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Speeches & Testimony

Remarks by Martin J. Gruenberg Chairman, FDIC Third Annual American Banker Regulatory Symposium Arlington, VA
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Good afternoon. I appreciate the opportunity to take part in this third annual American Banker Regulatory Symposium. I intend to touch on two subjects in my remarks this afternoon. The first is the condition of the banking industry based on the results of the FDIC�s recent second quarter 2013 Quarterly Banking Profile (QBP). The second is the recent rulemakings by the banking agencies on risk- based and leverage capital requirements.

Condition of the Industry

The FDIC released second quarter results for insured commercial banks and savings institutions on August 29th. The report provided further evidence of the gradual recovery that has been underway in the banking industry for almost four years now. Net income for the industry was $42.2 billion, marking the sixteenth consecutive quarter that earnings posted a year-over-year increase. Average return on assets was 1.17 percent for the quarter -- still well below the highs we saw in the early 2000s, but the highest in over six years. Asset quality improved, loan balances grew, fewer institutions were unprofitable, and the number of failing banks and problem banks continued to fall. These improvements were shared across the banking industry, from small to large institutions.

Commercial and industrial lending continued to be relatively strong during the quarter and nonmortgage consumer lending trended up, while real estate loans declined slightly. Importantly, small business loans were up, with community banks leading the increase. The number of problem banks declined for a ninth consecutive quarter, to 553, bringing the �Problem List� down to a level that is nearly 40 percent below its peak of 888 institutions in the first quarter of 2011. So far this year 22 banks have failed. That compares to 42 at this time last year. To provide further perspective, failing banks peaked in 2010 at 157 institutions, fell to 92 in 2011, and declined to 51 last year.

The Deposit Insurance Fund (DIF) balance rose to $37.9 billion as of June 30, up from $35.7 billion at the end of March. Assessment income continues to drive the growth in the Fund balance. I would note that at its low point during the crisis, the DIF was over $20 billion in the red. The reserve ratio�which is the Fund balance as a percent of estimated insured deposits�increased to 0.63 percent at June 30 from 0.59 percent at March 31. The Deposit Insurance Fund must achieve a minimum reserve ratio of 1.35 percent by 2020, and we remain on a pace to meet that objective.

Despite these positive overall trends, challenges remain. Narrow net interest margins and modest loan growth have made it difficult for banks to increase revenue. And the rise in interest rates during the second quarter contributed to a decline of $51 billion in the value of available-for-sale securities, which was the largest such decline since banks started reporting these data in 1994. Unrealized gains and losses on available-for-sale securities do not affect current earnings, but they have implications for future earnings if the securities are sold. These gains and losses also do not currently affect regulatory capital. But that will change under the new Basel III capital rules at large banking organizations that are subject to the advanced approaches requirements, as well as other institutions that choose not to opt out of that provision of the new rules as is permitted.

These developments underscore the importance of managing interest rate risk, an issue that has been an ongoing concern to the banking agencies. It will continue to be a focus of attention in FDIC safety and soundness examinations, as well as guidance we provide to insured institutions.

Recent Capital Rulemakings

As we continue to see gradual but steady improvement in the banking industry from the recent financial crisis and

ensuing recession, I thought I would take a few moments to talk about the two important regulatory capital rulemakings that the federal banking agencies acted on earlier this year. At its July 9th meeting, the FDIC Board issued an interim final rule that significantly revises and strengthens risk-based capital regulations, adopting with revisions three notices of proposed rulemaking from 2012 — the Basel III NPR, the Basel III Advanced Approaches NPR, and the Standardized Approach NPR. The FDIC also issued a separate, complementary notice of proposed rulemaking to strengthen the leverage requirements for the largest, most systemically significant banking organizations and their insured banks. I'll discuss first the risk-based capital rule, and then, in particular, the reasoning behind the proposed increase in the leverage capital requirement.

Risk-Based Capital Rule

The rule implementing the Basel III international accord substantially strengthens both the quality and the quantity of risk-based capital for all banks in the United States by placing greater emphasis on Tier 1 common equity capital. Tier 1 common equity capital is widely recognized as the most loss-absorbing form of capital, and the Basel III changes are expected to result in a stronger, more resilient industry better able to withstand periods of economic stress in the future.

While there has been general recognition in the aftermath of the financial crisis that higher capital levels as a buffer against economic stress would be appropriate, community banks in particular raised a number of concerns regarding the potential impact of some of the proposed changes to regulatory capital. I should mention that given the complexity of the proposed rules, the FDIC engaged in significant outreach efforts to explain the proposals in order to place banks, particularly community banks, in the best position to submit detailed informed comments. Specifically, both the Basel III and Standardized Approach notices of proposed rulemaking included addenda to aid smaller banks in identifying and understanding the aspects of the proposals that would apply to them. In addition, the FDIC held a national teleconference to provide an overview of the proposed changes, held a series of informational sessions in each of our six regions, and provided an online tool for estimating the impact of the proposed rules on an individual institution.

The agencies received a large number of highly specific comments that identified three main areas of concern, particularly for community banks: the risk-weighting for residential mortgages; the treatment of accumulated other comprehensive income (or AOCI, which includes unrealized gains and losses on "available-for-sale" securities held by an institution); and the treatment of Trust Preferred Securities (or TruPS) issued by smaller bank holding companies. These comments proved very helpful as the agencies moved forward with the rulemaking. As a result, unlike the NPR, the rule did not make any changes to the current risk-weighting approach for residential mortgages. It allows for a one-time opt-out from the regulatory capital recognition of AOCI, except for large banking organizations that are subject to the advanced approaches requirements. Further, the rule reflects that the Federal Reserve adopted the grandfathering approach permitted by section 171 of the Dodd Frank Act for TruPS issued by smaller bank holding companies with less than $15 billion in assets. At the end of the day, the industry's comments enabled the agencies to craft a rule that significantly strengthened the capital framework while still being responsive to specific community bank concern.

