching full employment will spur business investment - rising wages and difficulty hiring will spur investment in labor-saving equipment. I believe the economy as a whole is still short of full employment, but there are likely some industries where all the labor market slack has been taken up. Are we seeing increased business investment in those industries?

In principle, when the economy is nearing full employment and labor markets tighten, the incentive for most firms to invest in labor-saving technologies should rise. Such investment should in turn raise the contribution of capital deepening (i.e., the amount of capital services per employee) to the growth rate of trend labor productivity and lift the longer-run growth rate of the U.S. economy as a whole. Higher trend productivity and additional labor market strengthening should both support stronger growth in hourly compensation.

In practice, it is difficult to discern a clear link between labor market slack and business investment in the available data. A simple cross correlation between industry-level equipment investment and industry-level unemployment rates in the past few years shows essentially no relationship. Investment in some industries with low unemployment rates, like utilities and healthcare, does appear to have accelerated. But in other low-unemployment industries, like finance and insurance, investment does not appear to have accelerated.

That said, good quality industry-level investment data is only available with a considerable lag and tends to be quite volatile from year-to-year. Thus, it may take several more years for a clearer pattern to emerge in the data. More generally, there are many other factors besides labor market slack that affect investment, including economic growth, profit expectations, financing conditions, tax policy, and uncertainty. Therefore, isolating a statistically significant relationship between labor market slack and business investment may continue to prove elusive.

6. Business investment is the key to productivity growth which in turn is the key to sustained high wage growth. What do you believe is the single most important policy adjustment we could make to spur business investment?

Despite strong labor market conditions, including an unemployment rate near half-century lows, available indicators generally suggest that hourly labor compensation growth remains moderate by historical standards despite picking up some of late. Moderate compensation gains likely reflect the offsetting influences of a strengthening labor market and productivity growth that have been weak through much of the expansion. A sustained pickup in productivity, as well as additional labor market strengthening, would support stronger gains in hourly compensation.

Considerable debate remains about the reasons for the slowdown in productivity growth, but the weakness may be partly attributable to the sharp pullback in business investment during the most recent recession and the relatively slow recovery that followed. All else equal, a pickup in net investment—that is, investment in excess of what is needed to replace depreciated capital—should raise the contribution of capital deepening (i.e., the amount of capital services per employee) to the growth rate of trend labor productivity.

Congress has instructed the Federal Reserve to promote maximum employment and stable prices. Generally speaking, all policies that boost the growth potential of the economy should help to spur business investment on a sustainable basis. In the longer term, it would be important to put the federal budget on a sustainable path, as high and rising federal debt could restrain private investment, thereby reducing productivity and overall economic growth. What types of policies are most appropriate to promote business investment are for Congress and the Administration to decide.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

January 16, 2020

The Honorable Jimmy Panetta
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all of the questions that you submitted following the November 14, 2019,[1] hearing before the Committee on Budget. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on November 26, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative Panetta:</u>

We are in a moment of great uncertainty regarding trade, as our farmers and businesses don't know what markets they are going to have access to in the future. The trade outlook in China remains extremely unclear, and even as we worked towards getting to "yes" on a renegotiated NAFTA agreement, the President has threatened 5% tariffs on all goods coming in from Mexico.

The Administration has, on several occasions, led the public to believe that we are closer to a deal with China than we really were:

- **In April, Treasury Secretary Steven Mnuchin said that trade negotiations were entering the "final laps."**
- **In October, Mnuchin said the U.S. and China had a "fundamental agreement," but the President days later clarified that nothing had been agreed to an that a deal had yet to even be written down.**
- **And recently, officials from the Trump Administration stated there was an agreement to roll back tariffs, only to be disputed by the President.**

Positive announcements and tweets along the way have boosted stocks, which then fell as it became clear the Administration was overstating their progress.

While the daily rise and fall of stocks is concerning, I'm much more concerned with how the Administration's assertions are impacting economic decisions on a larger scale.

In deciding to cut rates by another 25 basis points in October, you noted trade policy remained uncertain, but also seemed optimistic about a deal with China.

In your press conference, you stated in response to a question about trade, "I would say that the situation in our trade negotiations with China seems to have taken a step closer to resolution."

- **What level of trust does the Fed have in trade announcements from the Administration?**
- **How closely is the Federal following trade negotiations and global trade trends?**
- **How important is trade policy in determining Federal Reserve policy?**

I appreciate your interest in how the Federal Reserve incorporates trade developments into our economic outlook and policy decisions. However, trade policy is not the Federal Reserve's responsibility. Our focus is on achieving our mandated goals of maximum employment and price stability. We look at trade developments as one of many factors that affect the economic outlook. In doing so, we try to take a step back from the daily ups and downs of trade negotiations to focus on the implications for the economy in the medium run.

For quite some time we have heard from our business contacts around the country that uncertainty about trade policy has negatively affected their willingness to invest in expanding their businesses. It appears that trade developments have contributed to the global slowdown and have weighed on manufacturing, capital spending, and exports in the United States. Removing some of the trade policy uncertainty could improve business sentiment and support the economy over time.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

January 16, 2020

The Honorable Jan Schakowsky
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to all of the questions that you submitted following the November 14, 2019,[1] hearing before the Committee on Budget. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 26, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative Schakowsky:</u>

1. During the November 14th hearing I stated that I was discouraged by the 5-year delay in implementing the Federal Reserve's FedNow real-time payment system. This was based off of the Fed's press release that stated FedNow would be available in "2023 or 2024."[1] Mr. Powell responded that it should in fact be implemented in 3 to 4 years. Please clarify when we may expect FedNow to be available.

Please also explain why developing this infrastructure is taking so long, particularly when other central banks have had these systems in place for more than a decade.

[1] https://www.federalreserve.gov/newsevents/pressreleases/other20190805a.htm

The development of the FedNow℠ Service will be a key focus area for the Federal Reserve Board (Board) for the foreseeable future. The Board anticipates that the FedNow Service will be available sometime in 2023 or 2024, although an official launch date has not yet been established. When a specific launch date and implementation timeline have been finalized, that information will be provided publicly. The Board recognizes that time to market is an important consideration for many industry participants and is committed to establishing the FedNow Service as soon as practicably possible. Ongoing work to finalize business requirements, determine engagement with external vendors, and assess the industry's views on features and design will help inform the implementation timeline for the FedNow Service.

The Board is working diligently to make sure that the service is safe and effective in meeting the needs of depository institutions of all sizes and their customers. Achieving these objectives is a complex undertaking that will inevitably take some time, particularly in light of the diversity of the nation's banking industry. The United States has more than 10,000 depository institutions that vary greatly in terms of size, level of technical capabilities, operational practices, and customers and communities served. Providing connectivity to banks of all sizes will require a flexible approach, and the Board is leveraging its significant experience as a service provider to address implementation challenges.

The Board is developing the FedNow Service as a new system that can serve as core infrastructure for the next generation of payment services in the United States. Globally, jurisdictions have taken varied approaches to develop systems for faster payments, reflecting, among other things, differences in their domestic banking and payment industries and differing roles of the central bank. Although faster payment systems have been in place for some time in a small number of jurisdictions, these systems often do not have the same design as the FedNow Service and serve substantially less complex banking industries. For example, in the United Kingdom, faster payments settle between banks on a deferred basis (that is, at a time after end-user customers have received funds) at the Bank of England, which contrasts with the real-time interbank settlement at the Federal Reserve Banks that will occur in the FedNow Service. In other jurisdictions, such as Australia and the European Union, implementation of faster payment systems based on real-time settlement has occurred in recent years. These more recent examples have involved extended periods of industry consultation and system development, similar to the experience of the United States.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

January 31, 2020

The Honorable Tim Burchett
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the November 14, 2019,[1] hearing before the Committee on the Budget. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on November 26, 2019.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Representative Burchett:</u>

1) Keeping in mind the state of the economy of 1998 and 1999, with current interest rates already low, does the Federal Reserve have less ammunition than normal to fight future recessions?

While there is a wide range of estimates of the neutral federal funds rate, most estimates have declined significantly over the past two decades. The neutral rate is the level of the federal funds rate that is neither expansionary nor contractionary and would keep the economy growing at full employment with price stability. A lower neutral rate implies that the level of interest rates consistent with the Federal Reserve's dual mandate of maximum employment and price stability is lower than in the past and hence closer to the effective lower bound. As a result, there likely will be less room to reduce the federal funds rate to support the economy in the event of a future recession. However, the Federal Reserve has at its disposal other tools to provide additional economic stimulus, such as forward guidance about the course of interest rates in the future and balance sheet policies. These tools were effective in providing additional stimulus after the financial crisis and could be used again in the future if economic circumstances warranted. That said, the relatively low level of the neutral rate poses challenges for the conduct of monetary policy, and the Federal Open Market Committee is mindful of the risks posed by the effective lower bound.

Does Congress have an important role to enact pro-growth policies to prevent and alleviate future recessions?

In the event of recession, both fiscal and monetary policy are capable of, and effective in, supporting the economy. With regard specifically to fiscal policies determined by Congress, the experience in the United States demonstrated that counter-cyclical fiscal policy can be a valuable and important element in the policy response to economic downturns. This is particularly the case in our low-interest rate environment where the effective lower bound may constrain monetary policy.

2) Chairman Powell, do you agree or disagree with the assessment that below-market interests rates create a bubble that is at risk of bursting?

The Federal Reserve monitors financial conditions and institutions for signs of excessive risk-taking. Experience suggests many factors besides low interest rates influence risk-taking, including attitudes toward risk, uncertainty, and the strength of the economy. In our periodic Financial Stability Report (FSR), we include a comprehensive review of a range of vulnerabilities, including those that could be spurred by low rates.

As noted in the most recent FSR[1], we do not currently see large vulnerabilities. Indeed, the long economic expansion is notable for the lack of significant financial imbalances. Broad measures of risk appetite are not out of line with their historical ranges, total debt owed by businesses and

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[1] https://www.federalreserve.gov/publications/2019-november-financial-stability-report-purpose.htm.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

March 6, 2020

The Honorable Anthony Gonzalez
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

Some of us on this committee have expressed concern about Facebook's Libra project given that it is based outside the US and that it creates a basket of different currencies that could make it difficult for the Fed to control monetary policy. Some other stablecoin projects seem different, however, in that they're based in the US and are backed only by dollars rather than by baskets of currencies. Vice Chairman Quarles, do you have concerns about these non-Libra, single-currency stablecoins and, if so, what are your concerns?

Single currency, U.S.-based stablecoins likely raise a narrower set of issues than initiatives such as Libra. Nonetheless, they still entail risks and merit attention. For example, these stablecoins raise the same potential for illicit payment activity that other cryptocurrencies do. While the substance and applicability of anti-money laundering expectations are clear in the U.S., monitoring and enforcement challenges may still exist. Additionally, single-currency stablecoins may raise consumer protection concerns similar to cryptocurrencies generally, including risks of fraud and theft. While stablecoins intend to reduce or lessen the price volatility seen with many cryptocurrencies, users of a stablecoin may or may not have a direct claim on its issuer or on the assets held by the issuer, and redemption terms also vary. Relatedly, depending on how they are structured, nonbank digital wallets may not offer the same safeguards as traditional bank accounts, including deposit insurance.

Cryptocurrency and stablecoin products have not to date achieved widespread adoption. As such, these instruments raise limited concerns with respect to financial stability and monetary policy, although more serious policy issues may result if they achieve wide-scale use or experience increasing financial linkages to traditional financial intermediaries. Even for a solely U.S. dollar-based stablecoin, the implications for financial stability and monetary policy would be highly dependent on the speed of its adoption and its design features, such as what kind of assets the stablecoin is backed with, whether it is interest-bearing, and its degree of separation from the traditional banking system.

Single-currency stablecoins, depending on their specific designs, likely would have simpler issuance, redemption, and asset management processes than are described in Libra's public materials. Nonetheless, payment networks that transfer these stablecoins or wider financial products developed from the coins would entail credit, liquidity, and operational risks that should be properly managed and that could create systemic risk at scale. Moreover, commercial bank funding models and the credit provided to households and businesses could also be affected by widespread single-currency stablecoin adoption, depending on the assets backing the single-currency stablecoin and whether households and businesses substitute away from traditional bank deposits.

I appreciate the insights provided by the regulators in their Interagency Statement on the Use of Alternative Data in Credit Underwriting. I am deeply committed to helping the underserved access credit to help themselves and their families and I think that AI and the use of alternative data points could be a part of the solution. As a part of the AI Task Force

I have learned about the attendant issues here and would love for either of you to expound on what the statement refers to as the potential for a "second look" for applicants that may have been denied under legacy underwriting and scoring systems and what that second look might mean for their ability to ultimately access credit?

As noted in the Interagency Statement, some firms may choose to use alternative data only for those applicants who would otherwise be denied credit based on traditional criteria, often called a "second look" approach. Applying alternative algorithms only to such consumers could help ensure that the algorithms expand access to credit. While such "second look" algorithms still must comply with fair lending and other laws, they may raise fewer concerns about unfairly penalizing consumers than algorithms that are applied to all applicants.[1]

At the end of your statement you assert that the agencies "may" provide more guidance on the use of alternative data. Can you pledge to me that you will work in tandem on all things related to any clarification of existing regulations and guidance related to AI, and that you will work with the CFPB as well, which is not represented here today? It is so important that we have regulatory consistency on these issues, issues like model risk guidance and things like the use of alternative data as well as fair lending related matters. Will you pledge to work on an interagency basis?

The Federal Reserve Board (Board) regularly coordinates with our fellow banking agencies on innovation-related matters in the supervision area. For example, staff from the federal financial institution supervisory agencies, including the Consumer Financial Protection Bureau, participate in an Interagency Fintech Discussion Forum, hosted by the Federal Reserve. Past discussion items have included topics such as model risk management, artificial intelligence, and alterative data. The agencies will continue these discussions at future meetings of the Interagency Fintech Discussion Forum. The Board also engages in discussions through an interagency task force on fair lending, as well as through the Federal Financial Institutions Examination Council's Task Force on Supervision and Task Force on Consumer Compliance.

I have a question about the regulatory workforce. AI and machine learning tools are powerful and complex. The race for talent for those that focus on these issues is competitive. Do you think regulators are well equipped to properly supervise the use of these powerful new tools using the existing framework?

The Board is committed to hiring and maintaining a highly professional workforce with the skills necessary to supervise effectively the activities of financial institutions subject to our supervision. As we have with other areas of specific expertise, we have enhanced our workforce with new staff experienced in the area of financial technology (fintech), as well as expanded the knowledge of existing staff. For the latter, the Board has launched a series of fintech examiner training tools to ensure that examination staff are equipped to engage with financial institutions that are adopting innovative technologies to meet their customers' needs. Among those training

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[1] See Carol A. Evans, "Keeping Fintech Fair: Thinking About Fair Lending and UDAP Risks," *Consumer Compliance Outlook* (Board of Governors of the Federal Reserve System, Dec. 2017), https://www.consumercomplianceoutlook.org/2017/second-issue/keeping-fintech-fair-thinking-about-fair-lending-and-udap-risks/.

tools are seminars, online learning sessions, and materials that discuss the latest developments in artificial intelligence/machine learning (AI/ML).

Do regulators have the required personnel in place to understand these tools and work with industry to address any concerns?

In addition to providing broad training programs, the Board maintains specialized examiners skilled in business technology risk assessment who are available to participate in examinations targeted at specific technologies. These include data scientists, technology analysts, and modeling experts with in-depth knowledge of fintech activities, as well as an ability to keep up to speed with the latest developments.

Board staff routinely meet with representatives from industry and academia whose work is on the cutting edge of fintech innovation. Through these discussions, staff remain abreast of recent developments in this fast-changing landscape. In addition to recent hires and ongoing training, Board leaders are exploring further ways to expand current expertise through hiring more staff with key technology skillsets, providing hands-on supervisory experience, and employing academic fellows experienced in financial technologies.

I know regulators have lots of lawyers and economists, but do you all have lots of data and computer scientists as well?

The Board has multi-disciplinary teams working on fintech issues, including (as noted above) data and computer scientists as well as technology analysts and modeling experts. We believe that having a supervisory team with different skill sets, experience, and perspectives provides the most comprehensive approach to understanding and supervising our institutions' use of fintech.

As one of the two national ACH operators, what steps (if any) can the Federal Reserve take to help prevent unauthorized withdrawals or reversals from occurring, such as those that occurred during the MyPayrollHR incident?

As an automated clearinghouse (ACH) operator, the Reserve Banks primarily act as a central clearing facility that receives and distributes payment files and information to its customers (financial institutions) and then performs settlement. The Reserve Banks offer certain risk origination and receipt services for use by financial institutions to help support their role in the payment system. Originating financial institutions are ultimately responsible to know their originators and have the appropriate controls in place in their payment processes. In addition, the National Automated Clearing House Association (Nacha) manages the rulemaking functions, including consumer protections, for the ACH Network. The Nacha Rules do not permit unauthorized withdrawals or reversals.

The MyPayrollHR incident presented a situation whereby the Nacha Rules were circumvented. In response, Nacha formed an industry work group that included the Board to discuss the errors made by ACH participants and the specific violations of the Nacha Rules. This work included the identification of best practices, aimed at further educating the ACH industry, as well as certain proposed amendments to the Nacha Rules to strengthen them going forward. The Board will continue to pursue and participate in efforts to prevent these type of incidents from occurring.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

February 21, 2020

The Honorable Andy Barr
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

In your testimony you stated that the Federal Reserve Board is currently considering how best to implement the remainder of the international Basel III agreement, or Basel endgame, as a package -- and that the FRB is aware that the impact of implementing Basel III revisions into the U.S. framework may result in "significantly raising the aggregate level of capital in the industry." You also stated that the FRB "regularly look[s] at the calibration of the GSIB surcharge and we are considering it in the context of the overall body of regulation."

Additionally, Chairman McWilliams noted that the Basel Committee conducted a quantitative impact study (QIS) in 2009 at one of the worst times for banks' balance sheets that included only 14 U.S. banks. Chairman McWilliams suggested that she would support an analysis focused on a more specific impact in the United States.

I agree with your and Chairman McWilliams' statements that a holistic and comprehensive review of the capital framework in the U.S. is necessary to ensure that capital levels are calibrated appropriately to maintain a level playing field with our international counterparts, especially given the many post-crisis reforms that we have discussed.

When does the Federal Reserve Board plan to complete the comprehensive review and publish the results so that they may be made available to lawmakers and to the public?

