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Statement by

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

Banking Conditions

Overall, the banking system remains sound and resilient. Banks continue to report capital and liquidity ratios above minimum regulatory levels. Overall asset quality remains generally sound. Lending continues to grow but has slowed from the rapid pace of 2022, reflecting decreased demand and tighter lending standards.

Capital ratios increased throughout 2023, leaving the system better positioned to weather potential losses, such as those from defaults on loans, or declines in the fair value of investment securities, which continued to accumulate at some banks this past year.

Liquidity conditions overall are stable. Notably, liquid assets on bank balance sheets remained above their 10-year average throughout 2023, largely the result of a significant buildup in cash positions. Aggregate deposits were generally stable in the second half of 2023 and have been steadily increasing in the first three months of 2024, reaching a level not seen since before the stress of March of last year. Additionally, there has been a decrease in the share of uninsured deposits in the system.

However, both supervisors and banks must remain vigilant and ready for expected and unexpected stresses, and presently there are several risks we are monitoring. For example, delinquency rates are rising among certain commercial real estate (CRE) loans, such as those backed by offices, and some consumer loan sectors. CRE delinquencies are now at a five-year high. Credit card and auto loan delinquencies have been rising. In response to rising delinquencies, banks have increased loan loss provisions. On this basis, combined with their capital positions, the banking sector as a whole should be prepared to absorb loan losses that may materialize and continue fulfilling its vital role providing credit to households and businesses. The Federal Reserve continues to monitor these conditions closely.

The recovery from the acute stress experienced in March of last year is in no small part due to the success of the Bank Term Funding Program (BTFP). This program was established shortly after the failure of Silicon Valley Bank (SVB) to help assure the stability of the banking system and to support the economy. The BTFP helped to alleviate liquidity pressures, particularly for banks that had experienced significant declines in the value of securities. The BTFP ceased making new loans as scheduled in March without any related liquidity stress in the banking system.

Supervision

It has been a little over a year since the sudden failure of SVB and ensuing stress in the banking system—events which prompted questions about how banks manage risks and how we at the Federal Reserve and other agencies supervise that risk-taking. As noted in my testimonies last year, these events highlighted the need to improve the speed, force, and agility of supervision to align better with the risks, size, and complexity of supervised banks, as appropriate.

As the banking system changes, supervision must adapt with it and appropriately account for banks of different sizes and levels of complexity. Risks can materialize quickly and come from various sources, and in March of last year, we saw that these risks can lead to failure more quickly than ever. Therefore, supervisors must take timely action as risks build up; deploy supervisory tools and escalation effectively; account for changes in market, economic, and financial conditions in their examination priorities and supervisory conclusions; and identify new and different patterns of risks. We have been making progress on these goals.

First, we are working to ensure supervision intensifies at the right pace as a bank grows in size and complexity. This involves more frequently assessing the condition, strategy, and risk management of large and complex banking organizations and engaging more frequently with these firms through the supervisory process. Additionally, supervisors are encouraging growing regional banking organizations to enhance their risk capabilities commensurately with their risk profiles so that the transition to higher standards is more of a gradual slope rather than a cliff.

Second, we are modifying supervisory processes so that once issues are identified, they are addressed more quickly by both banks and supervisors. For example, examiners have been conducting additional supervisory activities for firms with large unrealized losses on securities, high CRE exposures, or other material vulnerabilities. Where weaknesses in risk management have been identified, examiners are requiring firms to address these weaknesses promptly and encouraging them to bolster their capital and liquidity positions.

Third, we are finding ways to better incorporate forward-looking analysis into supervision. A forward-looking view supports the goal of identifying and addressing material risks before they become serious issues. Forward-looking risk analysis also may help to challenge supervisory assessments and foster meaningful action where risks are underappreciated.

Regulation

The lessons learned from SVB are not only applicable to our supervisory framework. Certain aspects of the failure showed that enhancements to our regulatory framework would benefit the safety and soundness of our banking system.

Long-Term Debt

One of these enhancements was already in process several months before SVB's failure through an advance notice of proposed rulemaking—expanding the application of long-term debt requirements to additional large banks. Subsequently, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the agencies) followed up with a proposed rule calibrated to reflect the lower risk profiles of such banks as compared to the largest and most complex. The proposal would increase the options available within the resolution process and enhance financial stability. Losses to the Deposit Insurance Fund related to the bank failures last year could have been mitigated in part by the proposed requirements. We are going through comments we received on this proposal carefully.

Liquidity

Another important area is liquidity risk management. A striking feature of last year's bank stress was that SVB, Signature Bank, and First Republic struggled to cope with unprecedented deposit outflows arising from a loss of confidence by their uninsured depositors. Other banks that experienced spillovers during this period struggled with insufficiently robust liquidity risk management. Banks found it difficult to monetize their held-to-maturity securities through repo transactions under severe stress and were not adequately prepared to utilize the Federal Reserve's discount window. Additionally, the stress revealed that some forms of deposits—such as those from venture capital firms, high-net-worth individuals, crypto firms, and others—may be more prone to faster runs than previously assumed. We are exploring targeted adjustments to our regulatory framework that would address each of these concerns: deposit outflows, held-to-maturity monetization, and discount window preparedness.

Discount Window Operations

Discount window preparedness is essential. The Federal Reserve's lending to banks through the discount window plays an important role in supporting the liquidity and stability of the banking system and the effective implementation of monetary policy. By providing ready access to funding, the discount window helps depository institutions manage their liquidity risks. Providing liquidity in this way is one of the original purposes of the Federal Reserve System. It is important that we continue to work to improve this tool. To that end, we are reaching out to a wide range of depository institutions of all sizes to learn from their experiences with the discount window. From this outreach, we will identify and prioritize changes to operations that can improve the efficacy of our liquidity provision.

Capital

A safe and sound banking system is critical to a healthy economy, and capital is foundational to safety and soundness. Well-capitalized banks have more capacity to support the economy by continuing to lend to households and businesses through stressful conditions. A well-capitalized banking system reduces the probability that stressful conditions result in financial crises, which inflict devastating economic costs and suffering for families and businesses all across the country. Strong capital also reduces the risk that the government would need to intervene in unusual and exigent circumstances.

This brings me to the agencies' proposal to enhance capital requirements. Since my last testimony, we have received numerous and meaningful comments on the proposal. We also received additional data from a special data collection. We are closely analyzing this information, and I expect we will have a set of broad, material changes to the proposal that allow us to have a broad consensus in moving the proposal forward. The changes will enable us to have a safer financial system that better serves American households and businesses.

Thank you. I am happy to take your questions.