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Written Testimony
House Financial Services Committee
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Chairman Frank, Ranking Member Bachus, and members of the Financial Services Committee, thank you for the opportunity to testify before you today about international regulatory issues relevant to the implementation of the Dodd-Frank Act, particularly reform of global capital standards.

Last week the Federal Reserve, the OCC, and the FDIC reached agreement with their principal foreign counterparts to substantially increase the levels of capital that major banks will be required to hold. As a result of this agreement, banks will have to hold substantially more capital. The new standards are designed to ensure that major banks hold enough capital to withstand losses as large as what we saw in the depths of this recession and still have the ability to operate without turning to the taxpayer for extraordinary help.

This agreement will make our financial system more stable and more resilient. By forcing financial institutions to hold more capital, we will both constrain excessive risk-taking and strengthen banks' abilities to absorb losses. This agreement is designed to allow banks to meet these more stringent standards gradually over time, so that they can continue to perform their essential function of providing credit to households and businesses.

These standards will help establish a more level playing field around the world. By moving quickly to recapitalize our financial system, we have been in a strong position to insist on tough standards abroad.

The Importance of Capital and Liquidity

Excess leverage, a term that describes the amount of risk firms take relative to the financial reserves they hold against those risks, has played a central role in virtually all financial crises.

Capital requirements determine the amount of losses firms can absorb and the magnitude of the risks they can take without risking failure. They help the market provide discipline by forcing shareholders who enjoy profits in good times to be exposed to losses in bad times.

Capital requirements are the financial equivalent of having speed limits on our highways, antilock brakes and airbags in our cars, and strong building codes in communities prone to earthquakes.

Failures in our system of capital requirements were major contributors to the severity of this crisis. Where we had capital requirements, they were too low and they were not supplemented with complementary liquidity requirements. Furthermore, there were no systematic capital requirements in the rapidly emerging "shadow banking" system. Finally, capital standards were not applied consistently around the world. Banks in many parts of the world were allowed to operate with low levels of capital relative to the risks they took on.

At last year's Pittsburgh Summit, the G-20 Leaders, led by the Obama Administration, called for financial institutions to raise the quality and quantity of capital, strengthen liquidity standards and implement rules to limit leverage. Strengthening capital requirements for major financial institutions was also an important objective in the legislative debate on reforming U.S. financial regulation. Both the Dodd-Frank Act and the Basel process are designed to ensure that major financial institutions are subject to rigorous and consistent capital requirements. The agreement just reached in Basel is an important step towards realizing that goal and fulfilling the G-20's call, and it will be presented to G-20 Leaders at their November Summit in Seoul.

The New Standards

The work of the Basel Committee over the last year, culminating in the agreement announced last week, will significantly tighten the system of global capital requirements in a number of important ways.

First, the amount of capital that banks will be required to hold relative to risks they take will increase substantially.

Under the new agreement major banks will be subject to two tiers of capital requirements. All firms will need to hold a substantial minimum level of capital. Further, they will be required to hold an added buffer of capital above the minimum. If a firm suffers losses that force it to eat into that buffer, it will have to take active steps, such as reducing dividends or limiting share repurchases, to restore the buffer. The buffer is important because it will force banks to move more quickly to strengthen their balance sheets as the risk of potential losses increases.

Capital requirements are set relative to a bank's assets, which are weighted to reflect the riskiness of those assets. That is, capital requirements are defined as a ratio of so-called "risk-weighted assets" (RWA). The level of the new minimum and buffer – 4.5 percent and 2.5 percent of banks' RWA, respectively – have been set to ensure that major banks hold enough capital so they can withstand losses similar to what we saw in the depths of this recession and still have the ability to operate without turning to the taxpayer for extraordinary help.

Second, banks will be required to hold more capital against more risky products and activities, including derivatives, which caused substantial financial damage during the crisis. These assets and exposures are held predominantly by the very largest firms. Consequently, this aspect of the Basel reforms will generate large increases in capital requirements for risky activities typically undertaken by the biggest banks, but is likely to have only a modest impact on smaller banks.