If the nature of the review is ongoing and long-term, when can we expect an initial set of findings to be released based on provisions that are currently being implemented?

As I mentioned in my testimony, the Federal Reserve Board (Board) is paying close attention to the coherence of our capital regime. We are reviewing public comments on a proposed stress capital buffer framework, which would simplify our regime by integrating our stress-test and point-in-time capital requirements while maintaining the current strong levels of loss absorbency. We are also actively considering how the final Basel III standards could be implemented to maintain the aggregate level of loss absorbency across the industry, avoid additional burden at smaller banking organizations, and support our principles of transparency and due process.

While the framework developed by the Basel Committee suggests that participating jurisdictions could have a number of years to finish implementation of the remaining elements of the Basel III standards, I believe that we should view these standards as a package in evaluating their effects—implementing none until all are calibrated—and that we should therefore move more quickly to develop a proposal for implementing these remaining standards. This would also facilitate an evaluation of the likely effects on bank capital levels of completing implementation of Basel III, which would in turn enable an evaluation of whether recalibration of any existing standards would be appropriate to reflect Basel III completion (as you know, some of our existing standards were calibrated above international minimums to reflect, among other factors, the fact that some elements of the comprehensive framework were not yet in effect).

While we do not have a fixed deadline for completing this process—and while some portions of it will involve interagency coordination, which further complicates the projection of a timeline—development of a package proposal will be a high priority of mine over the coming year.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

March 6, 2020

The Honorable Joyce Beatty
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

1. As you know the Federal Reserve is currently developing capital requirements for insurance companies that own depository institutions, otherwise known as insurance savings and loan holding companies, due to passage of the Insurance Capital Standards Clarification Act in 2014. This legislation clarified that the Federal Reserve should tailor capital standards for insurance companies. I am concerned and perplexed why the proposed rule would impose a separate Section 171 banking capital calculation on these insurance companies. This seems to me to stand in contradiction to congressional intent. Imposing a Basel banking capital calculation on insurance companies is the outcome that Congress was trying to avoid when we passed that law back in 2014.

Will you commit to addressing my concerns in the final rule and ensuring that your rule respects Congressional intent to avoid imposing banking capital requirements on insurance companies?

Section 171 of the Dodd-Frank Act requires the Federal Reserve Board (Board) to establish minimum risk-based capital requirements for depository institution holding companies on a consolidated basis. The Insurance Capital Standards Clarification Act of 2014 (Clarification Act) amended section 171 to permit, but not require, the Board to exclude state-regulated insurers from this consolidated minimum risk-based capital requirement. The Clarification Act does not provide a blanket exemption for an entire holding company structure. In particular, it explicitly does not exempt a depository institution holding company from calculating its capital requirements for non-insurance entities in the corporate chain.

In September 2019, the Board issued a proposal on risk-based capital requirements for certain depository institution holding companies significantly engaged in insurance activities (proposal). The proposal would establish an enterprise-wide risk-based capital framework, known as the Building Block Approach, which is intended to facilitate the assessment of overall risk-based capital adequacy for a depository institution holding company that is significantly engaged in insurance activities by measuring aggregate capital while taking into consideration state insurance capital requirements. The proposal also includes a minimum risk-based capital requirement for the non-insurance entities within the holding company structure required by section 171, as amended by the Clarification Act (section 171 calculation). The section 171 calculation would use the flexibility afforded by the Clarification Act and exclude state-regulated insurers from minimum risk-based capital requirements to the extent permitted by law.

The Board recently invited public comment on all aspects of the proposal, including the section 171 calculation. Some comments suggested that the Building Block Approach would comply with the statutory requirements without an additional calculation. Consistent with the Administrative Procedure Act, the Board will consider this and other comments before making a final rule.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

February 27, 2020

The Honorable Ted Budd
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

1. Mr. Quarles, in addition to FedNow, the Fed also proposed expanding the operating hours of the Fedwire Funds Service. The purpose of this proposal as I understand it is to provide greater liquidity for supporting payments – including FedNow and other real-time payment systems – around the clock.

What is the status of this proposal?

Do you plan to implement these expanded hours before FedNow goes live?

Are there any impediments with moving forward?

The Federal Reserve Board (Board) is currently analyzing an expansion of operating hours for the National Settlement Service (NSS) and the Fedwire® Funds Service, up to 24x7x365, to support a wide range of payment activities, including liquidity management for faster retail payments. As part of its analysis, the Board is engaging with industry participants in order to understand the industry's specific needs and readiness related to expanded hours. In addition, the Board intends to publish at least two *Federal Register* notices in order to seek public comment on issues related to, and potential approaches for, expanding the Fedwire Funds Service and NSS operating hours, and announce its progress and any decisions related to expanded hours.

The timeline for the Board's analysis will depend in part on the diversity and complexity of issues that the Board identifies during its review. In addition, the timeline for assessing and potentially implementing expanded hours will take into account any dependencies and impacts associated with the implementation of the FedNow℠ Service. Given the systemic importance of the Fedwire Funds Service, any decisions on expanding hours could have significant impacts on market participants. The Board is committed to carefully evaluating the potential benefits, risks, and costs of any decision to expand hours of the Fedwire Funds Service and NSS.

At the same time that the Board considers expanding operating hours for NSS and the Fedwire Funds Service broadly, the Board will continue to assess the appropriateness of incremental changes to relevant Federal Reserve financial services in response to specific industry needs. For example, the Board recently completed analysis of an expansion of operating hours for NSS and the Fedwire Funds Service in order to support enhancements to the same-day automated clearinghouse (ACH) service. In December 2019, the Board announced an expansion of operating hours for NSS and the Fedwire Funds Service that will be implemented in March 2021 in order to add a third same-day ACH processing and settlement window.[1]

[1] See https://www.federalreserve.gov/newsevents/pressreleases/other20191223a.htm.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

April 24, 2020

The Honorable Bill Foster
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on December 20, 2019.

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

1. Vice Chairman Quarles, in recent months, a number of Federal Reserve officials have publicly commented on the impact of climate change impacts to the economy.

In fact, the Fed recently held its first conference on the economics of climate change in November, where San Francisco Fed Chief Daly said that severe weather cost insurers more than $50 billion in 2018 alone, and including uninsured damage nearly doubles that number.

Kevin Stiroh at the New York Fed recently noted that the US economy has experienced more than $500 billion in direct losses over the last five years due to climate and weather-related events, and that number grows by many factors if indirect losses are included.

As I believe is well-established with the Fed by now, climate change is a growing threat to our economy.

a. To date, has the Fed issued any guidance to supervised entities on how to account for these risks? What are the implications of climate change on supervisory policy?

The Federal Reserve Board's (Board) supervisory framework guides supervisors in their oversight of supervised entities with respect to their risk management practices over a wide range of risks, including those that are related to climate-related risks. Long-standing Board guidance encourages bank management to take into account all relevant risks in underwriting and review practices, while other guidance specifically addresses lending to sectors where assessments of severe climate-related risks are critical for due diligence and underwriting.

More broadly, analytic work on the relationship between climate and financial risks is in its early stages, and Federal Reserve researchers are among those working to advance it. The Board and Reserve Banks are exploring new sources of climate-related data and computational resources, engaging in research projects involving existing supervisory data collections, and participating in conferences and workshops to share our efforts with the public. We expect these efforts to improve our ability to assess the ways climate-related risks may affect the safety and soundness of financial institutions, as well as the economy and financial stability more broadly.

b. How should risk managers at financial institutions incorporate climate change risks into their capital models?

The Federal Reserve requires institutions to understand, assess, manage, and monitor, as well as to hold both capital and reserves against, a range of risks material to their operations. The most appropriate way for an institution to meet these requirements—and the most relevant information it uses to do so—may vary according to the characteristics and activities of the institution. The banking institutions we regulate are all expected to measure the risks associated with their business, including their loan exposures. Large institutions typically gather data on the probability of default and loss on the loans they hold on their balance sheets. In many cases, climate-related risks could affect these measurements.

Depending on the circumstances an institution faces, the data that are relevant to doing so may differ—depending, for example, on whether an institution's credit exposures are secured by coastal or plain property, or are tied to business revenues in agriculture or construction. We expect institutions to use a range of risk-management data appropriate to their activities, and our supervisors consider whether such data is used in a way that promotes safety and soundness.

c. In terms of potential effects on the economy, what data sets or models does the Fed use to evaluate the potential effects of climate change on economic output and productivity?

For the Federal Reserve's near-term macroeconomic analysis, we do take into account information on the severity of weather events. When a severe weather event occurs, we closely monitor the effects on local economies, assess the implications for broader measures of economic production and employment, and adjust our economic forecasts accordingly.

For example, our staff has relied on data from the Federal Emergency Management Agency and the Department of Energy to gauge the disruptions to oil and gas extraction, petroleum refining, and petrochemical and plastic resin production in the wake of hurricanes that have affected the Gulf region. Our staff regularly uses daily measures of temperatures and snowfall from the National Oceanic and Atmospheric Association weather stations to better understand how severe weather may be affecting measured and real economic activity in specific areas.

Our understanding of what economic activities will be affected by a severe weather event depends critically on data produced by the federal statistical agencies, such as the Census Bureau's County Business Patterns data, as those data provide information on economic activity in different geographic locations. In addition, our staff uses credit and debit card transactions data for gauging how specific types of severe weather might be affecting consumer spending in areas affected by those events.

At present, we do not directly model how changes in temperatures over long periods of time affect economic activity. But to the extent that climate change affects the economic data on which our models are built—including the trends and the cyclical behavior of investment, consumption, production, and employment—then climate change will be incorporated in our macroeconomic analysis over time.

d. Governor Brainard recently said that the Fed was in discussions about participating in the Central Banks and Supervisors Network for Greening the Financial System in order to learn from peers abroad. The Network's purpose is to enhance the role of the global financial system to manage risks related to climate change. There are currently 42 Members and 8 Observers, including our peers such as the ECB, Bank of England, Bank of Japan, and Bank of Canada, and major multi-lateral institutions such as the IMF, World Bank, Bank for International Settlements, and the Basel Committee. Do

you think it would be a good idea for the US to join this Network? When do you anticipate the US being able to join?

As I noted at the hearing, I have strongly urged that the Federal Reserve participate in the Network for Greening the Financial System (NGFS). Federal Reserve staff have attended recent NGFS discussions as guests and we will continue to do so. We are also exploring how we might participate further in a way that is consistent with the full range of our responsibilities. A wide range of other international work is also underway on climate-related economic and financial risks, including at the Financial Stability Board, which I chair. We are participating actively in these efforts and have been in close communication with our counterparts in other jurisdictions to learn from their research and supervisory efforts.

2. Vice Chairman Quarles, in October, the Federal Reserve Board finalized "tailoring" rules for enhanced prudential standards and resolution planning requirements for domestic and internationally-headquartered firms. This included incorporating risk-based indicators for determining categorization of firms. However, the Board's supervisory frameworks, such as the Large Institution Supervision Coordinating Committee (LISCC), do not reflect those final categorizations. You testified that the Board is in the process of "considering refinements" to the LISCC designation process.

a. As part of your review, is the Board considering aligning the LISCC framework with categorization under the new tailored regulatory requirements?

b. When do you expect the Board to complete its LISCC review process?

The Large Institution Supervision Coordinating Committee (LISCC) is a Federal Reserve Systemwide committee with the task of overseeing the supervision of the largest, most systemically important financial institutions in the United States and chaired by the director of the Board's Division of Supervision and Regulation. The LISCC was formed after the financial crisis to bring an interdisciplinary and cross-firm perspective to the supervision of the largest, most systemically important financial institutions.

Since the 2007 crisis, we have been giving significant thought to the composition of our supervisory portfolios, and, in particular to whether and how we should address the significant decrease in size and risk profile of the foreign firms in the LISCC portfolio over the past decade. I believe there is a compelling justification to make changes today to the composition of the foreign banks in the LISCC portfolio. I think it is important that all the Federal Reserve's supervisory portfolios have a clear and transparent definition. My goal is to develop, prospectively, a clear and transparent standard for identifying LISCC firms. My preferred approach for achieving this objective would be to align the LISCC portfolio with our recent tailoring categorizations.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

May 8, 2020

The Honorable French Hill
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted to me following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on December 20, 2019.

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

2. Chair McWilliams and Vice Chair Quarles, I have heard from banks in my district that the enforcement actions for BSA compliance have increased without updated guidance from the prudential regulators. What are the prudential regulators doing to ensure a joint approach to help provide more clarity to banks with regards to the BSA examination process?

In July 2019, the federal banking agencies and the Financial Crimes Enforcement Network (FinCEN) issued a Joint Statement on Risk-Focused Bank Secrecy Act/Anti-Money Laundering Supervision.[1] This statement emphasizes the risk-focused approach to examinations of banks' Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance programs. In addition, the federal banking agencies have been reviewing and revising sections of the Federal Financial Institutions Examination Council's (FFIEC) BSA/AML Examination Manual (Manual) and expect to release several sections in early 2020. On April 15, 2020, the FFIEC released several updates to the BSA/AML examination manual.[2] The revised Manual reflects that a bank's BSA/AML compliance program may have minor weaknesses or deficiencies and will still be assessed as adequate. All the federal banking regulators, including the Federal Reserve, use the Manual and apply its procedures in conducting their BSA examinations. Moreover, updates to the Manual are completed through an extensive interagency process involving collaboration with staff of the federal and state banking agencies and FinCEN, as well as in consultation with the industry.

Finally, subsequent to the release of the updated sections earlier this month, on April 29, the banking agencies held an FFIEC Examiner Exchange training webinar event for federal and state examiners that highlighted the relevant changes and provided information for their implementation. These changes also will be incorporated in other FFIEC training offered, such as the FFIEC Anti-Money Laundering Workshop and the FFIEC Advanced BSA/AML Specialists Conference, as well as Federal Reserve-specific training. Individually, the banking agencies, including the Federal Reserve, have various training initiatives aimed at promoting consistency in BSA/AML examinations.

3. Vice Chair Quarles, has the Federal Reserve analyzed or thought about ways to create a path for a new payments rail that is based on blockchain technology and could be accessed by banks and non-banks to offer wholesale and retail token payment solutions?

Since its founding more than a century ago, the Federal Reserve has provided payment and settlement services, alongside and in cooperation with the private sector, as part of its core function of promoting an accessible, safe, and efficient U.S. payment system. The Federal Reserve provides payment and settlement services to depository institutions, the U.S. federal government, and certain other entities as authorized by statute. Broadly, additional

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[1] See https://www.fincen.gov/sites/default/files/2019-10/Joint%20Statement%20on%20Risk-Focused%20Bank%20Secrecy%20Act-Anti-Money%20Laundering%20Supervision%20FINAL1.pdf.

[2] https://www.ffiec.gov/press/pr041520.htm.

services are considered from the perspective of enhancing safety, efficiency, and accessibility of payments on behalf of all participants in the U.S. economy.[3] The Federal Reserve recognizes that the rapid evolution of technology presents a pivotal opportunity for the Federal Reserve and the payment industry to modernize the nation's payment system and establish a safe and efficient foundation for the future, but we are not currently pursuing new services based on the blockchain technology.

[3] The Board's policy on evaluating new services is found within, "The Federal Reserve in the Payments System," (Issued 1984; revised 1990). Available at https://www.federalreserve.gov/paymentsystems/pfs_frpaysys.htm.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

March 6, 2020

The Honorable Blaine Luetkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

President Obama signed the Insurance Capital Standards Clarification Act into law in 2014. That overwhelmingly bipartisan legislation made clear that Congress intended the Federal Reserve Board of Governors to tailor capital standards for insurance savings and loan holding companies and avoid the imposition of bank-centric standards. While there is support in Congress for the proposed building block approach framework, I am concerned by the Board's decision to also use the section 171 calculation, which runs contrary to Congressional intent by imposing a bank-centric capital standard on supervised insurers.

Why has the Board chosen to move forward with this additional calculation when it is not required pursuant to section 171?

Will you commit to working with me to ensure the intent of the Insurance Capital Standards Clarification Act is upheld through the application of tailored capital requirements?

Section 171 of the Dodd-Frank Act requires the Federal Reserve Board (Board) to establish minimum risk-based capital requirements for depository institution holding companies on a consolidated basis. The Insurance Capital Standards Clarification Act of 2014 (Clarification Act) amended section 171 to permit, but not require, the Board to exclude state-regulated insurers from this consolidated minimum risk-based capital requirement. The Clarification Act does not provide a blanket exemption for an entire holding company structure. In particular, it explicitly does not exempt a depository institution holding company from calculating its capital requirements for non-insurance entities in the corporate chain.

In September 2019, the Board issued a proposal on risk-based capital requirements for certain depository institution holding companies significantly engaged in insurance activities (proposal). The proposal would establish an enterprise-wide risk-based capital framework, known as the Building Block Approach, which is intended to facilitate the assessment of overall risk-based capital adequacy for a depository institution holding company that is significantly engaged in insurance activities by measuring aggregate capital while taking into consideration state insurance capital requirements. The proposal also includes a minimum risk-based capital requirement for the non-insurance entities within the holding company structure required by section 171, as amended by the Clarification Act (section 171 calculation). The section 171 calculation would use the flexibility afforded by the Clarification Act and exclude state-regulated insurers from minimum risk-based capital requirements to the extent permitted by law.

The Board recently invited public comment on all aspects of the proposal, including the section 171 calculation. Some comments suggested that the Building Block Approach would comply with the statutory requirements without an additional calculation. Consistent with the Administrative Procedure Act, the Board will consider this and other comments before making a final rule.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

April 24, 2020

The Honorable Ben McAdams
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

Vice Chairman Quarles, it is reported that the Federal Reserve will not join the FDIC and OCC on a forthcoming proposal regarding the Community Reinvestment Act.

- **Can you elaborate on what aspects of the proposal specifically the Federal Reserve does not agree with the other agencies?**
- **Are you concerned that a lack of coordination amongst the agencies on a reform proposal will create confusion for market participants and community organizations?**

While the Federal Reserve Board (Board) did not join the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) in their recently issued Notice of Proposed Rulemaking (NPR) revising elements of Community Reinvestment Act (CRA) regulation, the Board has shared detailed analysis and proposals on CRA reform with our counterparts at the OCC and FDIC in the preparation of the NPR, and the NPR reflects much input from the Board. We will be reviewing the comments that are submitted to the FDIC and OCC on the NPR, and we expect to learn much—including much related to the aspects of the NPR that reflect our own input—from the review. As a result, it would be premature to identify any specific areas of disagreement—rather, we are all in the process of working to determine the best path forward. We continue to view a common approach as the best outcome, but we have not yet determined the best next steps to achieve that outcome.

