FINANCIAL REGULATORY REFORM: THE INTERNATIONAL CONTEXT

HEARING

BEFORE THE

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FINANCIAL REGULATORY REFORM: THE INTERNATIONAL CONTEXT

Thursday, June 16, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Hensarling, Royce, Manzullo, Biggert, Capito, Garrett, Neugebauer, McHenry, Pearce, Posey, Fitzpatrick, Westmoreland, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Hurt, Dold, Schweikert, Grimm, Canseco, Fincher; Frank, Waters, Maloney, Watt, Sherman, Capuano, Hinojosa, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Ellison, Perlmutter, Carson, and Carney.

Chairman BACHUS. The hearing will come to order.

Without objection, all members' written statements will be made a part of the record. The Chair will recognize himself for an opening statement.

When President Obama signed the Dodd-Frank Act into law last summer, he set in motion the most ambitious changes in financial institution regulation since the Great Depression.

While American regulators and financial institutions sort through its 2,300 pages to find out what the new legislation means for them and to race to meet its deadlines, the international implications of the law have garnered relatively little attention.

Receiving even less attention has been the work of the Basel Committee on Banking Supervision. Last November, the G-20 formally adopted its recommendations for Basel III, a new global framework for determining the minimum amount of capital that banks must hold to cushion against losses or insolvency. These complex matters are too significant to ignore.

During today's hearing we will examine the implementation of these new bank regulations and the implications for the competitiveness of our financial markets. We need to know, if we lead, will others follow? Does it matter?

It has been said that if banks impose cost and risk on a country's economy, the country is better off with rules that limit the risk and cost, even if others are not doing the same.

That might be true, if the only risk and cost to a country were the risk and cost of bank failure. But there are other threats and dangers. If we overregulate and ignore the plans of the rest of the world, then I fear we will push capital, industry, and jobs out of the country.

At a time when each new release of government data seems to underscore the sensitivity of our economic recovery, it is fair to ask Treasury and other agencies represented on our first panel whether they have carefully considered the cumulative effect that the tsunami of regulatory mandates unleashed by Dodd-Frank is having on the real economy.

We will be discussing four critical issues during this hearing and raising important questions I hope our panelists will address.

First, capital and liquidity. Will the Basel III rules make the financial sector more stable? And if so, at what cost? Is a banking system awash in capital worth the potential trade-off of slower economic growth, less innovation, and diminished credit availability?

Second, regulation of SIFIs. Is Governor Tarullo's proposal to impose additional capital requirements on the SIFIs that reflect the amount of harm a SIFI failure will inflict on the rest of the financial system the right approach, or will it just make U.S. significantly important financial institutions less efficient and less competitive without making the system safer?

As we dial up the capital and liquidity constraints on the regulated financial sector, do we run the risk that more activity will migrate to the shadow banking system and the jurisdictions offering a lighter regulatory structure?

Third, derivatives regulation. Should we expect that participants in derivatives markets will shift their business to non-U.S. firms, if other countries refuse to follow our lead on margin and capital requirements? How should we expect U.S. firms to compete if they face higher costs than their foreign competitors?

And fourth, regulation of proprietary trading. Not even Paul Volcker claims that proprietary trading caused the financial crisis in 2008, but the Dodd-Frank Act Volcker Rule prohibits banks and non-bank financial companies from engaging in trades for their own gain.

Now that the rest of the world has rejected the call to impose similar proprietary trading bans on their institutions, what effect will unilateral U.S. application of the Volcker Rule have on the liquidity and vibrancy of our capital markets?

These are important questions, and I am pleased we have two distinguished panels of witnesses with us today to answer them. I look forward to the discussion, and I will now recognize the ranking member.

Mr. FRANK. Mr. Chairman, before I start, how much time on each side?

Chairman BACHUS. We have 12 minutes on each side.

Mr. FRANK. Then I will yield myself 5 minutes.

Chairman BACHUS. Okay.

Mr. FRANK. I was looking at the testimony of Mr. Zubrow, which we will hear later, and I was pleased to see him say in his first page, "Certainly, the financial crisis exposed serious flaws in the U.S. regulatory system, particularly the dangers of unchecked leverage and regulatory arbitrage. Most of the reforms imposed in the wake of the recent financial crisis by market participants, accounting authorities, supervisors, regulators and the Congress will improve the soundness of our system while allowing U.S. firms to remain competitive."

