FINAL

Martin J. Gruenberg

Chairman

Federal Deposit Insurance Corporation

to the

Institute of International Bankers

Annual Washington Conference

Washington, D.C.

March 7, 2016

Introduction

Good afternoon and thank you for the opportunity to take part in this conference today.

I would like to talk with you about two issues.

The first is the ongoing recovery of the U.S. banking industry. In many ways, the industry has staged an impressive turnaround from the most severe financial crisis and economic downturn in the United States since the 1930s, but the industry still faces a range of challenges.

Second, of particular relevance to the IIB, I would like to discuss the substantial progress that has been made to foster cross-border cooperation among the major jurisdictions of the world on the resolution of systemically important financial institutions.

Recent Performance of U.S. Banks

I want to begin by discussing the financial condition of U.S. banks as well as some of the key supervisory challenges going forward.

The FDIC recently released financial results for U.S. banks through the end of 2015 in our *Quarterly Banking Profile*. These results continue to reflect the recovery in U.S. bank earnings and balance sheets during the current economic expansion, now in its seventh year.

FDIC-insured institutions earned nearly $164 billion in 2015, a new record. Almost two-thirds of all institutions reported higher earnings in 2015 than in 2014. Noncurrent loans fell for the twenty-third consecutive quarter and now stand at the lowest level since the recession began in late 2007.

Only eight institutions failed last year—also the lowest number since 2007. The number of problem banks fell below 200 at the end of 2015 for the first time since 2008. And the reserve ratio of the Deposit Insurance Fund, a measure of the fund balance as a percentage of estimated insured deposits, rose to 1.11 percent, its highest level in almost eight years.

The improved financial condition of U.S. banks has, in turn, better positioned the industry to support our economy by extending loans to creditworthy borrowers. Indeed, total loans and leases at the end of the year were 6.4 percent higher than a year earlier, which is the fastest pace of loan growth in seven and a half years.

These figures convey a sense of the broad-based recovery that has taken place in the financial condition and earnings performance of FDIC-insured institutions since the financial crisis of 2008.

Going forward, the banking industry is generally well positioned to withstand less-favorable economic and financial market conditions. Regulatory agencies have been working together to ensure that banks have strong balance sheets. Capital ratios and the percentage of highly liquid assets are significantly higher than they were before the crisis.

Supervisory Challenges Ahead

As the recovery in the banking industry has matured, a number of significant challenges have emerged that are the focus of ongoing supervisory attention. The FDIC and other supervisors are focused on several areas, including interest rate risk, credit risk and cybersecurity.

Interest rate risk

One of our supervisory priorities continues to be interest rate risk.

A seven-year period of zero nominal short-term interest rates came to an end in December, as the Federal Reserve raised its target federal funds rate by a quarter of a percentage point. In one sense, most banks will welcome a normalization of interest rates, as higher rates will help to lift net interest margins from the historically low levels that the industry has reported in recent quarters.

But insured banks also have accumulated high levels of long-term assets in recent years as a means of maintaining their net interest margins in the zero-rate environment. Accordingly, some institutions could be vulnerable to losses if interest rates were to rise further and faster than anticipated.

Examiners will continue to evaluate the overall strategy that each institution takes to managing interest rate risk, as well as how well they have implemented that strategy.

Credit risk and the economy

Supervisors are also monitoring credit risk.

Lending in higher-risk loan categories has been growing, as noted in last year's Shared National Credits review of large syndicated loans. It is important that supervisors focus on the trends in credit risk because—as history tells us—lending decisions made during this phase of the credit cycle could lead to future losses.

Further, over the past few months, investors and analysts have lowered their expectations for global economic growth and are evaluating the implications this may have for credit

performance. These concerns are reflected in rising credit spreads in high-yield bond markets and credit downgrades that have been concentrated among energy firms that are being adversely affected by falling oil prices.

Supervisors at the FDIC are closely evaluating the possible effects that the decline in energy prices may have on insured institutions.

In general, the *direct exposure* of U.S. banks to energy producers is relatively modest. For the most part, the recent wave of investments in U.S. oil extraction has been financed through the capital markets or through loans financed by very large banks. Measured as a percent of total equity capital, these large-bank exposures generally appear to be fairly modest.

However, given the relative importance of the oil exploration and extraction industries to some local economies, banks must also consider their *indirect exposure* to household borrowers and other businesses affected by low oil prices. Indirect exposure is likely to be more important to community and regional institutions that may not lend directly to oil production companies but which may have substantial exposure to affected borrowers in their local markets.