In October, the Federal Reserve finalized "tailoring" rules for enhanced prudential standards and resolution planning requirements for domestic and internationally-headquartered firms. This included a categorization of firms based on certain risk-based indicators. It is my understanding that the Board's supervisory frameworks, such as the Large Institution Supervision Coordinating Committee (LISCC), do not match the final categorizations from the tailoring rules. You testified that the Board is in the process of "considering refinements" to the LISCC designation process.

- **As part of your review, is the Board considering aligning the LISCC framework with the categorizations under the new tailored regulatory requirements?**
- **What is the timeframe for the Board to complete its LISCC review process?**
- **In the hearing, you stated that revisions to the "LISCC designation process that will make it both more concrete, more rules based and more transparent." Can you expand upon what steps the Board will take to meet those objectives in the LISCC designation process?**

The Large Institution Supervision Coordinating Committee (LISCC) is a Federal Reserve Systemwide committee with the task of overseeing the supervision of the largest, most systemically important financial institutions in the United States and chaired by the director of the Board's Division of Supervision and Regulation. The LISCC was formed after the financial crisis to bring an interdisciplinary and cross-firm perspective to the supervision of the largest, most systemically important financial institutions.

Since the 2007 crisis, we have been giving significant thought to the composition of our supervisory portfolios, and, in particular to whether and how we should address the significant decrease in size and risk profile of the foreign firms in the LISCC portfolio over the past decade. I believe there is a compelling justification to make changes today to the composition of the foreign banks in the LISCC portfolio. I think it is important that all the Federal Reserve's supervisory portfolios have a clear and transparent definition. My goal is to develop, prospectively, a clear and transparent standard for identifying LISCC firms. My preferred approach for achieving this objective would be to align the LISCC portfolio with our recent tailoring categorizations.

In general, we want to promote and encourage the long-term growth of companies. Such growth can help companies innovate and create new jobs – but such growth is often dependent on a variety of sources of capital, including directly from banks. I support the policy behind the Volcker Rule to prevent banks from engaging in short-term proprietary trading directly. However, it is my understanding that some provisions of the rule, specifically aspects of the covered funds provisions, may prohibit long-term investments if such investment is made using a fund structure. Chairman Powell has previously testified that a bank's long-term investments in covered funds is not an activity that typically threatens safety and soundness.

In the 2019 final rule related to the Volcker Rule, the agencies stated that they "continue to consider comments received and intend to address additional aspects of the covered funds provisions in the future covered funds proposal."

In this forthcoming rulemaking, do you expect to provide additional certainty to banks through an exclusion for investments in long-term investment vehicles in order to allow additional sources of capital for growing companies?

On January 30, 2020, the Board, the FDIC, the OCC, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the Agencies) agencies jointly issued approved a notice of proposed rulemaking (NPR)[1] addressing that would amend the covered fund provisions of the Volcker Rule regulations. The NPR, which was developed jointly by the Agencies, includes provisions that would give banking entities increased flexibility to invest in and sponsor venture capital funds and funds that extend credit.

[1] See https://www.federalreserve.gov/aboutthefed/boardmeetings/files/volcker-rule-fr-notice-20200130.pdf.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

March 6, 2020

The Honorable Denver Riggleman
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

I commend the Fed, FDIC, FinCEN, OCC, and CSBS on the joint statement to "provide clarity regarding the legal status of commercial growth and production of hemp and relevant requirements for banks." The statement goes on to say that since hemp has been de-scheduled via the farm bill that SARs are no longer required because it is a transaction involving hemp and that banks should follow standard BSA / AML procedures on these accounts. Finally, the statement says that FinCEN will issue additional guidance after further review of the USDA's rule.

What has the FDIC and Fed done to limit redundant or unnecessary SARs, and what can your agencies do to work with FinCEN to ensure that whatever guidance is issued is done so expediently and in a manner that is clear and concise for both examiners and financial institutions, especially regarding hemp banking?

As noted, the Interagency Statement on Providing Financial Services to Customers Engaged in Hemp-Related Businesses was issued on December 3, 2019.[1] Specifically, the statement clarified that because hemp is no longer a Schedule I controlled substance under the Controlled Substances Act, banks are not required to file a Suspicious Activity Report (SAR) on customers solely because they are engaged in the growth or cultivation of hemp in accordance with applicable laws and regulations. The Federal Reserve Board (Board) will provide training to examiners on this topic through our regular Systemwide Bank Secrecy Act (BSA) trainings, as well as in conjunction with the other federal banking regulators through classes and seminars provided by the Federal Financial Institutions Examination Council.

The guidance also indicates that the Financial Crimes Enforcement Network (FinCEN) intends to issue additional comprehensive guidance regarding hemp, which, in conjunction with the Interagency Statement, should limit redundant or unnecessary hemp-related SARs. FinCEN's additional guidance regarding hemp will be developed in consultation with the Federal Reserve and other banking agencies.

Has your agency engaged with any of the public private partnerships that are driving a consensus driven AML reform, and if so, will your agency be releasing any of the results or findings to the public?

The Board participates in public-private partnerships focused on anti-money laundering (AML) issues led by the U.S. Treasury. For example, the Board participates in the Bank Secrecy Act Advisory Group (BSAAG), where issues of AML reform are discussed on a public-private basis. The BSAAG is the means by which the U.S. Treasury receives advice on the operation of the BSA. The Director of FinCEN, as chair of the BSAAG, is responsible for ensuring that relevant issues are placed before the BSAAG for review, analysis, and discussion. The BSAAG

[1] See Supervision and Regulation letter 19-14, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20191203a1.pdf.

consists of representatives from federal regulatory and law enforcement agencies, financial institutions, and trade groups with members subject to the requirements of the BSA.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

May 4, 2020

The Honorable David Scott
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on December 20, 2019.

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

Vice Chair Quarles, to date the Board has not published the criteria it considers when designating firms to the LISCC portfolio, nor can the frequency of review for inclusion be reasonably determined. In a hearing before the House Financial Services Committee you stated that the Board will be working in the near-term to make the LISCC designation process more "concrete, more rules-based, and more transparent."

a. **How can we, as lawmakers, help ensure this process provides due process for institutions, is transparent and risk-sensitive?**
b. **Can you provide a timeline for when the Board expects to complete its review of the LISCC supervisory framework?**

The Large Institution Supervision Coordinating Committee (LISCC) is a Federal Reserve Systemwide committee with the task of overseeing the supervision of the largest, most systemically important financial institutions in the United States and chaired by the director of the Federal Reserve Board's (Board) Division of Supervision and Regulation. The LISCC was formed after the financial crisis to bring an interdisciplinary and cross-firm perspective to the supervision of the largest, most systemically important financial institutions.

Since the 2007 crisis we have been giving significant thought to the composition of our supervisory portfolios, and, particular to whether and how we should address the significant decrease in size and risk profile of the foreign firms in the LISCC portfolio over the last decade. I believe there is a compelling justification to make changes today to the composition of the foreign banks in the LISCC portfolio. I think it is important that all the Federal Reserve's supervisory portfolios have a clear and transparent definition. My goal is to develop, prospectively, a clear and transparent definition. My preferred approach for achieving this objective would be to align the LISCC portfolio with our recent tailoring categorizations.

Given the necessary focus of key Federal Reserve supervisory staff on responding to prudential and macroprudential issues arising from the current economic downturn, the schedule for implementing this approach is necessarily delayed, and it is still too early to determine how long that delay might last. However, providing additional transparency, due process, and risk sensitivity in supervision generally, including the LISCC designation process, will remain a high priority during my term.

Vice Chairman Quarles, as you know the Federal Reserve has been contemplating implementing the Stress Capital Buffer (SCB) for several years now. In fact, former Governor Dan Tarullo stated in his last speech in April 2017 that the Stress Capital Buffer would "simplify our capital regime." As you know the SCB would integrate capital rules with stress testing and streamline the process. Stress testing is an important exercise to ensure our financial institutions have enough capital to undergo an economic downturn and still have the ability to lend. As the Federal Reserve prepares for its 2020 Comprehensive Capital Analysis and Review (CCAR) scenarios, it is critical it provide

certainty and clarity. In response to a question during the House Financial Services hearing on December 4, 2019, regarding the Federal Reserve's expected timing of the Stress Capital Buffer, you stated "We are still aiming to have [the SCB] done in time for this stress testing cycle ...We have not decided yet whether we would re-propose or proceed in a different administrative procedure fashion."

- **Could you please expand upon what the specific timing of a re-proposal would look like to allow for a sufficient comment period and robust consideration of those comments. If the Federal Reserve would proceed with a different "administrative procedure," what would that procedure be specifically, what parts of the rule would be addressed, and what would the timing of seeking an alternative procedure be?**

On March 4, 2020, the Board issued a final rule that simplified its capital framework for large banks, preserving the strong capital requirements in place, with the introduction of a stress capital buffer (SCB). The SCB integrates the Board's stress test results with its non-stress capital requirements by using the results of the supervisory stress test to determine large banks' ongoing regulatory capital requirements. The SCB will be effective for the Comprehensive Capital Analysis and Review in 2020.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

March 6, 2020

The Honorable Bryan Steil
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

Vice Chairman Quarles, I want to thank you for your strong leadership in negotiations related to the Insurance Capital Standard (ICS). Like many members of the Financial Services Committee, I support our state-based system of insurance regulation and I am concerned about the prospect of importing incompatible European regulations through the ICS or a similar agreement.

What are your plans to ensure that the U.S. approach to insurance regulation is respected?

The Federal Reserve advocates for the U.S. approach to insurance regulation at the International Association of Insurance Supervisors (IAIS). As part of this advocacy, the U.S. members of the IAIS are developing an aggregation alternative to the Insurance Capital Standard (ICS). During the recent IAIS negotiations in Abu Dhabi, we agreed to a plan that creates space for this aggregation alternative to be recognized as providing comparable outcomes to the reference ICS. Under this plan, the IAIS will consult on the approach for assessing comparability in 2020 and 2021,with the goal of finalizing the approach in 2022, and then conducting the comparability assessment of the aggregation alternative. The Federal Reserve will continue to advocate for the U.S. approach at each of these decision points.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

March 6, 2020

The Honorable William Timmons
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

1. You have previously testified that the International Capital Standard (ICS) as currently structured is not fit for the US economy and could cause harm to the U.S. and maybe other national economies as well. Knowing this, I was pleased to see that as part of the deal reached in Abu Dhabi, there is a provision calling for an economic impact assessment of the ICS as part of the 5-year monitoring period.

- **Can you assure us that the Fed, and the Financial Stability Board, will actively follow up with the International Association of Insurance Supervisors (IAIS) to expedite the economic impact assessment of whether the ICS, if adopted, would cause harm to the U.S. and the global economy, including its effect on the US insurance industry's ability to provide insurance products of vital importance to US consumers?**

Team USA, which includes the Federal Reserve Board (Board), Treasury, and the National Association of Insurance Commissioners (NAICS), was the leading advocate for conducting an economic impact assessment on the International Capital Standard (ICS) during the monitoring period. The Board will contribute to this work and raise issues regarding it in an appropriate forum. The International Association of Insurance Supervisors will provide updates to the Financial Stability Board, which I chair, on developments on the ICS during the monitoring period.

2. Given the vast number of financial contracts that will have to be rewritten and renegotiated before the end of 2021, including many consumer mortgages, do you think it makes sense to extend the deadline for ending the use of LIBOR as a benchmark rate in financial contracts? Especially given the impact to the average consumer?

LIBOR-panel banks have only committed to submit quotes through the end of 2021; the decision to extend this deadline rests with the submitting banks themselves. Thus far, no banks have publicly committed to doing so, and the U.K. Financial Conduct Authority, the regulator of LIBOR, has said that it will not compel banks to submit after 2021. Since the publication of LIBOR is not guaranteed past that date, financial markets and institutions should prepare for such an event.

The Alternative Reference Rates Committee (ARRC) is guiding the transition from USD LIBOR and is acting under the assumption that LIBOR will stop sometime after 2021. The ARRC has encouraged liquidity in markets using the Secured Overnight Financing Rate (SOFR), so that a robust alternative to LIBOR is available to market participants, and has offered recommendations for fallback language for those who continue to issue new LIBOR instruments.

Transitioning away from LIBOR will make our financial system and the global financial system stronger and more resilient. Along with the Financial Stability Oversight Council (FSOC) and other regulators, the Federal Reserve is working with consumer groups, borrowers, and lenders to develop a fair and transparent process to make sure a large number of contracts are not disrupted when LIBOR becomes unavailable. Consumer awareness about LIBOR cessation is still low and the ARRC is working to broaden retail market education.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

February 10, 2020

The Honorable Ann Wagner
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to all the questions that you submitted following the December 4, 2019,[1] hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 20, 2019.

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

1. Mr. Quarles, in your testimony you stated that you are "still aiming to have [the stress capital buffer] done in time for the stress testing cycle," referring to the 2020 Comprehensive Capital Analysis and Review (CCAR). You also stated that you "have not decided yet whether [the Fed] would repropose or proceed in a different administrative fashion."

To clarify, is it the Fed's intention to finalize the stress capital buffer before firms begin receiving CCAR instructions in Q1 of next year?

It is my aim to have the stress capital buffer finalized in time for the Comprehensive Capital Analysis and Review 2020, while considering additional modifications in the future. The Federal Reserve Board continues to review the comments made on the stress capital buffer proposal and will provide further information when it has reached a decision.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

May 7, 2020

The Honorable Sherrod Brown
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 2 and 3 that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. My response to your remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

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

2) In November 2019, the Federal Reserve issued a report on bank branch access in rural communities.[1] The report found that most rural counties experienced a significant decline in bank branches between 2012 and 2017, but small businesses and certain consumers prefer using local banks and cannot find comparable financial products and services elsewhere. How does the decline in bank branches or loss of all banks in a community affect the local economy? What policy steps will the Federal Reserve take to address the decline in bank branches? How did this analysis affect the Board's decision on the BB&T-SunTrust merger that will result in more branch closures?

[1] https://www.federalreserve.gov/publications/files/bank-branch-access-in-rural-communities.pdf

As noted in the report, the takeaways from the listening sessions indicated that the loss of a bank branch in a community appears to have a community-level effect that goes beyond the effects on particular individuals or businesses. Examples of such effects included declines in access to local financial advice, loss of important civic leadership, and the loss of a banker's personal touch. Research cited in the report also noted that when local bank branches close there is a negative effect on access to credit for local small businesses. To the extent that this decrease in credit access causes those businesses to reduce their overall level of economic activity, such a bank branch closure could have a corresponding negative effect on the local economy. Further research would be needed to assess the economic impacts of the loss of branches on local communities.

As with all merger applications, the Federal Reserve Board (Board) considered comments on the proposal from the public, including comments expressing concerns that the proposal could result in branch consolidations and closures. The Board's analysis with respect to these comments is detailed in the Board's order.[1]

3) Recently, the Federal Reserve approved the merger of BB&T and SunTrust – two institutions with a significant overlapping branch footprint. Many commenters on the application expressed concern that the proposal would result in branch consolidations and closures, which could negatively affect LMI and rural communities. The Federal Reserve's Order Approving the Merger states that BB&T has committed that Truist Bank would not have any merger-related branch closures for one year and would not have any merger-related branch closures in rural areas with populations under 2,500 for three years following consummation of the merger. BB&T also represented that Truist Bank would seek to open at least 15 new branches throughout its footprint in LMI and/or majority-minority census tracts through 2022.

[1] FRB Order No. 2019-16, pgs. 29-53 (November 19, 2019).

A. How does the Federal Reserve plan to enforce these commitments and representations? Will Truist be subject to any similar restrictions after 2022? Will the Federal Reserve reject any application to close a branch submitted by Truist Bank under these parameters? Will the Federal Reserve take action against Truist Bank if it does not open at least 15 new branches in LMI and majority-minority census tracts?

Truist Bank is a state non-member bank supervised by the Federal Deposit Insurance Corporation (FDIC), so the appropriate federal supervisory agency for purposes of the branch closure requirements and Community Reinvestment Act examination is the FDIC.

In addition, please provide a list of the rural areas with populations under 2,500 described in the Order.

As indicated, BB&T represented that it will not close branches within rural communities of 2,500 or fewer persons, as determined by the U.S. Census Bureau, for three years. The Federal Reserve has not compiled a list of all such communities in the Truist service area. Any branch that Truist proposes to close in the future can be evaluated at that time to determine whether it is in keeping with the commitment.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

February 27, 2020

The Honorable Catherine Cortez Masto
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all the questions that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

<u>Questions for The Honorable Randal K. Quarles, Vice Chair for Supervision, Board of Governors of the Federal Reserve System from Senator Cortez Masto:</u>

1) This spring, the Office of Management and Budget issued a memorandum that for the first time required independent regulatory agencies such as yours to submit final rules to the Administration before publishing them.

A. Has the Federal Reserve submitted its final rules and guidance to OMB? If so, which ones?

Pursuant to the Congressional Review Act (Act), the Federal Reserve Board (Board) requests a determination from the Office of Information and Regulatory Affairs (OIRA), which is within the Office of Management and Budget (OMB), as to whether a rule is a major rule for purposes of the Act (i.e., does the rule have an $100 million annual effect, or other substantial effect, on the economy). We submit these requests to OIRA for all final regulations that the Board issues, with the exception of regulations that fall within one of the exemptions under the Act.

The Board is currently reviewing OMB's 2019 memorandum on compliance with the Act with regard to the suggested procedures for submitting rules to OIRA in connection with its major rule determinations. We are considering how the 2019 memorandum applies to the Board's procedures for submitting rules under the Act. More broadly, in consultation with the other federal banking agencies, we continue to assess the scope of supervisory guidance documents to send to OIRA and Congress under the Act.

B. Did OMB ask you to make changes to any rulemaking?

With regard to requests submitted to OIRA pursuant to the Act, OIRA has not asked the Board to make any changes to any rulemakings.

2) Without the Community Reinvestment Act, the homeownership rate in our country, and especially for Latinos and African Americans, would be much lower. UnidosUS published a report, Latino Homeownership 2007-2017: A Decade of Decline for Latinos, which found that that the CRA helped facilitate between 15% to as much as 35% of home loans to Latinos. How would proposed changes to CRA close the racial and ethnic homeownership gap?