I appreciate that, because that is the framework in which we operate.

Now, within that framework there are several things we want to do: first, to make sure that capital is adequate; and second, not to put American institutions at a competitive disadvantage. But there are a couple of points I want to make about this first.

And I say to my friends in the financial industry, you do understand that we have to separate, to the extent that we can, two important desires that you have. One is not to be regulated in a way that puts you at a disadvantage vis-a-vis your foreign competitors, and two is the desire not to be regulated.

Now, I understand that. That doesn't make you bad people. Everybody would rather do what he or she wants and not be told what to do by others. And we won't always be able to make that clear.

But I do have to say, we have had a history—and that is why I was pleased that Mr. Zubrow mentioned; this is Mr. Zubrow, who is the chief risk officer of JPMorgan Chase—"the dangers," he said, "we learned of unchecked leverage and regulatory arbitrage."

Regulatory arbitrage is one of the factors we have to deal with, but what we have in part is a problem in which the desire of American institutions not to be regulated and the desire of European institutions not to be regulated can reinforce each other, and it is important for us to single those out.

There is a second point I want to make to my friends in the financial community, and I think another important distinction we have to keep in mind that I must say, to be honest, they don't always—and I can understand that—they are the means to a sound financial system. They are not the end. Their profitability in and of itself is not important to anyone other than themselves.

That doesn't make it unimportant. They have that right. But their role in the financial system is to be the intermediary. Their role in the financial system is to help us gather enough capital in the system from a variety of sources and make it available to people who will do things productively.

The fact that a particular financial institution may or may not be making a good profit is really not a matter for public policy.

That does not mean, as some have suggested, that we should set out consciously to try and reduce the role of the financial sector in the economy, although there was a very interesting paper by Adair Turner from the Financial Services Authority raising some of these questions.

It does say to me that if, as a consequence of regulation that we think preserves the safety and soundness of the system, the simple fact of a reduction in profitability from some very profitable institutions with some very well-paid executives is not a problem.

It is a problem if that reaches the point where it interferes with our ability to have capital formation. And I want to look at that.

Now, we also have the question of what comes first, the chicken or the egg? And that is a particular problem here. There is a danger that various financial institutions in each country will lobby to the point where there is an overall reduction.

I am told by some of our regulators that when they talk to their European counterparts in particular, they are told that the counterparts hear the same things that they hear: "If you don't stop, we are moving elsewhere."

I do know, for example, in the area of compensation, there is a strong argument from Europe, and I heard it myself from Michel Barnier, the markets commissioner of the European Union, that the extremely lax rules in America on compensation for chief executives puts Europeans at a disadvantage, that in fact Europe has much tougher rules on compensation.

That doesn't drive me to do anything differently, but I do have to note that.

I understand people talk about the level playing field and we are told that we won't have a level playing field here if we are too tough. I have noted something extraordinary about the level playing field, which would defy logic.

That is, in all the years I have heard people complain about the unlevel playing field, I have never heard of an instance in which anybody was at the top of the unlevel playing field. It is a constantly declining playing field. Maybe I get a Nobel prize for that, like a constantly declining—I yield myself another minute.

We have a constantly declining playing field in which everybody is at the bottom and no one has ever been at the top. And I worry that we get into that same situation in which all the financial institutions in the world will be able to prove to their regulators that they are at a disadvantage vis-a-vis every other financial institution in the world, and the result will be a net lowering.

There were some reasonable points to be made. I do not think, for example, that margin requirements on sovereign entities are a good idea. I could be persuaded otherwise. My New York colleagues have pointed out a very particular case where there might be some disadvantage.

I do believe, and I will be interested if the regulators have any different view, that the law as adopted gives them the flexibility to take that into account. I do not think that the CFTC would be mandated to do things that would put people at a disadvantage, if that can be clearly established for no other purpose.

But the general framework is, yes, as Mr. Zubrow said, we had a problem of unchecked leverage. We had a problem of there not being enough rules. We got into a terrible financial crisis because we hadn't done appropriate regulation.

And as we do the regulation, it is important to keep in mind two things, that the role of the financial institution is not to make money for themselves, but to be the intermediary between the various sources of capital and people who will put it to good use, and the need not to allow a competition to be used simply to denigrate regulation in general, but rather to try to get cooperation so that we get a good regulatory scheme that puts no one of our people at an international competitive disadvantage.