The challenges posed by lower commodity prices for banks operating in energy-producing areas are likely to play out over a period of time and will clearly be a focus of ongoing supervisory attention.

Declining prices for agricultural commodities, meanwhile, could also ultimately affect the credit performance of small institutions that specialize in agricultural lending. Here, too, supervisors are working with insured institutions to help ensure that they are well-positioned to withstand less-favorable economic and financial market conditions.

The recent uncertainty about global economic growth and the associated decline in commodity prices are playing out in the context of a U.S. economy that is otherwise growing at a steady—if relatively slow—pace. The U.S. economy added 2.9 million jobs last year, pushing the unemployment rate below 5 percent. Consumer spending has been solid and will be helped to the extent that oil prices stay low. Overall, the expectation is that the economic environment will remain supportive of continued strong financial performance of FDIC-insured institutions. As risk managers, however, we must remain prepared for more adverse economic scenarios that would lower the outlook for bank earnings.

Cybersecurity

Finally, supervisors continue to closely track the challenges associated with cybersecurity.

U.S. banking agencies have placed more emphasis on strengthening awareness and undertaking risk mitigation with respect to cyber risks during the past few years. Recent trends suggest a greater level of sophistication in the type of cyber-attacks, and a rising potential for high-impact events that could adversely affect insured institutions.

The FDIC and the other federal banking agencies have been working to enhance their abilities to address these risks. The agencies have initiated several programs to improve awareness among banks about potential cyber risks, and to provide practical tools to help mitigate that risk. The federal banking agencies also have worked together to improve examination policy, training, information sharing, and incident communication and coordination.

In addition, the FDIC has initiated a number of cybersecurity awareness and training programs. These include a series of "Cyber Challenges" that institutions can use to evaluate their preparedness to respond and restore operations as a result of a cyber-event.

Cybersecurity remains a long-term challenge for financial institutions in which it will be essential to continually adapt to new threats as they present themselves, if not before.

The Resolution of Systemically Important Financial Institutions

Now I would like to turn to the FDIC's work to enhance the stability of our financial system by addressing the orderly resolution of systemically important financial institutions.

The Dodd-Frank Act gave the FDIC important new authorities and responsibilities for facilitating the orderly resolution of systemically important financial institutions in the event that one of them should fail. Implementing those responsibilities and preparing to carry them out has been at the forefront of our list of priorities during the post-crisis period.

When the financial crisis hit in 2008, national authorities around the world were really quite unprepared to deal with the failure of a global, systemically important financial institution, or G-SIFI.

The crisis demonstrated that large, complex financial institutions *can* get into difficulty. Lacking the necessary authorities to manage the orderly failure of a large, complex financial institution, policymakers were forced to choose between two bad options: taxpayer bailouts or financial collapse.

In the United States, the Dodd-Frank Act provided, among other things, critical new authorities to manage the orderly failure of a systemically important financial institution.

Bankruptcy is the statutory first option under the framework. The Act requires the largest bank holding companies and designated nonbank financial companies to prepare resolution plans, also referred to as "living wills." These living wills must demonstrate that the firm could be resolved under bankruptcy without severe adverse consequences for the financial system or the U.S. economy.

The FDIC and the Board of Governors of the Federal Reserve System are charged with reviewing and assessing each firm's plan. If a plan does not demonstrate the firm's resolvability, the FDIC and the Federal Reserve may jointly determine that it is not credible or would not facilitate an orderly resolution of the company under the Bankruptcy Code and issue a notice of deficiencies. Ultimately, if a firm fails to submit a plan that demonstrates its resolvability in bankruptcy, the agencies may jointly impose requirements or restrictions on the firm or its subsidiaries, including more stringent capital, leverage, or liquidity requirements. The agencies may also restrict the firm's growth, activities, or operations.

If, after two years, the firm still fails to submit an acceptable plan, the agencies may order a firm to divest certain assets or operations to facilitate an orderly resolution under the Bankruptcy Code.

In August 2014, the FDIC and the Federal Reserve Board delivered individual letters to the largest financial firms regarding their second resolution plan submissions. In the letters, the agencies jointly identified common shortcomings of the plans, including the use of assumptions

the agencies regarded as unrealistic or inadequately supported. Further, the agencies found that the firms failed to make, or even identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly failure under bankruptcy. As a result, the agencies directed the firms to demonstrate in their 2015 plans that they are making significant progress to address all the shortcomings identified in the letters. The 2015 plans were submitted last July and are under review by the FDIC and Federal Reserve Board.