As you noted, the Community Reinvestment Act (CRA) is an important law that ensures banks help meet the credit needs in all of the communities they serve. Throughout the reform process, the Federal Reserve has emphasized a set of core principles to guide our work and I believe that carrying out CRA reform consistent with these principles could help address homeownership credit needs for underserved families, including for communities of color. For example, any revisions to the CRA regulations should reflect the credit needs of local communities and work consistently through the business cycle. They should be tailored to banks of different sizes and business strategies. They should provide greater clarity in advance about how activities will be evaluated. They should encourage banks to seek opportunities in distressed and underserved areas. And they should recognize that the CRA is one of several related laws to promote an inclusive financial sector.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

March 6, 2020

The Honorable Kevin Cramer
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1 and 3 that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. My response to your remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

Questions for The Honorable Randal K. Quarles, Vice Chair for Supervision, Board of Governors of the Federal Reserve System from Senator Cramer:

1. One issue impacting banks in rural areas of my state are the limitations Regulation O places on the financial institution being able to serve the banking needs of their senior leadership. The regulation put in place in the late 1970's and its $100,000 limitation on extensions of credit to executives is most problematic. In most cases, a boat loan and an agriculture loan leave an officer in violation of this rule. An employee's children could not have all their car loans – or credit cards – with the bank that employs them. These banks have executive officers who have had to take out loans at other financial institutions because they've crossed the threshold, which is unfortunate. It is like forcing a Nike employee to wear Under Armor to work.

Because this issue affects so few individuals, it likely doesn't get much attention. Where does the Fed stand on modernizing this 40-year-old regulation by simply raising the threshold from the current $100,000 to $500,000, or an increased limit based on percentage of capital held by the bank - when inflation alone from the 1970's would place the limit well above these suggestions?

Regulation O (which implements sections 22(h) and (g) of the Federal Reserve Act) is intended to address the potential for conflicts of interest and self-dealing by bank executive officers. As you know, extensions of credit to executive officers of banks are limited because these individuals are in a position to have significant influence over the bank's credit decisions which can be improperly used to benefit the executive officer to the detriment of the bank. There is currently some important flexibility to the rule: banks are able to lend to executive officers to finance a child's education or to purchase or improve a home without limit, and the $100,000 lending limit only applies to loans for other purposes when the loans are not secured by liquid assets. Nonetheless, the problems you identify definitely merit our attention.

The Federal Reserve Board (Board) periodically reviews regulations to ensure that regulatory thresholds are set at an appropriate amount to support the objective of the rule. The Board expects to review Regulation O and as part of that review, it will consider whether the applicable threshold for extensions of credit to executive officers warrants adjustment. Obviously, any proposed change in the threshold would involve consultations with the other banking agencies.

3. This Committee is considering legislation that would aim at providing some regulatory certainty to banks working with cannabis-related companies in the 47 states that have taken various steps towards legalization. Would legislation such as the SAFE Banking Act be a constructive step toward providing a framework for financial institutions to serve companies that comply with state cannabis laws?

In general, questions about legislative policy are the purview of Congress. It is our understanding that the Secure and Fair Enforcement Banking Act would provide that a bank that offers services to a marijuana-related business in a state that has legalized marijuana may not be held liable under federal law solely for providing those services. Such legislation could provide financial institutions with some legislative clarity on the conflict between federal and some state laws related to the legalization of marijuana. However, other aspects of federal law and state law would likely remain in conflict, such as, for example, laws concerning certain types of use and distribution of marijuana.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

February 27, 2020

The Honorable Doug Jones
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all the questions that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

Questions for The Honorable Randal K. Quarles, Vice Chair for Supervision, Board of Governors of the Federal Reserve System from Senator Jones:

1. The Federal Reserve conducts the Small Business Credit Access Survey every year. The Survey shows that many small business owners use personal credit cards to pay for business expenses. Small businesses have struggled to receive loans from traditional institutions and some have turned to online based loan servicers to fulfill their financing needs.

How have small businesses utilized financing from loan providers that are exclusively online? Are small businesses likely to return to traditional financial institutions after successfully receiving financing from internet based businesses?

As documented in the Federal Reserve Banks' Small Business Credit Survey, small business applications to online lenders have been increasing over the past few years.[1] The 2018 report[2] found that approximately 14 percent of all employer firms, or 32 percent of those employer firms that had applied for financing over the previous 12 months, applied to at least one online lender. These data in the 2018 report demonstrate an increase from the data in the 2017 report, which found that approximately 10 percent of all employer firms, or 24 percent of those employer firms that had applied for credit in the previous year, applied to an online lender. This increase may reflect a growing awareness among small business owners of the existence of online lenders as a potential source of funding.

A more detailed analysis of the 2018 Small Business Survey data with respect to use of online lenders is provided in a report published by the Federal Reserve Bank of Cleveland.[3]

Nearly two-thirds of small businesses that applied to an online lender during the previous year also applied for credit from a traditional lender during the same period. Small businesses that applied to online lenders differ from those that applied only to traditional lenders along several dimensions. Businesses that applied to online lenders tended to be younger (but at least three years old), smaller with regard to both revenue and number of employees, less profitable, and riskier (as measured by self-reported credit scores) than small businesses that applied only to traditional lenders. Businesses seeking funding from online lenders were much more likely than those applying only to traditional lenders to report that they sought funds to cover operating expenses.

Applicants with medium or high credit risk were more likely to have their applications approved by online lenders than by small banks or large banks. Survey respondents reported that the most important factors leading them to apply for loans from online lenders were the speed with which

[1] It is important to note that the Small Business Credit Survey is conducted using a convenience sample of small firms rather than a random sample.

[2] See *2018 Small Business Credit Survey: Report on Employer Firms* at https://www.newyorkfed.org/smallbusiness/small-business-credit-survey-2018.

[3] See *Click, Submit 2.0: An Update on Online Lender Applicants from the Small Business Credit Survey* at https://www.clevelandfed.org/en/community-development/reports-by-topic/small-business.aspx.

they would be provided a decision regarding their application or would receive funding, the probability of obtaining funding, and the absence of a collateral requirement.

We do not have data to respond to the question of whether small businesses that receive loans from online lenders are likely to subsequently apply for loans from traditional financial institutions.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

February 10, 2020

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all the questions that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

Questions for The Honorable Randal K. Quarles, Vice Chair for Supervision, Board of Governors of the Federal Reserve System from Senator Menendez:

Earlier this year, Comptroller Otting said that the Office of the Comptroller of the Currency (OCC) was taking the lead on writing a rule to rein in risky incentive-based compensation practices at large financial institutions that reward senior bank executives for irresponsible risk-taking. Additionally, at a House Financial Services Committee hearing in May, Otting said that the OCC shared its proposal with the Securities and Exchange Commission (SEC).

1) **Chair McWilliams and Vice Chair Quarles, has Comptroller Otting shared the OCC's proposal with either of your agencies?**

   A. **If yes, what does the proposal contain?**

   B. **If yes, are all six regulators on board with the proposal?**

   C. **If yes, when can we expect to see a notice of proposed rulemaking posted?**

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Securities and Exchange Commission, and National Credit Union Agency (the agencies) to jointly establish regulations or guidelines that require disclosure related to incentive compensation arrangements, and that prohibit incentive compensation arrangements that could provide excessive compensation or lead to material financial loss. Federal Reserve staff has been working with staff from these other agencies to draft a regulation that would meet this statutory mandate.

2) **Have all six regulators (FDIC, Fed, NCUA, SEC, OCC, and FHFA) sat down together to discuss this rulemaking?**

   A. **If yes, when did these discussions take place?**

   B. **If yes, have all six regulators decided to move forward with a proposed rule?**

Staff of all six regulators have been meeting regularly to determine a way to move forward. These discussions are continuing.

3) **If the OCC decides to move forward on executive compensation rule without all six regulators, are you concerned the OCC will create two different standards, encouraging banks to shop for the regulator with the weakest requirements?**

There is a longstanding practice of federal financial regulators working together on issues related to incentive-based compensation. For example, the federal banking agencies jointly issued Guidance on Sound Incentive Compensation Policies in June 2010. The agencies also jointly issued proposed rules on incentive-based compensation in 2011 and 2016, and are working together on recent discussions concerning these issues. We fully anticipate that the agencies will continue to work jointly on this topic.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

April 24, 2020

The Honorable Mike Rounds
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all the questions that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

Questions for The Honorable Randal K. Quarles, Vice Chair for Supervision, Board of Governors of the Federal Reserve System from Senator Rounds:

1. As members of the Financial Stability Oversight Council (FSOC), I would like to express my gratitude for FSOC's finalization of its revised interpretive guidance on nonbank financial company designations. As the lead sponsor of the Financial Stability Oversight Council Improvement Act of 2019, I am well aware of the need to reform the process for designating financial institutions as systemically important financial institutions (SIFIs). Although no revised guidance or regulation can take the place of reforming the ill-conceived designation process that came about as a result of Dodd-Frank, I am nonetheless grateful that FSOC has taken a step to this end.

A. The Financial Stability Oversight Council Improvement Act of 2019 shares many goals with the guidance. Can you expand on why you chose to prioritize an activities-based approach?

The activities-based approach is intended to prioritize efforts to identify, assess, and address potential risks to U.S. financial stability on a system-wide basis by focusing on activities. Through this approach, the FSOC intends to monitor markets to assess how certain characteristics could amplify potential risks from specific products, activities, or practices by market participants. According to the guidance, once the FSOC has identified a particular activity as being risky to financial stability, the FSOC would first engage with the relevant regulatory agency to address the risk. The guidance states that the FSOC will maintain the ability to pursue entity-specific designations when a potential risk or threat cannot be adequately addressed through an activities-based approach.

2. As one of the original sponsors of the Improving Laundering Laws and Increasing Comprehensive Information Tracking of Criminal Activity in Shell Holdings (ILLICIT CASH) Act, I am well aware of the pitfalls associated with our current anti-money laundering systems as well as the challenges that financial services institutions have in complying with current anti-money laundering rules and regulations.

Financial institutions trying to understand and comply with our existing anti-money laundering rules frequently rely on the Federal Financial Institutions Examination Council's (FFIEC) Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) Examination Manual. This manual was last updated in November 2014, before substantial changes like the finalization of the Customer Due Diligence Rule.

A. When will the manual be updated to reflect changes made after November 2014?

The Federal Financial Institutions Examination Council (FFIEC)[1] issued new examination procedures on the final Customer Due Diligence rule on May 11, 2018.[2] In addition, the FFIEC agencies have been reviewing and revising sections of the Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) Examination Manual (Manual). On April 15, 2020, the FFIEC released several updates to the BSA/AML examination manual. The revised Manual reflects that a bank's BSA/AML compliance program may have minor weaknesses or deficiencies and will still be assessed as adequate. All the federal banking regulators, including the Federal Reserve, use the Manual and apply its procedures in conducting their BSA examinations. Moreover, updates to the Manual are completed through an extensive interagency process involving collaboration with staff of the federal and state banking agencies and the Financial Crimes Enforcement Network (FinCEN), as well as in consultation with the industry.

B. In future updates, how will the manual promote consistency among each of the regulatory agencies that are members of the FFIEC?

As noted above, all the federal banking regulators, use the Manual and apply its procedures in conducting their examinations. Updates to the Manual are completed through an extensive interagency process between staff of the federal and state banking agencies and FinCEN, as well as in consultation with the industry. Subsequent to the release of the updated sections in early 2020, the banking agencies are planning an FFIEC Examiner Exchange training event for federal and state examiners that will highlight the relevant changes and provide information for their implementation. These changes will also be incorporated in other FFIEC training offered, such as the FFIEC Anti-Money Laundering Workshop and the FFIEC Advanced BSA/AML Specialists Conference. Individually, the banking agencies, including the Federal Reserve, have various training initiatives aimed at promoting consistency in BSA/AML examinations.

3. Vice Chair Quarles, when does the Federal Reserve intend to finalize or re-propose its rule on the Net Stable Funding Ratio (NSFR)? Given the plethora of regulatory changes since the NSFR was first proposed, is the NSFR going to be revised to consider measures like additional liquidity requirements and volatility in the market for repurchase agreements?

In 2019, the Board, along with the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC), adopted final rules to tailor capital and liquidity requirements for domestic and foreign banking organizations. As part of these tailoring rules, the agencies reproposed, but did not finalize, the scope of application of the proposed net stable funding ratio (NSFR) rule. The Board is continuing to work with the OCC and FDIC to evaluate the comments received on the original NSFR proposal and reproposal. In developing any final NSFR rule, the Board will consider changes in the overall regulatory framework and financial markets that have occurred since the original proposal in a manner consistent with the Administrative Procedure Act, which includes considering comments that discussed such changes.

[1] Members of the FFIEC include the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau and the State Liaison Committee.

[2] See Supervision and Regulation letter 18-3, May 11, 2018; https://spweb.frb.gov/sites/BSRWeb/SR/Policy/PolLtrDocs/sr1803.pdf.

4. I understand that the Federal Reserve is considering changes to the supervisory Large Institution Supervision Coordinating Committee (LISCC) framework. Similar to my concerns with the NSFR, it's important for changes to be made to the LISCC that reflect the plethora of other recent capital rules that are also weighing on institutions overseen by the LISCC. In particular, I'm keenly interested in understanding how the Fed intends to coordinate the LISCC framework with the recently announced regulatory tailoring rules for domestic and foreign banks.
You've made public comments indicating that the Fed is considering revisions to the LISCC designation process that will make it more "concrete, more rules-based, and more transparent."

A. What is your timeline for considering and enacting those revisions?

B. More specifically, how does the Fed intend to revise the LISCC framework with respect to foreign and domestic institutions?

The Large Institution Supervision Coordinating Committee (LISCC) is a Federal Reserve Systemwide committee tasked with overseeing the supervision of the largest, most systemically important financial institutions in the United States and chaired by the director of the Board's Division of Supervision and Regulation. The LISCC was formed after the financial crisis to bring an interdisciplinary and cross-firm perspective to the supervision of the largest, most systemically important financial institutions.

Since the 2007 crisis, we have been giving significant thought to the composition of our supervisory portfolios, and, in particular to whether and how we should address the significant decrease in size and risk profile of the foreign firms in the LISCC portfolio over the past decade. I believe there is a compelling justification to make changes today to the composition of the foreign banks in the LISCC portfolio. I think it is important that all the Federal Reserve's supervisory portfolios have a clear and transparent definition. My goal is to develop, prospectively, a clear and transparent standard for identifying LISCC firms. My preferred approach for achieving this objective would be to align the LISCC portfolio with our recent tailoring categorizations.

5. As I'm sure you're aware, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) are preparing to move forward with updates to the Community Reinvestment Act without the participation of the Federal Reserve.

A. Should the CRA be updated?

Yes, as I have stated previously, it is important to strengthen the Community Reinvestment Act (CRA) regulations to help better meet the credit needs of the local low- and moderate-income communities, provide more clarity and consistency in our evaluations of banks, and more closely align with changes in the ways financial products and services are delivered.

B. How is the Fed going to proceed?

While the (Board did not join the FDIC and the OCC in their recently issued Notice of Proposed Rulemaking (NPR) revising elements of CRA regulation, the Board has shared detailed analysis and proposals on CRA reform with our counterparts at the OCC and FDIC in the preparation of the NPR, and the NPR reflects much input from the Board. We will be reviewing the comments that are submitted to the FDIC and OCC on the NPR, and we expect to learn much—including much related to the aspects of the NPR that reflect our own input—from the review. As a result, it would be premature to identify any specific areas of disagreement—rather, we are all in the process of working to determine the best path forward. We continue to view a common approach as the best outcome, but we have not yet determined the best next steps to achieve that outcome.

C. What are the downsides to the OCC and FDIC moving forward without the Federal Reserve?

As noted above, we continue to believe that a common approach to CRA reform in a final rule would be the best outcome. We expect we will learn a great deal from the comments that are submitted in response to the NPR and we expect those comments will inform our next steps. Before adopting any reforms we want to make sure we are confident that the proposed changes will have the desired effects in terms of making the regulations more efficient and effective.

6. I understand that there are many potential causes to this fall's turbulence in the market for repurchase agreements, but I'd like to dive deeper into one potential cause that I've asked the Fed about in the past: the enhanced supplementary leverage ratio or eSLR. We're nearing the two year anniversary since the Fed first proposed recalibrating the eSLR.

While I was encouraged to see this proposal come out in April 2018, continued inaction on this front fails to uphold a promise that the Federal Reserve made in 2015 to "periodically review the [eSLR] coefficients and make adjustments as appropriate" to "ensure changes in economic growth do not unduly affect firms' systemic risk scores." By failing to finalize the recalibration of the eSLR, the Fed is doing the exact opposite of its 2015 commitment.

A. What happened to the eSLR proposal?

The Board, along with the OCC and FDIC, issued a final rule in November 2019 to implement section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). Consistent with section 402, the final rule recalibrates the supplementary leverage ratio for qualifying banking organizations by excluding certain central bank deposits from the denominator of the ratio calculation. The agencies stated in that final rule that further changes to the enhanced supplementary leverage ratio (eSLR) standards and SLR may be considered by the agencies in subsequent rulemakings. In its finalization of the eSLR standards, the Board would consider the effects of other announced revisions to the capital rule.

B. One of the causes of the spike in the market for repurchase agreements is quarter-ending supervisory and cash management targets that banks have to meet. Is there any reason for the eSLR proposal to not be finalized by the end of the calendar year to help prevent another spike?

The Board may take further action with respect to the eSLR standards that apply to U.S. global systemically important bank holding companies. Further action on the eSLR proposal would take into account the various changes to the Board's capital rule since the eSLR recalibration proposal was issued, most notably the final rule to implement section 402 of the EGRRCPA.

With respect to your concerns about the eSLR proposal in view of the recent repo market events, the SLR was adopted in 2013 and the eSLR was adopted in 2014. U.S. firms have also been subject to the traditional U.S. tier 1 leverage ratio for many years. Banking organizations have therefore managed their activities, including their repo market activities, in light of leverage capital requirements for some time. Further, both the eSLR and SLR are calculated based on an average of month-end numbers, while the tier 1 leverage ratio is calculated based on a daily average, both of which are designed to reduce variability over the quarter.

The Board will continue to monitor the implementation of the capital rule and other prudential standards for potential market impacts. Over recent months, the Federal Open Market Committee has taken steps to address pressures in money markets that could adversely affect policy implementation, and conditions in the secured funding market were orderly at the end of the fourth quarter of 2019.