Third, the Basel agreements will improve the quality of capital that banks hold. In contrast to the current rules, which allow a wide range of forms of capital, the new requirements are set in terms of high quality common equity, tightly defined to mean capital that will truly absorb first losses when firms get into trouble.

Taken together, the new Basel agreements impose a very substantial increase in capital requirements on banks around the globe. The change in the ratios alone represents more than a three-fold increase in high quality capital required in the system. Before the recent crisis, banks were implicitly required to hold common equity equal to 2 percent of their risk weighted assets. Now banks will effectively be required to hold tangible common equity equal to 7 percent – the

4.5 percent minimum plus the 2.5 percent buffer – of their risk-weighted assets. In addition, both the new more restrictive definition of what is allowed to count as capital and the more stringent assessment of the risks associated with derivatives, trading-related assets, and exposures to other financial firms will effectively raise capital requirements even further. Importantly, these additional effects will fall most heavily on the largest, most inter-connected banks.

In addition to new capital requirements, the Basel Committee has agreed to impose new global standards for liquidity management. During the recent crisis banks were poorly prepared for the funding pressures that occurred, and this was a major factor that intensified stress throughout the financial system. The new liquidity standards are designed to ensure that firms can withstand a severe shock in liquidity without deepening a crisis by, for example, selling assets in a panic, cutting credit lines indiscriminately, or turning to central banks for excessive liquidity support.

The Basel Committee also agreed that banks should be subject to a U.S.-style cap on leverage as a backstop for the more complex risk-weighted capital requirements. The new internationally applied leverage ratio requirement will, for the first time, include firms' off balance sheet commitments and exposures.

Finally, the recent agreement, by providing a more constrained definition of capital and by expanding to include new international standards on liquidity and aggregate leverage, provides a framework for more rigorous and consistent global capital standards.

We cannot know with certainty how the economy and the financial system will evolve, but these heightened capital requirements, along with other important reforms, should substantially reduce the likelihood that we will soon repeat the sort of severe financial crisis that we have just lived through.

The Transition

Capital requirements are going up substantially. But if we were to raise them too fast we could hurt economic recovery. To limit that possibility, the agreement gives banks a meaningful transition period to meet the new standards.

The new capital requirements will not become effective until the beginning of 2013, and banks will not have to meet the full minimum common equity capital requirement of 4.5 percent of risk-weighted assets until the beginning of 2015. The buffer will be phased in between 2016 and 2019. In addition, the definition of capital becomes progressively more stringent between 2013 and 2018.

It is important to note that because we moved so quickly with the bank stress tests in early 2009 that forced banks to raise more common equity, the U.S. financial system is in a very strong position internationally to adapt to the new global rules. For the most part, banks should be able to meet these new requirements through future earnings, which will help protect the recovery currently underway.

The Road Ahead

The agreement that has just been reached is a major milestone in the process of reforming global capital standards. But we still have more work to do.

The liquidity requirements are a new part of the Basel system. We will need to make sure that they are calibrated correctly before they are fully implemented.

It is also essential that the Basel agreements are implemented by national authorities in a way that generates a 'level playing field' in our increasingly integrated global financial system. We will engage our foreign counterparts to look for ways to ensure that that these agreements are implemented in a transparent and consistent way by supervisors in different countries.

We will also continue to explore innovative ways, such as the use of counter-cyclical buffers and contingent capital, to expand the capacity for the system to absorb unexpected losses without amplifying shocks to the system.

The new capital standards have to be implemented at the national level. The agreement that was just reached, and other so-called Basel III proposals, must be fully implemented through national regulations by the end of 2012. The United States is committed to meeting these deadlines.

In conclusion, the agreement reached in Basel last week, working with the Dodd-Frank Act, will significantly lower the probability and severity of future financial crises, and it will help protect taxpayers by limiting excessive risk-taking by financial institutions. The Basel agreement is the result of thoughtful and diligent work by the men and women of key regulatory and supervisory agencies here and around the world. We owe them our thanks.