Given the challenges and the uncertainty surrounding any particular failure scenario, the Dodd-Frank Act also provides the Orderly Liquidation Authority, which is effectively a public-sector bankruptcy process for institutions whose resolution under the U.S. Bankruptcy Code would pose systemic concerns. This authority is triggered only after recommendations by the appropriate federal agencies and a determination by the Secretary of the Treasury in consultation with the President.

The Orderly Liquidation Authority is the mechanism for ensuring that policymakers will not be faced with the same poor choices they faced in 2008. Its tools are intended to enable the FDIC to carry out the process of winding down and liquidating the firm, while ensuring that shareholders, creditors, and culpable management are held accountable and that taxpayers do not bear losses.

The Orderly Liquidation Authority provides the FDIC several authorities—not all of which are available under bankruptcy—that are broadly similar to those the FDIC has to resolve banks. They include the authority to establish a bridge financial company, to stay the termination of certain financial contracts, to provide temporary liquidity that may not otherwise be available, to

convert debt to equity, and to coordinate with domestic and foreign authorities in advance of a resolution to better address any cross-border impediments. In the years since enactment of Dodd-Frank, the FDIC has made significant progress in developing the operational capabilities to carry out a resolution if needed.

Cross-Border Cooperation

As in the United States, major reforms have been enacted in other jurisdictions establishing systemic resolution authorities. In each of these jurisdictions, strategies are being developed and operational capabilities are being put into place. Similarly, these jurisdictions have recognized the importance of developing close relationships with other national authorities.

This cooperation is essential to identifying issues and addressing obstacles to cross border-resolution. There is an ongoing process among key jurisdictions to develop cross-border relationships that will foster the basis for cooperation in the event of the failure of one of our G-SIFIs or a foreign G-SIFI with substantial U.S. operations.

At the FDIC this has been a priority for several years.

The FDIC has worked closely with all the major financial jurisdictions – the United Kingdom, the European banking union, Switzerland, and Japan – to develop an understanding of how a G-SIFI could fail in an orderly way without imposing costs on taxpayers. This cooperation is essential to identifying and addressing obstacles to cross-border resolution.

The bilateral relationship between the United States and the United Kingdom is of particular importance. Of the 30 G-SIFIs identified by the Financial Stability Board, four are headquartered in the United Kingdom and eight are headquartered in the United States. Moreover, the majority of foreign assets held by the U.S. G-SIFIs are located in the United Kingdom.

To advance the close working relationships between U.S. and U.K. financial authorities, the FDIC hosted in October 2014 a meeting of the heads of the Treasuries, central banks, and leading financial regulatory bodies of the two countries. This event's high-level discussion furthered understanding among the principals regarding the key challenges to the successful resolution of U.S. and U.K. G-SIFIs, and how the two jurisdictions would cooperate in the event of a cross-border resolution. The event built upon prior bilateral work between authorities in our two countries, which, since late 2012, has included the publication of a joint paper on G-SIFI resolution and participation in detailed simulation exercises between our respective staffs.

At the same time, the FDIC is working with Europe's new Single Resolution Board, which oversees the Single Resolution Mechanism for the 19 Eurozone Member States, to provide support as the Board stands up its operation and to discuss cooperation and resolution planning for G-SIFIs with assets and operations in the United States and the Eurozone.

The FDIC and the European Commission have established a joint working group—with senior executives from the European Commission responsible for financial regulation and senior executives from the FDIC—that meets twice a year to focus on both resolution and deposit insurance issues.

Additionally, we have regular discussions with Swiss authorities to improve our understanding of issues that could arise in a cross-border resolution, and are planning a staff level table top exercise for this year. The FDIC also has held yearly bilateral meetings with our Japanese counterparts, including an in-person facilitated discussion, regarding multiple aspects of resolution strategies under the Federal Deposit Insurance Act, the Dodd-Frank Act, and the Japanese ordinary and special resolution regimes.

I would also note that cross-border crisis management groups of regulators have been formed for each of the G-SIFIs. The U.S. participates in the groups for all of the U.S. G-SIFIs and in a number of the groups for foreign G-SIFIs.

QFCs and TLAC

To illustrate how our cooperative efforts are improving resolution capabilities, let me point to two specific examples.

A major impediment to the orderly resolution of a financial firm is the potential for early termination of certain derivatives contracts, commonly referred to under U.S. law as "qualified financial contracts," or "QFCs." In the case of the Lehman Brothers bankruptcy, parties to such contracts were able to exercise early termination rights, resulting in the disorderly termination of the contracts and the fire sale of underlying assets.