7. You likely remember the fact that Dodd-Frank transferred examination authority over consumer financial protection matters to the Consumer Financial Protection Bureau. This applied to banks with over $10 billion in assets. Section 1061 of Dodd-Frank clearly states, "all consumer financial protection functions of the Board of Governors are transferred to the Bureau". I've heard reports from some institutions that the Fed still conducts examinations over consumer protection matters.

A. Why is this?

The Dodd-Frank Act transferred responsibility for examination and enforcement of certain federal enumerated consumer protection laws and regulations (enumerated laws) at insured depository institutions with more than $10 billion in assets and their affiliates to the Consumer Financial Protection Bureau (CFPB). In the case of state member banks (SMBs) over $10 billion, or smaller SMBs affiliated with banks over $10 billion, the Federal Reserve has retained supervisory authority for the non-enumerated laws and regulations (non-enumerated rules). For example, the Federal Reserve evaluates compliance by all SMBs (regardless of size) and their affiliates with the Fair Housing Act, the Servicemembers Civil Relief Act, the National Flood Insurance Act, and prohibitions on unfair or deceptive acts or practices (UDAP) under the Federal Trade Commission Act. For SMBs not supervised by the CFPB, the Federal Reserve continues to examine for compliance with both the enumerated and non-enumerated rules, irrespective of the consolidated assets of the holding company.

B. When will the Fed cease in this duplication of examination?

The Federal Reserve coordinates examination and enforcement activities closely with the CFPB to avoid unnecessary duplication of supervisory activities between the two agencies. To memorialize that coordination, in 2012, the agencies executed a public "Memorandum of Understanding on Supervisory Coordination." This memorandum encompasses coordination of examination schedules and sharing of supervisory documentation to minimize unnecessary supervisory burden on supervised institutions and avoid unnecessary duplication of effort.

8. As the Fed has stated, the purpose of the Building Blocks Approach (BBA) is to build on existing state-based insurance standards while establishing a group capital supervision framework that is specific to the business of insurance. I believe the BBA should satisfy the requirement in Section 171 of Dodd-Frank and follow-up legislation, The Insurance Capital Standards Clarification Act of 2014, which required the creation of minimum capital standards for insurance groups but gave regulators the flexibility to tailor such standards to the business model of insurers.

A. Why is the Fed still applying a Section 171 calculation on top of the BBA? This should have been eliminated in the implementation of The Insurance Capital Standards Clarification Act of 2014.

Section 171 of the Dodd-Frank Act requires the Board to establish minimum risk-based capital requirements for depository institution holding companies on a consolidated basis. The Insurance Capital Standards Clarification Act of 2014 (Clarification Act) amended section 171 to permit, but not require, the Board to exclude state-regulated insurers from this consolidated minimum risk-based capital requirement. The Clarification Act does not provide a blanket exemption for an entire holding company structure. In particular, it explicitly does not exempt a depository institution holding company from calculating its capital requirements for non-insurance entities in the corporate chain.

In September 2019, the Board issued a proposal on risk-based capital requirements for certain depository institution holding companies significantly engaged in insurance activities (proposal). The proposal would establish an enterprise-wide risk-based capital framework, known as the Building Block Approach, which is intended to facilitate the assessment of overall risk-based capital adequacy for a depository institution holding company that is significantly engaged in insurance activities by measuring aggregate capital while taking into consideration state insurance capital requirements. The proposal also includes a minimum risk-based capital requirement for the non-insurance entities within the holding company structure required by section 171, as amended by the Clarification Act (section 171 calculation). The section 171 calculation would use the flexibility afforded by the Clarification Act and exclude state-regulated insurers from minimum risk-based capital requirements to the extent permitted by law.

The Board recently invited public comment on all aspects of the proposal, including the section 171 calculation. Consistent with the Administrative Procedure Act, the Board will consider this and other comments before making a final rule.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

April 24, 2020

The Honorable Kyrsten Sinema
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all the questions that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

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

1. Earlier this year, regulators finalized a 2018 proposed rulemaking to update the Volcker Rule. The Fed has stated that covered fund provisions, including the definition of a covered fund, will be addressed in future proposals. Will a covered fund definition be addressed in the next appropriate proposal? If so, what is the timeline?

On January 30, 2020, the Federal Reserve Board (Board), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the Agencies) issued a notice of proposed rulemaking addressing the Volcker Rule covered fund provisions.[1] The notice of proposed rulemaking, which was developed jointly by the Agencies, includes provisions that would give banking entities increased flexibility to invest in and sponsor venture capital funds and funds that extend credit.

2. In April 2018, the Fed issued its proposed rulemaking to update stress buffer requirements and introduced the Stress Capital Buffer (SCB). In November 2018, you stated the Fed would adopt a final rule in the "near future." Now over a year out, we have not seen any further progress on the SCB. What is the status of SCB implementation? Does the Fed plan to adopt a final SCB rule by the 2020 Comprehensive Capital and Analysis Review?

On March 4, 2020, the Board issued a final rule that simplified its capital framework for large banks, preserving the strong capital requirements in place, with the introduction of a stress capital buffer (SCB). The SCB integrates the Board's stress test results with its non-stress capital requirements by using the results of the supervisory stress test to determine large banks' ongoing regulatory capital requirements. The SCB will be effective for the Comprehensive Capital Analysis and Review in 2020.

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[1] See https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200130b.htm.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

May 11, 2020

The Honorable Jon Tester
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all the questions that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

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

1) Montana, and many areas of the country, face challenges of housing availability, affordability, and aging housing stock. As you know, this is a significant issue for rural as well as urban areas and is one of the largest barriers to success nationally. In Montana, lack of workforce housing is one of the greatest inhibitors of economic development.

A. What can be done to increase workforce housing and encourage more affordable housing to be built?

A wide range of factors and policies outside of the purview of the Federal Reserve Board (Board) affect the availability and affordability of housing in the United States. The Board monitors developments in housing and labor markets to assist in our understanding of the broader economy.

Since 2008, the number of housing units constructed in the U.S. has remained well below historical averages resulting in a shortage of two million to three million units. Various industry reports cite shortages and rising costs in the factors of production. Regulation also reportedly restricts new construction in many parts of the country and we are aware that many state and local governments are now pursuing various interventions (such as subsidies, land grants, zoning changes, and other incentives) to encourage the production of new housing units.

In light of the evolving impacts of the current public health crisis, the Board is monitoring housing and related conditions through surveys and outreach to gain insight into new challenges that may be arising with regard to building workforce and affordable housing in rural communities.

B. What do you see as the largest barrier to affordable housing, particularly in rural areas?

The cost of housing does appear to weigh on the budgets of households living in rural areas. For example, almost half of households that rent in rural areas are "cost-burdened," meaning they spend more than 30 percent of their income on rent.[1] Among owner-occupied households in rural areas, the cost-burdened share is much lower, though homeownership may still feel unaffordable for households with low income, low wealth, or imperfect credit histories.
One potential barrier to affordable housing in rural areas is constraints on the production of new housing. For example, construction sector data and various industry reports suggest that construction labor for the country as a whole is in short supply. Regulation or constraints on other construction inputs may also restrict new construction in rural areas. These constraints may be pushing up the cost of housing. Indeed, median gross rent in rural areas increased 64 percent between 2000 and 2017, far more than inflation.[2]

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[1] See https://ipums.org. Calculation from the 2017 American Community Survey. Rural areas are areas that are not in an identifiable metropolitan area, as defined by the Office of Management and Budget.

[2] Id. Calculations from the 2000 Census and 2017 American Community Survey.

Another barrier to affordable housing is stagnant incomes for many households. Inflation-adjusted median household income among both rural and non-rural households changed little between 2000 and 2017. A variety of factors, many related to developments in the labor market, have weighed on income growth for the typical household. Even if rents in rural areas had not grown as robustly as they did over the past couple decades, many households likely would have still faced housing affordability pressures due to a lack of income growth.

Preliminary data suggests that employment losses due to the COVID-19-induced economic slowdown have disproportionately affected sectors primarily comprised of low-wage workers, including retail sales and hospitality. We know that workers in these sectors faced significant affordability challenges even prior to the current downturn. We are closely monitoring ongoing changes in employment and housing markets to assess the effects of these developments on overall housing affordability, including with an eye towards understanding new or increasing disparities that may exist for certain vulnerable groups.

C. How has the [fed/FDIC/NCUA] worked to support housing? Where is there room for additional efforts?

Over the last several years, the Board and Reserve Banks have conducted research to help shed light on obstacles in the marketplace, as well as highlight innovative approaches aimed at overcoming roadblocks. Examples of the Board's research into the increasing prevalence of housing affordability issues include staff papers entitled "Rural Affordable Rental Housing: Quantifying Need, Reviewing Recent Federal Support, and Assessing the Use of Low Income Housing Tax Credits in Rural Areas"[3] and "Rental Housing Affordability in the Southeast: Data from the Sixth District."[4] Board economists have also researched the effect of state and local regulatory impediments, as published in a piece entitled "Regulation and Housing Supply."[5]

Additionally, the Board has brought together local, state, and national stakeholders to discuss potential causes of, and solutions for addressing, the current high incidence of housing affordability challenges. Furthermore, in light of the impact on household finances related to COVID-19, staff are working to conduct research, field surveys, and engage with a broad cross-section of stakeholders to gain insight into the implications for housing markets.

2) I appreciated the responses to my questions during the hearing, and the focus on supporting our farmers and ranchers and their families through the current challenges facing the agriculture sector while continuing to prioritize the safety and soundness of our community financial institutions.

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[3] See Dumont, Andrew; Rural Affordable Rental Housing: Quantifying Need, Reviewing Recent Federal Support, and Assessing the Use of Low Income Housing Tax Credits in Rural Areas, at https://www.federalreserve.gov/econres/feds/files/2018077pap.pdf.

[4] See Carpenter, Ann; White, Douglas; Hirt, Mary; Assessing the Use of Low Income Housing Tax Credits in Rural Areas and Rental Housing Affordability in the Southeast: Data from the Sixth District, at https://www.frbatlanta.org/community-development/publications/discussion-papers/2018/02-rental-housing-affordability-in-the-southeast-2018-07-19.aspx.

[5] See Gyourko, Joseph E., and Raven Molloy (2015). "Regulation and Housing Supply," in Duranton, Gilles, J. Vernon Henderson, and William C. Strange eds., Handbook of Regional and Urban Economics. Volume 5B. Handbook of Regional and Urban Economics. Amsterdam; San Diego and Oxford: Elsevier, pp. 1289-1337.

A. Is there anything that you would like to add on this topic?

The Federal Reserve continuously monitors agricultural conditions, loan volumes, and agricultural credit risk indicators as well as how conditions affecting the agriculture sector may impact the banks and bank holding companies we supervise. As conditions evolve, the Board will continue to monitor developments in agriculture and the potential for implications in other segments of the national or regional economy. Prior to the emergence of global economic developments related to COVID-19, growth in farm lending continued to show signs of slowing. We recognize that the sector-related weakness we had seen has been compounded by COVID-19, and that agricultural borrowers may experience hardships in meeting all of their contractual obligations. Our long-standing practice has been to encourage financial institutions to work constructively and proactively with borrowers, including agricultural borrowers, and to consider prudent loan modifications consistent with safe and sound lending practices to strengthen the credit and mitigate credit risk.

As a complement to our ongoing monitoring of agricultural conditions and lending, and routine supervisory activities, the Federal Reserve also hosts biannual National Agricultural Credit (NAC) conferences. The NAC conferences serve as an exchange of information in Washington, D.C. and across all of the Federal Reserve Districts on developments in agricultural finance among institutions involved in various aspects of agricultural lending, regulation, and research. Among other conferences focused on the agriculture sector, the NAC meetings serve as an important source of information and have been of great value. The Washington meetings concentrate on policy-related matters that have an effect on agricultural finance conditions and lending. Discussions may focus on a wide range of policies, including farm, energy, trade, regulatory, monetary or other areas as conditions evolve. The Federal Reserve District meetings focus on agricultural and lending conditions within the region that a meeting takes place, and include academic researchers focusing on issues related to agricultural finance.

3) I recently wrote to Comptroller Otting, with colleagues on this committee, to express the importance of considering the many unique challenges in accessing financial services in rural America. It is imperative that the CRA work for communities throughout America, and that the process for potential reforms to this vital rule should reflect that. Any updates to the CRA should be done in coordination between your three agencies, and must be consistent with the original purpose of this Civil Rights-era law to bringing financial services and credit access to low- and moderate-income and underserved communities throughout our country.

A. As you consider changes to the Community Reinvestment Act, how are you considering and engaging rural America?

As we have explored Community Reinvestment Act (CRA) reform options, we have engaged with rural stakeholders in a number of ways. First, we partnered with the Federal Reserve Banks to hold 29 external roundtables in 2018 and early 2019 with attendees that included representatives of consumer and community organizations and banks. The Board published a summary of the key findings from these roundtables in June of 2019.[6] These roundtables also included organizations and financial institutions focused on rural concerns and reflected a number of recommendations related to rural communities.

We also continue to conduct research that helps inform our understanding of rural issues. For example, a Federal Reserve report issued in November 2019 focused on branch access in rural areas and helped inform our CRA regulatory approach on retail services.[7] This report found that just over 40 percent of rural counties lost bank branches between 2012 and 2017, with 39 rural communities being “deeply affected” by the loss of more than half of their bank branches.

The Federal Reserve also reviewed the more than 1,500 comments submitted in response to the Advance Notice of Proposed Rulemaking (ANPR) that the Office of the Comptroller of the Currency (OCC) published in 2018. A number of the comments submitted in response to the ANPR focused on ways to improve the CRA to better meet the needs of rural communities. In considering any CRA reforms, we will continue to focus on ensuring the needs of rural communities are well-served. We are reviewing the comments that have been submitted to the OCC and Federal Deposit Insurance Corporation on their Notice of Proposed Rulemaking (NPR), and we expect to learn much—including much related to the aspects of the NPR that reflect our own input—from the review.

4) I would like an update on an issue I’ve followed and written to the Federal Reserve and FDIC about, the ‘covered funds’ definition in the Volcker Rule. As drafted, banks are prevented from activities that they are regularly allowed to do directly on their balance sheets. Oftentimes clients, such as large pension funds, want their banks to provide long-term investments or loans in these fund structures to have some skin in the game. I continue to strongly support the Volcker Rule’s purpose of preventing speculative trading that is at odds with the public interest. As your agencies continue their process here, I encourage you to work towards an outcome that allows capital for growing and innovating companies and the ability to invest in long-term investment vehicles, while keeping a focus on preventing the activities that the rule is intended to stop.

As your agencies look at the impact of rules and any potential changes, will you consider activities that are considered safe and allowable elsewhere in banks? And especially the impact on the availability of funding for companies in the middle of America looking to grow?

On January 30, 2020, the Board, the Federal Deposit Insurance Corporation, the OCC, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the Agencies) jointly issued a notice of proposed rulemaking (NPR)[8] addressing the covered funds provisions of the Volcker Rule regulations. The NPR, which was developed jointly by the Agencies, includes provisions that would give banking entities increased flexibility to invest in and sponsor venture capital funds and funds that extend credit.

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[6] Board of Governors of the Federal Reserve System, "Perspectives from Main Street: Stakeholder Feedback on Modernizing the Community Reinvestment Act," (PDF) (Washington: Board of Governors, June 2019).

[7] Board of Governors of the Federal Reserve System, "Perspectives from Main Street: Bank Branch Access in Rural Communities," (PDF) (Washington: Board of Governors, November 2019).

[8] See https://www federalreserve.gov/aboutthefed/boardmeetings/files/volcker-rule-fr-notice-20200130.pdf.

5) Thank you all for your updated guidance on providing financial services to the hemp industry. As you know, this is an issue that has been very important to me. Montana leads the country in hemp production, and this guidance will help our producers and the financial institutions that are now able to serve them.

A. What will your agencies be doing to educate your examiners and the institutions that you oversee to adapt to working with hemp related businesses?

The Federal Reserve will provide training to examiners on this topic through our regular Systemwide Bank Secrecy Act (BSA) trainings, as well as in conjunction with the other federal banking regulators through classes and seminars provided by the Federal Financial Institutions Examination Council.

B. Are there areas that you anticipate will require additional guidance?

As stated in the December 3, 2019, statement,[9] the Financial Crimes Enforcement Network (FinCEN) will issue additional guidance on BSA requirements for hemp businesses after further reviewing and evaluating the U.S. Department of Agriculture interim final rule. Some banks, for example, have asked questions that involve interpretations of FinCEN's customer due diligence rule with respect to hemp (e.g., a bank's obligation to determine whether a hemp producer in a customer's supply chain is operating lawfully).

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[9] See https://www.fincen.gov/sites/default/files/2019-12/Hemp%20Guidance%20%28Final%2012-3-19%29%20FINAL.pdf.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

RANDAL K. QUARLES
VICE CHAIR FOR SUPERVISION

April 29, 2020

The Honorable Thom Tillis
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to all the questions that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

[1] Questions for the record related to this hearing were received on December 13, 2019.

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

1. The US regulatory agencies with jurisdiction over the Volcker Rule (the "Volcker Agencies") have long recognized the problems under the covered funds provisions for so-called "foreign excluded funds." Specifically, these funds that are not "covered funds" under the Volcker Rule because they are organized and operated outside the United States by a Foreign Banking Organization. However, foreign exempt funds are treated as banking entities to the extent they are controlled by a bank subject to the Volcker Rule. The Volcker Agencies have taken several steps, through FAQs and time-limited relief, to address this issue. In the July 2019 final rulemaking, the Volcker Agencies state that they are considering how to more permanently address the treatment of foreign excluded funds as part of the ongoing covered fund proposal and rulemaking.

A. Therefore, as part of any forthcoming proposal on Volcker Covered Funds, will you provide relief for "foreign excluded funds" on a permanent basis?

On January 30, 2020, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Agency, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the Agencies) jointly issued a notice of proposed rulemaking (NPR)[1] addressing the covered funds provisions of the Volcker Rule regulations. The NPR, which was developed jointly by the Agencies, includes provisions that would give banking entities increased flexibility to invest in and sponsor venture capital funds and funds that extend credit.

B. Additionally, is known that the prohibition of bank investment into venture capital funds has reduced the amount of capital available to American entrepreneurs and resulted in a disproportionate impact on communities located outside of Silicon Valley and other traditional tech hubs. It has also considerably hurt GDP and investment.