Although the new capital requirements are higher and more stringent than the previous requirements, the large majority of U.S. banks already meet the requirements of the rule. Importantly, however, the rule would have the effect going forward of preserving and maintaining the gains in capital strength the industry has achieved in recent years. As a result, banks should be better positioned to withstand periods of economic stress and serve as a source of credit to local communities.

The FDIC has again engaged in extensive outreach and is providing technical assistance to bankers on the rule. Our efforts have included compliance guides, another teleconference, an informational video that is available on the FDIC's website, a series of regional outreach meetings, and identifying subject matter experts at each of our regional offices whom banks can contact directly with questions. For easy access, we have consolidated all materials in a single location on our website (found at http://fdic.gov/regulations/capital).

Supplementary Leverage Ratio

Another issue raised by the Basel III international agreement and reflected in the rule was a new supplementary leverage ratio requirement. This represents an important enhancement to the international capital framework. Prior to this rule, there was no international leverage ratio requirement. For the first time, Basel III included an international minimum leverage ratio, and consistent with the agreement, the rule includes a three percent minimum

supplementary leverage ratio that applies only to the eighteen large banking organizations subject to the advanced approaches rule. The supplementary leverage ratio is more stringent than the existing U.S. leverage ratio since it includes certain off-balance sheet exposures in its denominator. Given the extensive off-balance sheet activities of many advanced approaches organizations, the supplementary leverage ratio is a significant new standard.

The FDIC also joined the Federal Reserve and the OCC in issuing an NPR which would increase the supplementary leverage ratio requirement in the rule for the largest, most systemically important banking organizations and their insured banks. Based on the NPR□s proposed definitions of $700 billion in total consolidated assets or $10 trillion in assets under custody to identify large systemically significant firms, the proposed requirements would currently apply to eight U.S. bank holding companies and to their insured banks.

The NPR would require these insured banks to satisfy a six percent supplementary leverage ratio in order to be considered well capitalized for prompt corrective action (PCA) purposes. For the eight affected banks, based on third quarter 2012 data, the agencies estimated this would represent $89 billion in additional capital.

Bank holding companies (BHCs) covered by the NPR would need to maintain supplementary leverage ratios of a three percent minimum plus a two percent buffer for a five percent requirement in order to avoid conservation buffer restrictions on capital distributions and executive compensation. Banking agency estimates indicate that this would require $63 billion in additional capital based on third quarter 2012 data.

As the NPR points out, maintenance of a strong base of capital at the largest, most systemically significant institutions is particularly important. As we saw during the financial crisis, capital shortfalls at these institutions can contribute to systemic distress and adverse effects on the economy. Although the Basel Committee□s establishment of a three percent minimum leverage ratio is a significant achievement, for the following reasons the agencies proposed to increase the leverage ratio requirement in order to further strengthen the capital base of the largest, most systemically significant banking organizations.

First, analysis by the agencies suggests that a three percent minimum supplementary leverage ratio would not have appreciably mitigated the growth in leverage among these organizations in the years preceding the financial crisis. The FDIC viewed this as problematic because one of the most important objectives of the capital reforms was to address the buildup of excessive leverage.

Second, the agencies also took into account the complementary nature of leverage capital requirements and risk-based capital requirements. From a safety and soundness perspective, each type of capital requirement offsets the potential weaknesses of the other, and the two working together -- as they have in the United States for over 20 years -- are more effective than either by itself. For example, risk-weighted asset calculations are subject to modeling error, subjectivity, and other uncertainties that can result in an undue buildup of leverage. This would be offset by a more robust leverage ratio. On the other hand, risk-based capital measures differentiate among asset exposures and may better capture outsized risk positions.

With that in mind, it is important to recognize that the Basel III risk-based capital ratios and the Basel III three percent minimum leverage ratio were developed for different purposes, using different standards of stringency. The risk-based ratios were set to absorb losses in a period of high stress. In contrast, the Basel Committee adopted the minimum leverage ratio to be more of a backstop and a generally lower requirement. Consequently, the Basel III rule increases risk-based capital requirements in the United States significantly more than it increases leverage requirements.

The result is that the rule places increasing reliance on the risk-based ratios relative to the leverage ratio. This represents a shift in terms of the longstanding complementary relationship in the United States between leverage capital requirements and risk-based capital requirements. It is a shift that is consequential for the largest, most systemically significant institutions, which historically have had the greatest tendency to maximize their use of financial leverage. Without a corresponding increase in the leverage requirement, there is a risk that these institutions could employ strategies that may increase their leverage to imprudent levels.

The increase in stringency in the leverage requirements represented by this proposal is roughly comparable to the increase in stringency of the Basel III risk-based capital requirements. This would serve as a tighter constraint on the leverage of these institutions and preserve the complementary relationship between the two types of capital requirements.

Part of the objective behind proposing higher capital standards for these institutions is to have an additional cushion of capital against the systemic risks they pose. Higher standards would result in additional private capital at risk before the Deposit Insurance Fund and the Federal government�s resolution mechanisms would be called upon. Moreover, as the preamble to the NPR points out, to the extent that these institutions may continue to have funding cost advantages, higher leverage standards for these institutions could result in a more level playing field for other financial institutions that do not present the same degree of systemic risk.

I view this proposed rulemaking as one of the most important steps the banking agencies could take to strengthen the safety and soundness of the U.S. banking and financial systems.The agencies look forward to considering the comments on the proposed rule.

Thank you very much.