Although the Dodd-Frank Act allows the FDIC to impose a temporary stay on QFCs, preventing parties from terminating their contracts immediately upon a firm being placed into an FDIC

receivership, this stay authority only addresses the risks posed by such contracts written under U.S. law.

Questions remain regarding contracts not subject to U.S. law. To address this problem, U.S. and foreign authorities, which face this same problem, needed to find a solution to avoid the early termination of contracts written under foreign laws. In 2014, the leaders of the FDIC, the Bank of England, the German authority BaFin, and the Swiss authority FINMA sent a joint letter to the International Swaps and Derivatives Association, or ISDA.

The letter discussed the importance of launching an initiative to allow for the continuation of derivative contracts, a major component of QFCs, when a resolution process is initiated. The goal was to prevent the initiation of a resolution process from severely disrupting financial markets. With the addition of the Japan Financial Services Authority, which later joined in the recommendation of the letter, the five major financial jurisdictions registered their support for work on this issue.

In November 2014, ISDA issued a resolution stay protocol to address the termination of covered over-the-counter derivative contracts in the event of a bankruptcy or public resolution of a systemic financial institution. In November 2015, ISDA announced an expanded version of the resolution stay protocol to capture "a wider universe of financial contracts," specifically securities financing transactions, which generally include repurchase agreements and securities lending transactions.

Initially, twenty-one major global financial institutions, which collectively represent a majority of the swaps market, adhered to the expanded version of the protocol. The provisions of the expanded protocol addressing cross-border recognition of stays for contracts not subject to

domestic law took effect on January 1, 2016. The Federal Reserve is expected to engage in rulemaking to codify compliance with the protocol. These efforts are essential to avoid gaming and to provide a level playing field for those institutions included in the rulemaking.

Another important effort by all the major jurisdictions has been to develop a standard for loss-absorbing capacity.

The purpose of such capacity would be to use it in the resolution of a failed or failing G-SIFI to keep its critical operations and services functioning until the institution and its subsidiaries can be sold, wound down, liquidated, or otherwise resolved. In the United States, this loss-absorbing capacity, particularly long-term debt, would make it possible for the top-tier parent company to be placed into receivership and a temporary financial holding company—termed a bridge financial company—formed to hold and manage the critical operating subsidiaries throughout the liquidation and wind-down process.

For this strategy to work, however, the parent company needs to hold sufficient debt to absorb losses and recapitalize its subsidiaries. There is now broad agreement internationally on the need for a minimum standard to provide such loss-absorbing capacity in the event of a failure of a G-SIFI.

On November 9th, the Financial Stability Board issued its Total Loss Absorbing Capacity, or TLAC, standard and Term Sheet. Prior to that, the Federal Reserve announced the issuance of a Notice of Proposed Rulemaking on TLAC that included a long-term debt requirement for G-SIFIs with operations in the United States. The proposed rule would require U.S. firms to maintain a minimum amount of long-term unsecured debt outstanding at the holding company level. All covered intermediate holding companies of foreign banking organizations would be

required to maintain a minimum amount of internal TLAC in the form of outstanding eligible internal long-term debt instruments.

I believe that the improved cooperation among international regulatory authorities that has emerged since 2008 will not only help to mitigate common obstacles to resolution, but will also lead to a cross-border response that would be more effective and that would minimize the possible contagion effects that could result from the resolution of a G-SIFI. Fostering our cross-border relationships with key foreign jurisdictions remains an ongoing priority for the FDIC's work on systemic resolution.

Conclusion

The sustained recovery that has taken place in the financial performance and condition of the U.S. banking sector since 2008 has put the industry in a much stronger position than it found itself on the eve of the crisis. The improvement that has taken place in capital and liquidity positions, as well as the declines that have been observed in problem loans, have made the U.S. banking industry into a more reliable source of credit for the U.S. economy and a more secure foundation for financial sector stability during times of market stress.

Nonetheless, supervisors continue to address a range of market, credit, and operational risks, including those posed by the potential for adverse developments in the economic environment. The recent volatility we have seen in credit markets speaks to the ongoing challenges bank risk managers must address.

During the post-crisis period, the FDIC also has continued to work toward effective implementation of its new resolution authorities under the 2010 Dodd-Frank Act.

We have developed relationships and protocols with foreign regulatory authorities to promote the type of cross-border cooperation we know will be essential to resolving globally systemic institutions in a future crisis.

The net effect of these post-crisis developments is a U.S. banking system and regulatory framework that today is more resilient to shocks than was the case before the last crisis.

Yet, much work remains. It is essential that we sustain these efforts going forward to ensure that our financial system continues to be a source of stability for the U.S. economy.

Thank you.