C. Should venture capital be included in the definition of a 'covered fund'?

The January 30, 2020, NPR includes provisions that would give banking entities increased flexibility to invest in and sponsor venture capital funds. The Agencies welcome public comment on the NPR, including potential effects on startup investment and economic impact.

D. Is the Fed considering startup investment and economic impact during this reform process?

Please see the response to question 1 C.

2. In 2014, Congress passed and the President signed the Insurance Capital Standards Clarification Act of 2014 (S. 2270) that amended section 171 of the Dodd Frank Act to

[1] See https://www.federalreserve.gov/aboutthefed/boardmeetings/files/volcker-rule-fr-notice-20200130.pdf.

permit the Fed to create a tailored non bank centric capital regime for Fed supervised insurance groups. Under S. 2270, banking activities of insurers are subject to bank capital rules, but the law states that insurance standards should apply to insurance activities. However, the Fed continues to ignore the direction of Congress and the letter of the law and wants to apply a consolidated, bank centric capital requirement on Fed supervised insurance groups (section 171 calculation). The Fed's other group capital standard for Fed supervised insurers, the Building Blocks Approach (BBA), is tailored to the business of insurance.

A. **Why is the Fed pursuing an additional "section 171 calculation" that will apply in addition to the BBA calculation, when section 171 itself does not require this additional calculation?**

B. **This layering approach increases complexity for no reason or gain and is a drag on economic growth. Please explain how the Fed will act in compliance with the Insurance Capital Standards Clarification Act of 2014.**

Section 171 of the Dodd-Frank Act requires the Board to establish minimum risk-based capital requirements for depository institution holding companies on a consolidated basis. The Insurance Capital Standards Clarification Act of 2014 (the Clarification Act) amended section 171 to permit the Board to exclude state-regulated insurers from this consolidated minimum risk-based capital requirement. The Clarification Act, however, does not allow a blanket exemption for an entire holding company structure. In particular, it explicitly does not allow the Federal Reserve to exempt a depository institution holding company from calculating its capital requirements for non-insurance entities in the corporate chain.

In September 2019, the Board issued a proposal on risk-based capital requirements for certain depository institution holding companies significantly engaged in insurance activities (the proposal). The proposal would establish an enterprise-wide risk-based capital framework, known as the Building Block Approach, which is intended to facilitate the assessment of overall risk-based capital adequacy for a depository institution holding company that is significantly engaged in insurance activities by measuring aggregate capital while taking into consideration state insurance capital requirements. The proposal also includes a minimum risk-based capital requirement for the non-insurance entities within the holding company structure required by section 171, as amended by the Clarification Act (section 171 calculation). The section 171 calculation would use the flexibility afforded by the Clarification Act and exclude state-regulated insurers from minimum risk-based capital requirements to the extent permitted by law.

The Board recently invited public comment on all aspects of the proposal, including the section 171 calculation. Consistent with the Administrative Procedure Act, the Board will consider this and other comments before making a final rule.

3. In your testimony before the House Financial Services Committee you stated that the Fed is currently considering how best to implement the remainder of the international Basel III agreement and that the Fed is aware that the impact of implementing Basel III revisions into the US framework may result in "significantly raising the aggregate level of capital in the industry." You also stated that the Fed "regularly looks at the calibration of the GSIB surcharge and we are considering it in the context of the overall body of

regulation." Additionally, Chair McWilliams noted that the Basel Committee conducted a quantitative impact study in 2009 at one of the worst times for banks' balance sheets that included only 14 US banks. Chair McWilliams suggested that she would support an analysis focused on a more specific impact in the US. I strongly agree that a holistic and comprehensive review of the capital framework in the US is necessary to ensure that capital levels are calibrated appropriately to maintain a level playing field with our international counterparts, especially given the many post-crisis reforms that we have discussed.

A. When does the Fed plan to complete the comprehensive review and publish the results so that they may be made available to lawmakers and to the public?

As noted, I think it is important for the Board to consider the remaining elements of the Basel III framework (especially the operational risk element and the fundamental review of the trading book) as a whole, and then examine that whole in the context of the existing framework. As a number of my colleagues and I have noted, the existing regulatory regime has established a robust level of loss-absorbing capacity for the industry. Thus, if a sensible calibration of these final elements of Basel III would result in a material increase in the industry's aggregate capital level, that could suggest that some of the existing elements may be appropriately re-calibrated to the international norms. We will not be able to make a judgment about whether these final elements of Basel III would materially increase capital levels or, if they do, about which elements of the existing framework (if any) might merit reconsideration until we have done the very detailed work of preparing the regulatory text for all the remaining elements of Basel III, which is a large task.

At the beginning of the year, I had hoped that we might be in a position to propose NPRs for comment on this package of issues by the end of the year—although such a schedule would have been quite aggressive and well in advance of the internationally agreed timetable for implementation of the remaining Basel III measures. That aspirational schedule has now necessarily been delayed by the need to focus staff resources on responding to the economic distress created by government isolation measures intended to address current public health concerns. As the depth and duration of the government constraint of the economy remains highly uncertain, I cannot now estimate when I will be able to ask Federal Reserve staff to re-engage on the preparation of NPRs for the implementation of Basel III. The Basel Committee itself has extended the internationally agreed implementation timeline by a full two years. I do not believe that the U.S. process will need to be delayed this long, and it remains a high priority of mine to resume this process, and complete it as a package for the U.S. well in advance of the international deadline.

If the nature of the review is ongoing and long-term, when can we expect an initial set of findings to be released based on provisions that are currently being implemented?

Please see the response to question 3 A.

May 11, 2020

The Honorable Elizabeth Warren
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions that you submitted following the December 5, 2019,[1] hearing before the Committee on Banking, Housing, and Urban Affairs. Responses to questions 1 through 14 also are included in my response to your letter of December 13, 2019. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I may be of further assistance.

Sincerely,

Enclosure

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[1] Questions for the record related to this hearing were received on December 13, 2019.

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

BB&T-SunTrust Merger

Competitive Effects

1) The Fed evaluated how the transaction would affect competition in 81 geographic markets.2 These geographic markets are the areas used to measure the concentration of the relevant banking products. Were the definitions of any predefined markets altered from the time the merger application was filed to the time of the merger approval?

[2] Federal Reserve System, "Order Approving the Merger of Bank Holding Companies," https://www.federalreserve.gov/newsevents/pressreleases/files/orders20191119a1.pdf

In evaluating merger proposals, Federal Reserve staff considers whether pre-existing geographic market definitions are appropriate. It is common for Federal Reserve staff to consider redefining markets as part of its review of merger proposals. The Federal Reserve evaluates its existing geographic market definitions under the relevant legal standard set out in Supreme Court precedents, which require that the relevant geographic market reflect the area where "the effect on competition will be direct and immediate."[1] In reassessing its geographic markets, the Federal Reserve looks to demand and substitution—that is, possible consumer responses to changes in rates, fees, or other characteristics of banking services.[2] Local conditions, including commuting patterns and economic activity, are closely evaluated as part of this analysis. For this merger proposal, the Board examined available data for the relevant geographic markets and, as a result, redefined 16 markets to more accurately reflect current local competitive conditions, including with respect to commuting patterns and consumer economic activity. Some markets increased in concentration, while others decreased, as a result of the market re-definitions. Three markets were absorbed by other markets due to updated commuting data.

2) Approval Order mentions that the "Board has considered the relative shares of total deposits in insured depository institutions that BB&T would control."3 Did the Fed conduct a competitive analysis of any other product markets, such as small business lending or home mortgage lending? If not, why not?

[3] Id.

As required by Supreme Court precedent, the Board considered the cluster of products and services provided by commercial banks—that is, commercial banking—in evaluating the proposal by BB&T.[3] According to the Supreme Court in Philadelphia National Bank, "the cluster of

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[1] <u>See</u> <u>Philadelphia National Bank</u> and <u>Phillipsburg National Bank & Trust Co.</u>, <u>supra</u> n.
[2] <u>See</u> Federal Reserve and Department of Justice Frequently Asked Questions, question 10, available at https://www federalreserve.gov/bankinforeg/competitive-effects-mergers-acquisitions-faqs.htm#faq10.
[3] <u>See</u> <u>Philadelphia National Bank</u>, <u>supra</u> n.; <u>see also</u> <u>United States v. Connecticut National Bank</u>, 418 U.S. 656 (1974); <u>Phillipsburg National Bank & Trust Co.</u>, <u>supra</u> n.

products (various kinds of credit) and services (such as checking accounts and trust administration) denoted by the term 'commercial bank' . . . composes a distinct line of commerce."[4] Indeed, the Supreme Court in Phillipsburg National Bank & Trust Company explicitly rejected "submarkets" in the product market for evaluating the effect of competition of a merger between commercial banks because they were "not a basis for the disregard of a broader line of commerce that has economic significance."[5] In light of this precedent, the Board focused its competition review of the BB&T-SunTrust merger proposal on the commercial banking line of commerce.

While the Board is required to focus its competitive inquiry in bank merger applications on the cluster of products and services that constitute commercial banking, it may investigate the competitive effects in submarkets if the parties or outside commenters raise a specific submarket as a potential issue. In the BB&T-SunTrust merger proposal, the Board reviewed competitive effects in mortgage lending in response to concerns raised by a commenter.

3) According to the Approval Order, in 13 of the geographic markets, the Herfindahl Hirschman Index (HHI) levels for deposits would exceed one or both of the 1800/200 thresholds, meaning that the expected change in market concentration is significant.4

[4] Id.

A. For the six markets where credit unions or thrifts mitigated the competitive concerns, please identify which credit unions and thrifts were included in the analysis, the dollar amount of their deposits, and any weights used for these institutions.

- North Lake-Sumter, Florida: Four credit unions were included at 50 percent weight:
    - Suncoast Credit Union: $120 million
    - Insight Credit Union: $103 million
    - Campus USA Credit Union: $79 million
    - Central Florida Educators Federal Credit Union: $75 million
- Atlanta, Georgia: Two thrifts were included at 100 percent weight and six credit unions were included at 50 percent weight:
    - Newton Federal Bank (thrift): $219 million
    - Cornerstone Bank (thrift): $209 million
    - Delta Community Credit Union: $4.5 billon
    - Georgia's Own Credit Union: $1.8 billion
    - Associated Credit Union: $1.2 billion
    - IBMSECU: $431 million
    - First Tech Federal Credit Union: $196 million
    - Wings Financial Credit Union: $156 million
- Milledgeville Area, Georgia: Two credit unions were included at 50 percent weight:
    - Robins Financial Credit Union: $97 million

[4] Philadelphia National Bank, supra n, at 356.
[5] Id. at 360. In Phillipsburg, the Supreme Court overturned a lower court decision, which focused its attention on "different groupings within" the commercial banking line of commerce.

  - o Midsouth Community Credit Union: $50 million
- Lexington, Virginia: Two credit unions were included at 50 percent weight:
  - o DuPont Community Credit Union: $24 million
  - o Beacon Credit Union, Inc.: $18 million
- Norfolk-Portsmouth, Virginia–North Carolina: One thrift was included at 100 percent and eight credit unions were included at 50 percent:
  - o Dollar Bank (thrift): $131 million
  - o Chartway Federal Credit Union: $1.1 billion
  - o Langley Federal Credit Union: $567 million
  - o ABNB Federal Credit Union: $482 million
  - o BayPort Credit Union: $437 million
  - o NAE Federal Credit Union: $110 million
  - o Northern Star Credit Union: $72 million
  - o Bronco Federal Credit Union: $55 million
  - o 1st Advantage Federal Credit Union: $43 million
- Richmond, Virginia: One credit union was included at 50 percent weight:
  - o Virginia Credit Union, Inc.: $2.3 billion

a. Unlike banks and thrifts, credit unions are not required to report deposits on a branch-level. Please indicate how the Fed obtained the deposit levels for credit union branches. If estimates were used, please describe the methodology.

As a general matter, when the Federal Reserve includes credit unions as a mitigating factor in its competitive analysis, it takes the total deposits of the credit union and divides the deposits by the total number of branches of the credit union to estimate the deposits held at each branch. However, in some cases, the Department of Justice (DOJ) obtains specific information about deposits held at branches by particular credit unions. When exact deposit information is available, the Board relies on that more specific information in its competitive analysis.

B. For the seven markets with divestitures, do any of these markets still approach either of the HHI thresholds even after considering the divestitures? If so, please indicate the geographic market and the HHI-levels before and after the merger.

The competitive effects of the proposal in these seven markets are described in extensive detail in the Board's public order. Each of these markets satisfied the DOJ Bank Merger Guidelines taking into consideration the divestitures—in each market the HHI increase would be less than 200 points or the pro forma HHI would be less than 1800 points. Specifically, pages 17 through 24 of the Board's order provide the pro forma HHI calculations and increase in HHI in each of the seven markets with divestitures. The pro forma HHI calculations are reproduced below for each of these markets:

- Eastern Shore, Virginia (page 19 of the Board's order): HHI increase of 3 points to 2043.
- Martinsville, Virginia (page 19 of the Board's order): HHI would decrease by 2 points to 2125.

- South Boston, Virginia (page 20 of the Board's order): HHI would increase 1 point to 1638. The Board required a divestiture in this market while the DOJ did not require a divestiture.
- Lumpkin County, Georgia (page 21 of the Board's order): HHI would decrease by 36 points to 2248.
- Wayne County, Georgia (page 22 of the Board's order): HHI would increase 4 points to 2057. The Board required a divestiture in this market while the DOJ did not require a divestiture.
- Winston-Salem, North Carolina (page 23 of the Board's order): HHI would increase by 30 points to 6429.
- Durham-Chapel Hill, North Carolina (page 24 of the Board's order): HHI would increase 29 points to 2162.

Financial, Managerial, and Other Supervisory Conditions

4) Please describe the process by which the Fed evaluated the financial soundness of the resulting institution.

Staff thoroughly reviewed the information provided in the application, as well as supplemental information provided by the organizations. Staff also considered the Federal Reserve's supervisory reviews, follow-up work, and on-going monitoring activities. In addition, staff consulted with relevant financial supervisory agencies and reviewed confidential supervisory information, including examination reports on the bank holding companies and the depository institutions involved. Staff also reviewed the financial condition of the organizations on both parent-only and consolidated bases, as well as information regarding the financial condition of the subsidiary depository institutions and the organizations' significant nonbanking operations. The review included, but was not limited to, the capital adequacy, asset quality, liquidity, and earnings performance of both BB&T and SunTrust. Additionally, staff considered the future prospects of the combined organization, its pro forma financial condition, the proposed business plan, and its ability to absorb the costs of the proposal and effectively integrate the institutions' operations. Staff also considered an updated capital plan provided by BB&T and the ability of the combined company to maintain adequate capital levels in baseline and stressed conditions.

5) Please describe the process by which the Fed evaluated the management of the resulting institution.

Staff considered information provided by BB&T relative to its proposed personnel appointments, managerial structure, and oversight plans, to assess managerial resources and plans for operating the combined organization. Similar to our financial analysis, staff reviewed the confidential supervisory records of BB&T, SunTrust, and their subsidiary depository institutions, including assessments of their management, risk-management systems, operations, and compliance with banking laws and regulations. Staff also considered the policies, procedures, and controls in place at the organizations, as well as the risk-management program under development for the combined organization, the proposed integration plans, and the combined organization's ability to meet the enhanced regulatory requirements applicable to bank holding companies with $250 billion or more in total consolidated assets.

6) On the same day the merger was approved, the Federal Reserve issued a consent order against SunTrust as a result of misleading or inaccurate statements to business customers about the operation and billing of certain add-on products.

A. Are any executives who were in the chain of command responsible for these violations in a leadership position of the new Truist Bank?

As noted on pages 52-53 of the Board's order, a newly hired Chief Compliance Officer (CCO) at Truist Bank reports directly to Truist's Chief Risk Officer (CRO), formerly the BB&T CRO, who leads the Truist Bank risk management function. The CRO and CCO's direct report, the leader of the Fair Lending and Responsible Banking team, also a legacy BB&T employee, is primarily responsible for unfair and deceptive practices (UDAP) compliance, as well as implementation of an enhanced, firm-wide compliance risk management program. For these reasons, and other reasons explained in the Board's approval order, the Board found that the UDAP compliance program of the combined company would be consistent with approval of the proposal.

B. In the last five years, SunTrust was the subject of multiple enforcement actions, including by the Fed, the Securities and Exchange Commission, the CFPB, the DOJ and multiple state attorneys general.5 Are any executives who were in the chain of command responsible for these violations in leadership positions of the new Truist Bank?

[5] Good Jobs First, https://violationtracker.goodjobsfirst.org/prog.php?parent=&major industry sum=&primary offense sum=&agency sum=&agency sum st=&hq id sum=&company op=starts&company=Suntrust&major industry%5B%5D=&case category=&all offense%5B%5D=&pena1ty op,;,0/o3E&penalty=&govt level=&agency code%5B%5D=&agency code st%58%5D=&pen year%5B%5D=&pres term=&free text=&case type=&ownership%58%5D=&hq id=&naics%58%5D=&state=&city=&order=pen year&sort=desc

The enforcement actions brought by the Board and other financial regulators were taken against SunTrust or its subsidiaries, rather than any individuals. Individuals may be subject to enforcement actions by the Board, if the relevant legal standards are met. Please see response to question 3(a) above regarding leadership at Truist Bank.

C. In the last five years, BB&T has been the subject of five enforcement actions by the Securities and Exchange Commission.6 Are any executives who were in the chain of command responsible for these violations in leadership positions of the new Truist Bank?

[6] Good Jobs First, https://violationtracker .goodjobsfirst.org/prog. php ?parent=&major industry sum=&primary offense sum=&agency sum=&agency sum st=&hqid sum=&company op-starts&company=BB%26T&major industry%5B%SD-&case category=&all offense%5B%5D=&penalty op=%3E&penalty=&govt level=&agency code%5B%5D=&agency code st%SB%5D=&pen year%5B%5D=&pres term=&free

text=&case type=&ownership%5B%5D=&hq id=&naics%5B%SD-&state=&city- &order-pen year&sort-desc

The enforcement actions brought by the Securities and Exchange Commission were taken against BB&T subsidiaries, rather than any individuals. Individuals may be subject to enforcement actions by the Board if the relevant legal standards are met.

Convenience and Needs Considerations

7) The Fed is required by the Bank Holding Company Act to note and consider each institution's performance under the Community Reinvestment Act (CRA). As stated in the Approval Order, while BB&T has an outstanding record of meeting community credit needs, SunTrust only has a satisfactory record. "With respect to SunTrust Bank, [CRA] examiners noted that some branch closures and consolidations by SunTrust Bank may have adversely affected the accessibility of banking services in some of the bank's [Assessment Areas]."7 This effect on accessibility included eight branch closures in low income tracts and 21 closures in moderate-income tracts.

[7] Id.

A. Does the Fed find it appropriate to reward an institution for failing to meet the credit needs of the communities it serves?

As indicated in the Board's order, SunTrust had a satisfactory CRA record, including high satisfactory ratings for the Lending and Investment tests. More importantly, BB&T, the successor institution, has an overall outstanding CRA rating.

B. How will the Fed ensure that Truist does not engage in similar practices in the future?

As indicated in the Board's order, the federal banking supervisory agencies evaluate a bank's record of opening and closing branches, particularly branches located in LMI geographies or primarily serving LMI individuals, as part of the CRA examination process.[6]

C. During the merger review process, BB&T and Suntrust agreed to a "three-year, $60 billion community benefits plan," that will "increase financial resources for low- and moderate-income (LMI) communities across the eastern United States." How will the Fed ensure that Truist complies with this agreement?

Neither the CRA nor the federal banking agencies' CRA regulations require depository institutions to make pledges or enter into commitments or agreements with any organization.[7] Lending, investments, or services that Truist Bank provides, including those in furtherance of its

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[6] See, e.g., 12 CFR 228.24(d)(2). In addition, the Board noted that the FDIC, as the primary federal supervisor of Truist Bank, would continue to evaluate the bank's branch closures in the course of conducting CRA performance evaluations.

[7] See, e.g., CIT Group, Inc., FRB Order No. 2015-20 at 24 n.54 (July 19, 2015); Citigroup Inc., 88 Federal Reserve Bulletin 485 (2002); Fifth Third Bancorp, 80 Federal Reserve Bulletin 838, 841 (1994).

community benefits plan, will be taken into account as part of the FDIC's CRA evaluation of Truist Bank.

D. Of all the merger applications that have been withdrawn, how many were withdrawn because of a bank's CRA performance record?

The Federal Reserve System has released publicly its approach to applications that may not satisfy requirements for approval or that otherwise raise supervisory or regulatory concerns.[8] Potential applicants with supervisory issues, including with respect to CRA or consumer compliance, may therefore choose not to file applications until the issues are resolved.[9] Applications can be withdrawn at the request of the applicant for any number of reasons. For example, an applicant may withdraw for technical or procedural reasons, for reasons regarding the statutory factors that must be considered by the Federal Reserve that could include supervisory issues, or because an applicant has decided not to pursue the application for business or strategic reasons. In many cases, applicants do not provide specific reasons for withdrawing filings and are not required to do so. As a result, the Board does not have sufficient information to provide the number of cases withdrawn due to CRA considerations.

8) The Approval Order States that "several commenters alleged that BB&T and SunTrust were not meeting the credit needs of minority and LMI communities and borrowers, particularly in Florida and Durham, North Carolina, or unbanked and underbanked populations. One commenter alleged that BB&T made a disproportionately low number of home purchase loans to African American and Latino borrowers in the Houston, Texas, New York, New York, and Charleston, West Virginia, areas based on data reported for 2017 under HMDA."8

Following this statement, the Approval Order explains how BB&T denies the commenters' allegations. It later states that "The Board is concerned when HMDA data reflect disparities in the rates of loan applications, originations, and denials among members of different racial or ethnic groups in local areas. These types of disparities may indicate weaknesses in the adequacy of policies and programs at an institution for meeting its obligations to extend credit fairly. However, other information critical to an institution's credit decisions is not available from HMDA data."9

[8] Id.
[9] Id.

A. Did the Fed rely on BB&T's denials to determine that these allegations of lending discrimination not take place?

In evaluating bank applications, the Federal Reserve relies on the banks' overall compliance record, including recent fair lending examinations. In addition, the Federal Reserve considers the CRA records of the relevant depository institutions, assessments of other relevant supervisors, the

[8] This approach is reflected in SR 14-2 <u>supra</u> n.
[9] For example, financial holding companies with less-than-satisfactory CRA ratings are prohibited from acquiring companies engaged in financial activities in reliance on section 4(k) of the BHC Act. 12 U.S.C. § 1843(*l*)(2).

supervisory views of examiners, and information provided by the applicant and public commenters. Regarding the BB&T-SunTrust application, the Board considered all comments, including the specific allegations raised by the commenters that you reference. To evaluate the comments, as well as to consider whether the relevant institutions are helping to meet the credit needs of their communities and the potential effects of the proposal on the convenience and needs of the communities to be served, the Board considers the information provided by the applicant, public comments, and the institutions' examination records, including fair lending.

B. Does HMDA data indicate that these disparities do exist?

a. If so, what information was used to reach the conclusion that these concerns did not warrant further scrutiny and denial of the merger?

As indicated in the Board's order, Home Mortgage Disclosure Act (HMDA) data disparities must be evaluated in the context of other information regarding the lending record of an institution. Publicly available HMDA data do not provide a sufficient basis for conclusively determining whether an institution has engaged in discriminatory practices.[10] Public 2017 HMDA data available for the evaluation of this application did not include consumer credit scores, debt-to-income ratios and loan-to-value ratios.

In evaluating bank applications, the Federal Reserve relies on the banks' overall compliance record, including recent fair lending examinations, assessments of other relevant supervisors, and the supervisory views of examiners.

C. What additional information that is "critical to an institution's credit decision" would the Fed have needed to make a decision about whether BB&T was "meeting its obligations to extend credit fairly"?

As mentioned above, public 2017 HMDA data available for the evaluation of this application did not include consumer credit scores, debt-to-income ratios and loan-to-value ratios. When warranted by risk factors, examiners obtain additional information when conducting fair lending examinations to evaluate an institution's compliance with fair lending laws and regulations.

9) On the same day the merger was approved, the Federal Reserve issued a consent order against SunTrust as a result of misleading or inaccurate statements to business customers about the operation and billing of certain add-on products.10

[10] United States of America before the Board of Governors of the Federal Reserve System, "Consent Order,"
https://www.federalreserve.gov/newsevents/pressreleases/files/orders2019 111 9a2.pdf

A. When did the Fed first become aware of the activities SunTrust was engaging in that led to the consent order being issued?

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[10] Lee v. Board, supra n. at 915 (holding that the Board carefully considered the concerns expressed by the commenters and properly resolved the HMDA data related allegations).

Federal Reserve staff became aware of the practices addressed in the Consent Order beginning in 2016.[11] Those practices were terminated by SunTrust Bank around the same time.

B. When was it decided that it would be appropriate to publicly release the consent order at the same exact time as the announcement of the Fed approval of the merger? Who made that decision?

The Consent Order and merger application were voted on and approved by the Board at the same time. Staff's investigation of the matters underlying the Consent Order was completed prior to the Board's consideration of action on the application. Further, aligning the processing of these two matters was reasonable because the issues identified in the Consent Order needed to be addressed as part of the Board's consideration of the statutory factors for determining whether to approve the application.

10) In assessing the convenience and needs factor, the Fed considered the supervisory views of the Consumer Financial Protection Bureau.11

[11] Federal Reserve System, "Order Approving the Merger of Bank Holding Companies," https://www.federalreserve.gov/newsevents/pressreleases/files/orders20191119aI.pdf

A. What were those views?

As indicated in the Board's order, the Board considered the views of the CFPB regarding the consumer compliance records of both Branch Banking and Trust Company (Branch Bank) and SunTrust Bank. These interagency discussions and views are considered confidential supervisory information. The CFPB Director voted to approve the merger in the Director's capacity as a member on the FDIC board of directors.

B. Did the Fed review the Bureau's Consumer Complaint database in evaluating the merger?

As mentioned above, the Board considered the views of the CFPB regarding the consumer compliance records of both Branch Bank and SunTrust Bank.

C. A recent study has shown that SunTrust and BB&T ranked third and 12th in the most consumer complaints that year.12 Does the Fed find those statistics concerning?

[12] American Banker, "BankThink: CFPB should have a say in bank mergers," Jeremy Kress, September 03, 2019, https://www.americanbanker.com/opinion/cfpb-should-have-a-say-in-bank-mergers

Consumer complaints are taken seriously by the federal banking agencies. Complaints that implicate fair lending and other consumer protection laws and regulations are taken into account

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[11] See In the Matter of SunTrust Bank, Docket No. 19-028-B-SM (Nov. 19, 2019), available at https://www federalreserve.gov/newsevents/pressreleases/files/orders20191119a2.pdf.

as part of the assessment of an institution's consumer compliance record. The Board considered the views of the FDIC and the Federal Reserve Bank of Atlanta regarding the consumer compliance record of Branch Bank and SunTrust Bank, respectively. In addition, the Board considered the views of the CFPB regarding the consumer compliance records of both Branch Bank and SunTrust Bank.

Financial Stability Factor

11) The Approval Order states that "In light of all the facts and circumstances, this transaction would not appear to result in meaningfully greater or more concentrated risks to the stability of the U.S. banking or financial system."

A. Countrywide was a $200 billion institution when it failed.13 Washington Mutual was $307 billion.14 Together, they had the potential to do significant damage to the deposit insurance fund. Why does the Fed believe that the failure of a $450 billion institution would not present risks to the financial system?

[13] New York Times, "Bank of American to buy Countrywide," Gretchen Morgenson and Eric Dash, January 11, 2008, https://www.nytimes.com/2008/01/11 /business/worldbusiness/l liht-bofa.3.9157464.html
[14] M Reuters, "WaMu is largest bank failure," Elinor Comlay and Jonathan Stempel, https://www.reuters.com/article/us-washingtonmutual-jpmorgannews1/wamu-is-largest-u-s-bank-failure-idUSTRE48P05120080926

As described in detail on pages 54-60 of the Board's public order, the Board conducted an extensive analysis of the risks to stability of the United States banking and financial system. In particular, the Board considered the combined organization's size, the extent to which BB&T and SunTrust engaged in activities that were critical to the functioning of the U.S. financial system and whether there would be adequate and timely substitute providers of such activities, data regarding potential financial instability being transmitted to other institutions or markets within the U.S. banking and financial system, the extent to which the combined organization would contribute to the overall complexity of the U.S. banking or financial system, and the cross-border activities of each of BB&T and SunTrust.

Based on each of these factors individually and in combination, the Board concluded that the transaction would not appear to result in meaningfully greater or more concentrated risks to the stability of the U.S. banking or financial system. In particular, the Board noted that the combined organization would have a *de minimis* share of payment activities, assets under custody, and underwriting activities; have limited reliance on wholesale funding; have limited over-the-counter derivatives exposures and holdings of Level 3 assets; and engage in limited cross-border activities. In addition, the Board noted that both BB&T and SunTrust were predominately engaged in retail commercial banking activities with little reliance on short-term funding. The Board found that the combined organization would have minimal cross-border activities and would not exhibit an organizational structure, complex interrelationships, or unique characteristics that would complicate resolution of the firm in the event of financial distress. In addition, the Board found that the combined organization would not be a critical services provider or so interconnected with other firms or the markets that it would pose significant risk to the financial system in the event of financial distress.

B. In a July 2018 speech advocating for deregulation of regional banks, you favorably cited Fed research showing that the failure of a single $250 billion bank would be far worse for the economy than the failure of five $50 billion banks failed separately. And yet you concluded last month that the $450 billion BB&T-SunTrust merger would not materially increase risks to financial stability. Was this research considered in the context of the BB&T-SunTrust merger?15

[15] "Remarks by Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System at American Bankers Association Summer Leadership Meeting," July 18, 2018

The Board considers the resulting size of a financial institution when assessing the risks to financial stability, because larger financial firms generally pose a greater risk to the financial system and broader economy than smaller financial firms. However, asset size itself is not dispositive, and the Board considers additional factors to evaluate the potential threat to financial stability, including interconnectedness, complexity, cross-border activity, and substitutability for critical services.[12] Each of these factors was discussed in detail on pages 54-60 of the Board's order.

The July 2018 speech discussed tailoring regulation applicable to banks in the United States to reflect the variety of business models and risk profiles of those institutions. In particular, the Board's framework for supervision and regulation is designed to increase in stringency in tandem with the firm's size and systemic footprint. To offset risk, the Board requires larger firms to be subject to additional supervisory and regulatory requirements. In its consideration of the BB&T application, the Board considered these additional regulatory standards and requirements that would apply to the combined organization given the size of its total assets. As noted in the Board's order, BB&T represented that it had allocated additional staff resources to satisfy the additional regulatory requirements that would apply to bank holding companies with $250 billion or more in total consolidated assets. In addition, the combined organization would be subject to annual supervisory stress tests, company-run stress tests every other year, the countercyclical capital buffer, a supplementary leverage ratio, a liquidity coverage ratio requirement, and other reporting and liquidity requirements. These requirements would be more stringent than the requirements that would have applied to each of BB&T and SunTrust on a standalone basis.

C. Please describe the extent to which the Fed considered the cost of failure of the merged institution in its review.

As noted in the Board's order, the Board considered the degree of difficulty in resolving the resulting firm. The Board noted that BB&T and SunTrust do not engage in complex activities, such as being a core clearing and settlement organization for critical financial markets, that might complicate the resolution process by increasing the complexity, costs, or timeframes involved in a resolution. Because the structure and scope of activities at the combined organization were not

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[12] See supra n.

complex, the resulting firm would not engage in significant cross-border activities, and the combined organization would be predominately engaged in retail commercial banking activities, the resolution of the firm would be less complicated than that of the largest U.S. financial institutions.[13]

12) The Approval Order also listed various metrics considered when evaluating the financial stability factor, including size and the availability of substitute providers. For each metric, please indicate if the Fed has established numeric thresholds to evaluate whether or not it is triggered. If so, please identify the thresholds. If not, please describe how those factors were evaluated?

As required by statute, the Federal Reserve considers the impact on financial stability of every bank holding company merger proposal.[14] The metrics discussed in the Board's order are evaluated in every proposal. Specifically, these metrics include measures of the size of the resulting firm, the availability of substitute providers for any critical products and services offered by the resulting firm, the interconnectedness of the resulting firm with the banking or financial system, the extent to which the resulting firm contributes to the complexity of the financial system, and the extent of the cross-border activities of the resulting firm.[15] Because these categories are not exhaustive, the Board may consider additional categories to inform its decision. In addition to using quantitative measures, the Board also considers qualitative factors, such as the opaqueness and complexity of an institution's internal organization, that are indicative of the relative degree of difficulty of resolving the resulting firm.

In this case, the Board also considered the Globally Systemic Important Bank ("GSIB") Surcharge score of the combined organization. The GSIB Surcharge score is a measure of a firm's systemic importance.[16] On consummation of the proposal, the combined organization would have a GSIB method 1 score of approximately 30 basis points, well below the minimum threshold (130 basis points) that identifies a financial institution as a GSIB.

Transparency

This bank merger is the largest to occur since the financial crisis and consumers deserve to have a complete understanding of the decision-making process that led to its approval.

13) The depository data used for the anticompetitive analysis is non-confidential information. As such, when will the Fed be publishing the full anticompetitive analysis it undertook when reviewing the merger?

The full anticompetitive analysis for review of the merger is published on pages 7-24 and 63-80 of the Board's order.

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[13] See BB&T Corporation, FRB Order No. 2019-16, at 59-60 (Nov. 19, 2019).
[14] 12 U.S.C. § 1842(c)(7).
[15] See Capital One Financial Corp., supra n.
[16] See 80 Fed. Reg. 49082 (Aug. 14, 2015).

14) American Banker published an interview with the top executives of BB&T and SunTrust in which Truist's chairman and CEO, Kelly King stated, "I was told by several senior regulators there was no legal reason to object to the deal."16

[16] American Banker, "Truist rising: With megamerger clone, pressure to deliver," Paul Davis, December 09, 2019, https://www.americanbanker.com/news/truist-rising-with-megamerger-done-pressure-on-to-deliver

- **A. Were you one of those senior level regulators?**
- **B. Did any Fed staff have conversations with the executives, or their representatives of either institution before the merger application was filed?**
  - **a. If so, please disclose the date, participants, and substance of the conversation.**
  - **b. Did the Fed provide any comment regarding the likelihood of the approval of the deal, including whether the Fed anticipated there being any legal barriers to approval?**

The quote from Mr. Kelly King was published in an article on December 9, 2019, and appears to have been made after the Board's approval on November 19, 2019.[17] The Board concluded that all statutory factors that it was required to consider were consistent with approval based on its analysis of the application record.

As explained in Section III of my letter to you dated May 8, 2020, prospective applicants sometimes request to meet with Board staff before filing an application or prefiling and the Board considers it appropriate for staff to grant these requests. At the request of BB&T and SunTrust, members of Board staff met with representatives of the companies on February 22, 2019. Representatives from BB&T and SunTrust included members of senior management as well as external counsel for each company. Representatives from the Board included staff from the Division of Consumer and Community Affairs, the Division of Supervision and Regulation, the Division of Research and Statistics, and the Legal Division. BB&T and SunTrust representatives presented high-level information on a number of topics, including pro forma financial projections, information on geographic overlap, considerations related to the convenience and needs of affected communities, and early-stage risk management and technology integration plans. Board staff listened to the presentation and shared absolutely no information regarding the likelihood of approval or legal barriers to approval.

In addition, members of Board staff attended a meeting at the DOJ on February 19, 2019, wherein representatives of BB&T and SunTrust presented their competitive analysis and initial proposed divestitures. Meeting participants included representatives from senior management at BB&T and SunTrust, BB&T's external counsel, SunTrust's external counsel, staff at the DOJ, and Board staff from the Legal Division and the Division of Research and Statistics. Once again, Board staff listened to the presentation made by BB&T and SunTrust representatives and shared absolutely no information regarding the likelihood of approval or legal barriers to approval.

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[17] See supra n.

Community Investment Act Reform

In response to questioning during the December 5, 2019 hearing, you stated that the proposal to modify the Community Reinvestment Act (CRA) released this week by the FDIC and OCC "has benefited from a lot of Fed input."

15) Please describe which aspects of the proposal were based on input from the Fed.

The Federal Reserve has shared detailed analysis, data, and proposals related to possible metrics-based approaches with our counterparts at the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) in an effort to forge a common approach. The FDIC and OCC have considered this information and included in their proposal multiple metrics at the assessment level. For example, the OCC/FDIC metrics would evaluate a bank's distribution of the number of its retail loans to low-income tracts and low-income households.

16) Please describe why the Federal Reserve declined to join the FDIC and the OCC in their proposed rulemaking. Specifically:

A. Did career Fed staff disagree with or were otherwise unable to independently verify the analysis on the expected effects of the proposal?

We have had considerable engagement with the FDIC and OCC throughout the CRA reform process and have conducted research and analysis of various proposals. We are committed to getting CRA reform right and that is why we have focused so much on understanding the underlying data and potential impact of any proposal. We continue to believe the best outcome would be a joint interagency final rule which strengthens the CRA regulations to help banks better meet the credit needs of the local low-and moderate-income communities they serve and more closely align with changes in the ways financial products and services are delivered.

B. Does the Fed believe the proposed rule could negatively impact credit availability and affordability among low-income and minority populations?

a. If so, which aspects of the proposal trigger those negative effects? Please include any qualitative or quantitative analysis done by the Fed.

We are focused on developing a set of CRA reform ideas that are consistent with a few key principles. Specifically, we believe that revisions to the CRA regulations should reflect the credit needs of local communities and work consistently through the business cycle. They should be tailored to banks of different sizes and business strategies. They should provide greater clarity in advance about how activities will be evaluated. They should encourage banks to seek opportunities in distressed and underserved areas. And, they should recognize that the CRA is one of several related laws to promote an inclusive financial sector.

C. When in the rulemaking process did the Fed determine that it would not join the proposal? Were there any issues not addressed by the questions above that contributed to the proposal?

While the Board did not join the FDIC and the OCC in their Notice of Proposed Rulemaking (NPR) revising elements of CRA regulation, the Board shared detailed analysis and proposals on CRA reform with our counterparts at the OCC and FDIC in the preparation of the NPR, and the NPR reflects much input from the Board. We are reviewing the comments that have been submitted to the FDIC and OCC on the NPR, and we expect to learn much—including much related to the aspects of the NPR that reflect our own input—from the review. As a result, it would be premature to identify any specific areas of disagreement—rather, we are all in the process of working to determine the best path forward. We continue to view a common approach as the best outcome, but we have not yet determined the best next steps to achieve that outcome.

17) Will the Fed be releasing a separate reform proposal? Is it a possibility that the Fed will join the agencies in issuing a final rule? If so, what assurances would the Fed need to feel comfortable joining?

Please see the response to question 16. C.

18) What are the consequences of different banks having a different set of CRA requirements to follow based on their regulator?

A. How would CRA changes impact the Fed's review of CRA-performance for bank mergers? If CRA-ratings are based on different sets of standards for each regulator, how will the Fed be able to objectively compare CRA-performance among the banks?

We continue to view a common approach to CRA reform as the best outcome. The proposed regulatory changes would not change how the Federal Reserve reviews CRA performance for bank mergers. The CRA statute requires the Board to take into account the CRA performance record of an institution in mergers and acquisitions applications and the Board will continue to abide by this requirement, consistent with the law.

Climate Change Risk

19) On January 25, I signed a letter to Chairman Jay Powell regarding information on the Federal Reserve's steps to identify and manage climate-related risks in the U.S. financial system.[17] Chairman Powell's response on April 18 was disappointing, deferring responsibility to climate-related actions to other agencies.[18]

[17] Letter from 20 Senators to Chairman of the Board of Governors of the Federal Reserve System Jerome Powell, January 25, 2019, https://www.schatz.senate.gov/imo/media/doc/Letter%20to%20Federal%20Reserve,%20OCC,%20FDIC%20re%20Climate%20Change.pdf.
[18] Letter from Chairman of the Board of Governors of the Federal Reserve System Jerome Powell to Senator Warren, April 18, 2019. https://www.schatz.senate.gov/imo/media/doc/Chair%20Powell%20to%20Sen.%20Schatz%204.18.19.pdf.

A. **Chairman Powell's April 18 response stated, "The Board's framework provides a systemic way to assess financial stability; however, some potential risks do not fit neatly into that framework."[19] However, central banks around the world, including the Bank of England are far more aggressive in is taking steps to incorporate climate-related risks in their financial stress tests.[20] The Network for Greening the Financial System, a group of 18 central banks and bank supervisors has also acknowledged that "climate-related risks are a source of financial risk [and it is] within the mandates of Central Banks and Supervisors to ensure the financial system is resilient to these risks."[21]**

[19] *Id.*
[20] Reuters, "BOE to stress test its financial system against 'climate pathways': Carney," Kanishka Singh, October 8, 2019, https://www.reuters.com/article/us-climate-change-boe-carney/boe-to-stress-test-its-financial-system-against-climate-pathways-carney-idUSKBN1WN0GS.
[21] Network for Greening the Financial System, "NGFS First Progress Report," October 2018, https://www.banque-france.fr/sites/default/files/media/2018/10/11/818366-ngfs-first-progress-report-20181011.pdf.

a. **Please explain why the Federal Reserve System's framework does not currently incorporate climate-related risks in assessing financial stability, despite other international efforts to do so.**

It is not correct to say that the Federal Reserve's framework for assessing financial stability does not incorporate climate-related risks or that we are disconnected from international efforts in this area.

First, staff across the Federal Reserve System conduct extensive research on a range of issues related to the effects of climate change, including how climate-related risks can be amplified by the financial system. Through their research, staff are exploring new sources of climate-related data and developing methods to link this climate data with existing financial data. This research helps inform our supervision and outreach to market participants by enhancing our understanding of connections between climate risks and financial stability. These efforts involve nearly every division of the Board of Governors, as well as several Reserve Banks. These efforts improve our ability to assess the ways climate-related risks may affect the economy, financial stability, and the safety and soundness of financial institutions.

Second, Federal Reserve personnel contribute integrally to efforts by the Financial Stability Board (FSB), which I chair, and other standard-setting bodies to assess climate-related financial risks. The FSB's Standing Committee on the Assessment of Vulnerabilities evaluates as part of its mandate the potential for technological and policy shocks related to climate change. I have directed the FSB to continue its sponsorship of the Task Force for Climate-related Disclosures, which engages with companies to promote consistent public disclosures related to the risks of climate change. And the G20 has made the FSB responsible for coordinating the work of these international bodies related to the effect of climate change on the financial sector, recognizing that a patchwork of sector-specific groups could miss the emergence of critical financial vulnerabilities. Federal Reserve staff and I remain in frequent contact with our supervisory colleagues in other jurisdictions, following closely their own climate-related projects.

Third, in addition to this work on the long-term analysis of climate-change risk, the Federal Reserve's near-term supervisory framework captures a series of potential near-term risks related to severe weather events. One example includes the possibility of large losses to property and casualty insurers from historically atypical timing, intensity, or frequency of severe weather damages. The loss-absorbing capacity of insurers and their connections to the broader financial system is an important part of our financial stability framework. In addition, we look at the potential operational disruptions at large financial institutions, including network outages or other weather-related disturbances, which could present a near-term risk to financial stability.

With regard to the Network for Greening the Financial System (NGFS), as I have stated publicly for over a year, including twice at previous hearings of the Senate Banking Committee, I have urged the NGFS to accept comprehensive participation from the Federal Reserve. Federal Reserve staff have attended many NGFS discussions and will continue to do so. We are exploring how the NGFS might allow us to participate further in a way that is consistent with the full range of our responsibilities.

20) On November 8, the Federal Reserve Bank of San Francisco held a conference on "The Economics of Climate Change," which focused on "[discussing] quantifying the climate risk faced by households, firms, and the financial system; measuring the economic costs and consequences of climate change; accounting for the effects of climate change on financial asset prices; and understanding the potential implications of climate change for monetary, supervisory, and trade policy."[22]

[22] Federal Reserve Bank of San Francisco, "The Economics of Climate Change," November 8, 2019, https://www.frbsf.org/economic-research/events/2019/november/economics-of-climate-change/.

A. In her speech at the conference, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco Mary Daly stated, "The Federal Reserve's job is to promote a healthy, stable economy. This requires us to consider current and future risks – whether we have a direct influence on them or not. Climate change is one of those risks."[23]

[23] Federal Reserve Bank of San Francisco, "Why Climate Change Matters to Us," Mary Daly, November 8, 2019, https://www.frbsf.org/our-district/press/presidents-speeches/mary-c-daly/2019/november/why-climate-change-matters-to-us/.

   a. Does the Board of Governors of the Federal Reserve System disagree with President Daly's remarks that state that Federal Reserve is required to consider climate-related risks?

      i. If so, please explain the position that the Federal Reserve is not required to consider climate-related risks.

ii. If not, why has the Federal Reserve System not considered climate-related risks in its oversight of the financial system thus far?

Please see the response to question 19 a.

B. During the conference, Federal Reserve Governor Lael Brainard stated that "Climate risks are projected to have profound effects on the U.S. economy and financial system," and that the "Federal Reserve has important responsibilities for safeguarding the stability of our financial system so that it can continue to meet household and business needs for financial services when hit by negative shocks. Similar to other significant risks, such as cyberattacks, we want our financial system to be resilient to the effects of climate change."[24]

[24] Board of Governors of the Federal Reserve System, "Why Climate Change Matters for Monetary Policy and Financial Stability," Lael Brainard, November 8, 2019, https://www.federalreserve.gov/newsevents/speech/brainard20191108a.htm.

a. Has the Federal Reserve System formally assessed the systemic risks that climate change could pose to the financial system? If so, what tools and models does the Federal Reserve System use to inform those assessments?

b. Has the Federal Reserve System assessed if the financial system is resilient to climate-related risks or taken any actions to increase the financial system's resilience to climate change?

As I stated previously, the Federal Reserve's framework for monitoring financial stability assesses several potential vulnerabilities to the financial system. These vulnerabilities, in turn, could be susceptible to a series of near-term climate-related risks. Assessments of the resilience of the U.S. financial system conducted by Federal Reserve staff are published biannually in our Financial Stability Report.

For the Federal Reserve's near-term macroeconomic analysis, we do take into account information on the severity of weather events. When a severe weather event occurs, we closely monitor the effects on local economies, assess the implications for broader measures of economic production and employment, and adjust our economic forecasts accordingly.

For example, our staff has relied on data from the Federal Emergency Management Agency and the Department of Energy to gauge the disruptions to oil and gas extraction, petroleum refining, and petrochemical and plastic resin production in the wake of hurricanes that have affected the Gulf region. Our staff regularly uses daily measures of temperatures and snowfall from the National Oceanic and Atmospheric Association weather stations to better understand how severe weather may be affecting measured and real economic activity in specific areas.

Our understanding of which economic activities will be affected by a severe weather event depends critically on data produced by the federal statistical agencies, such as the Census Bureau's County Business Patterns data, as those data provide information on economic activity in different geographic locations. In addition, our staff uses credit and debit card transactions data for gauging how specific types of severe weather might be affecting consumer spending in areas affected by those events.

At present, neither we, or any other major central bank, directly models how changes in temperatures over long periods of time affect economic activity (modeling being a separate matter from the extensive economic analysis of this question that we do). But given that—the evolution of climate over time affects the economic data on which our models are built—including the trends and the cyclical behavior of investment, consumption, production, and employment—then climate change is incorporated in our macroeconomic analysis.

Other Topics

21) A report released by the Financial Stability Board, of which you are currently chair, highlighted the risks of technology companies entering the banking sphere to the broader financial system.

A. Can you please describe how both the FSB on an international level and the Federal Reserve on a domestic level are monitoring and evaluating these risks?

The FSB has published multiple reports on financial stability topics related to technology companies' roles in the financial sector. These include notes on cloud service provision, "BigTech" financial service provision, and use of decentralized financial technologies.[18] The FSB's 2020 work plan includes further work on BigTech service provision in emerging markets, a stock-take of financial regulators' and supervisors' use of technology, an update to the FSB's crypto-asset monitoring framework to incorporate stablecoins, and continuance of work underway on the Regulatory Issues of Stablecoins (RIS).[19] The RIS work was mandated by the G20 and will examine the regulatory issues of so-called "stablecoins" with the potential to reach a global scale—such as the Libra initiative—and will advise on multilateral responses as needed. This work picks up from the G7 Working Group on Stablecoins 2019 report.[20] The RIS working group issued a consultative document in April and is scheduled to submit a final report to the G20 during the third quarter of 2020.

In addition to contributing to FSB work, Federal Reserve staff are also active participants in work on related topics being conducted by the Basel Committee on Banking Supervision and the Committee on Payments and Market Infrastructures.

Domestically, Federal Reserve staff from multiple functions are following the interaction between banks and technology companies, including partnerships and third-party relationships, to assess

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[18] https://www.fsb.org/2019/12/third-party-dependencies-in-cloud-services-considerations-on-financial-stability-implications/; https://www.fsb.org/2019/12/bigtech-in-finance-market-developments-and-potential-financial-stability-implications/; https://www fsb.org/2019/02/fintech-and-market-structure-in-financial-services-market-developments-and-potential-financial-stability-implications/; https://www.fsb.org/2019/06/decentralised-financial-technologies-report-on-financial-stability-regulatory-and-governance-implications/.

[19] https://www.fsb.org/wp-content/uploads/P171219.pdf.

[20] https://www.bis.org/cpmi/publ/d187.pdf.

potential consumer protection risks; risks to banks' safety and soundness; and financial stability risks.

In 2016, the Federal Reserve created two working groups with the task of with monitoring and analyzing financial technology ("fintech") and related emerging technology trends and undertaking related market intelligence. These working groups also conduct research related to our supervisory and payment system responsibilities. Several of the Board's divisions now have staff dedicated to policy and research around fintech and digital innovations in their respective areas of focus.

The Federal Reserve also coordinates regularly with the other federal banking agencies on innovation-related matters in the supervision area. Our Consumer and Community Affairs division has convened an interagency fintech discussion forum to facilitate information sharing between federal banking regulators on fintech consumer protection and financial inclusion issues. The Federal Reserve also engages in interagency discussion of fintech-related issues through the FFIEC's Task Force on Supervision and its Task Force on Consumer Compliance. One current area of focus is the federal banking agencies' existing guidance on controls around partnerships and third party relationships aimed at ensuring those activities are conducted in a manner consistent with safe and sound banking practices. The Federal Reserve staff are reviewing this guidance to determine whether any adjustments or clarifications would be helpful to promote responsible innovation.

Additionally, as noted by Chair Powell previously in congressional testimony, the Board has set up a multidisciplinary working group to analyze risk and policy implications of the Libra initiative which would help organize Federal Reserve input into the work of the FSB in this area. Areas of focus include monetary policy, payment system risks, consumer protection, Bank Secrecy Act/Anti-money Laundering compliance, and financial stability. The working group also has been meeting with other regulators, both domestic and international.

Lastly, Federal Reserve staff routinely meet with technology companies and banks, engaging with these companies to better understand how their products work and the associated risks. The Federal Reserve held its first in a series of office hour sessions with banks and financial technology companies to provide two-way learning opportunities for the companies and Federal Reserve staff.[21] Given the impact of the current economic stress, future office hour sessions have been postponed temporarily.

B. Does the Federal Reserve have the sufficient tools to monitor and address these risks under the current regulatory framework?

The FSB report highlighted a diverse set of potential benefits and risks from the provision of financial services by large technology firms. The Board has tools to monitor and address certain of the identified potential risks, while others fall outside of the authorities of the Federal Reserve.

As a general matter, the Federal Reserve does not directly regulate or supervise technology companies. Our regulatory and supervisory authority generally focuses on state member banks

[21] https://www.federalreserve.gov/newsevents/pressreleases/other20191217a.htm.

and bank holding companies.

However, the Federal Reserve does have some authority over technology companies that provide certain financial services to, or in partnership with, banks we supervise. Of most relevance is the Bank Service Company Act, which grants the Board (and the other federal banking agencies) the authority to regulate and examine third-party service providers that perform certain services for depository institutions we supervise. Also, under the Federal Deposit Insurance Act, the Board has the enforcement authority to address unsafe and unsound practices, violations, and breaches of fiduciary duty by depository institutions we supervise and their institution-affiliated parties.

From a broader financial stability perspective, the Federal Reserve monitors risks to the financial system and works, usually with agencies at home and abroad, to help ensure the system supports a healthy economy for U.S. households, communities, and businesses. This monitoring includes vulnerabilities assessments, extensive research, and collaboration with other domestic agencies directly and through the Financial Stability Oversight Council (FSOC) to monitor risks to financial stability and to undertake supervisory and regulatory efforts to mitigate the risks and consequences of financial instability.

22) On the Frequently Asked Questions page regarding the proposed FedNow services, it states that additional analysis is required to fully evaluate the relevant operational, risk, and policy considerations for both the Federal Reserve Banks and service participants. When does the Fed expect to complete this analysis?

This language refers to the expansion of the Fedwire Funds Service and National Settlement Service (NSS) hours. The Federal Reserve Board (Board) is currently analyzing an expansion of operating hours for the National Settlement Service (NSS) and the Fedwire Funds Service, up to 24x7x365, to support a wide range of payment activities, including liquidity management for faster retail payments. As part of its analysis, the Board is engaging with industry participants in order to understand the industry's specific needs and readiness related to expanded hours.

In addition, the Board intends to publish at least two *Federal Register* notices in order to seek public comment on issues related to, and potential approaches for, expanding the Fedwire Funds Service and NSS operating hours, and announce its progress and any decisions related to expanded hours. The timeline for the Board's analysis will depend in part on the diversity and complexity of issues that the Board identifies during its review. Given the systemic importance of the Fedwire Funds Service, any decisions on expanding hours could have significant effects on market participants. The Board is committed to carefully evaluating the potential benefits, risks, and costs of any decision to expand hours of the Fedwire Funds Service and NSS.

As the Board considers expanding operating hours for NSS and the Fedwire Funds Service broadly, the Board will continue to assess the appropriateness of incremental changes to relevant operating hours in response to specific industry needs. For example, the Board recently completed analysis of an expansion of operating hours for NSS and the Fedwire Funds Service in order to allow for a third same-day automated clearinghouse (ACH) processing and settlement window. In December 2019, the Board announced an expansion of operating hours for NSS and the Fedwire Funds Service that will be implemented in March 2021 in order to add a third same-day ACH processing and settlement window.[22]

[22] See https://www.federalreserve.gov/newsevents/pressreleases/other20191223a.htm.