Chairman BACHUS. Thank you.

Mr. Royce for 1 minute?

Mr. ROYCE. Given where the financial crisis originated, Mr. Chairman, it is unfortunate how far off the radar this reform effort has gone. Let us not forget this all started when Congress decided to embark on a course of social justice to get everyone who wanted one into a home regardless of whether or not they could afford it. Then came the crisis, followed by Dodd-Frank.

Let us be clear: An avalanche of regulation doesn't mean better regulation. The new regulations were simply piled on top of the old ones. Will it make our financial system any safer? Unlikely.

Rather than giving markets more stability, this new law fundamentally weakened the global financial system by encouraging capital flight out of the most stable and liquid markets in the world.

Buried in the pile of new regulations coming down the pike may be a few good ideas, such as higher capital standards. Unfortunately, this effort is getting trumped by 2,300 pages of government attempting to micromanage virtually every player throughout our financial system.

As The Wall Street Journal noted today, the most competitive banking system is one with high capital requirements and few rules on the extension of credit, whether to a consumer or a corporate derivatives customer.

It is up to us to correct the mistakes and ensure the end result is a financial system built on higher capital, built on market discipline and commonsense regulation.

I yield back, Mr. Chairman.

Chairman BACHUS. Thank you.

Ms. Waters for 2 minutes?

Ms. WATERS. Thank you very much, Mr. Chairman.

I would like to thank our witnesses for coming today, particularly Chairman Bair, whose 5-year tenure at the FDIC will come to an end on July 8th.

Chairman Bair, I imagine this may be your last time testifying before this committee, so I would like to thank you for your service during this unprecedented, turbulent time for our Nation's financial system.

It has been almost a year since Democrats in Congress passed the most sweeping reform of our financial market since the Great Depression. Because of that reform, our regulators now have the tools to closely monitor systemically significant institutions, unwind failing firms in an orderly fashion, regulate the shadow banking industry, and bring transparency to the derivatives market.

Of course, the statutory authority we provided will only be as effective as the rules adopted to implement that authority, and the ability to prevent another crisis will only be realized if regulators are willing to test-drive the enforcement and resolution powers we granted.

Our hearing today is about implementation of Dodd-Frank, as well as Basel III. And I am very interested to hear from our regulators about how they are cooperating with their international partners. I am also interested to hear from the industry witnesses on the second panel, who are concerned about their competitive position relative to their international counterparts.

But I think it is extremely important to caution against engaging in a global race to the bottom when it comes to financial regulation. If we water down financial reform in order to entice firms to locate in the United States, we may find the only thing we have accomplished is ensuring that the next bailout recipient is headquartered in the United States.

As I have said consistently, strong, transparent, and fairly regulated markets are our best way to increase certainty, prevent another crisis, and create jobs.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Chairman BACHUS. Thank you.

Mr. Hensarling for 1 minute?

Mr. HENSARLING. Thank you, Mr. Chairman.

This week is the 1-year anniversary of the Administration's summer of recovery. We now have one in seven Americans on food stamps. New business starts are at a 17-year low.

It now takes 10 months, according to the Bureau of Labor Statistics, to find a job. This is the longest period in recorded history. And we now have 28 months where unemployment has been north of 8 percent, the longest period of sustained high unemployment since the Great Depression.

We now have on top of this, Dodd-Frank signed into law—which is fraught with intended and unintended consequences—that I believe has impeded and will harm job creation in America.

Dodd-Frank was not passed in the E.U. It was not passed by the G-20, and our regulators must proceed with great care. We do not know what the total impact is. We cannot afford greater job loss.

I yield back.

Chairman BACHUS. Thank you.

Mrs. Maloney for 2 minutes?

Mrs. MALONEY. Thank you, Mr. Chairman, for calling this hearing.

I welcome all of the witnesses today and thank you for your service.

And I join my colleagues in thanking Sheila Bair for her extraordinary leadership during one of the most difficult times in our history.

You did an incredible, outstanding job. Thank you. And I am interested in seeing what your next goal will be, and I am sure you will continue to have an outstanding career in service to our country.

I join the chairman and the ranking member in expressing my concern for any competitive disadvantage for American institutions in the world economy.

I am particularly concerned about a requirement in the Dodd-Frank Wall Street Reform Act, which responded to the worst financial crisis in our country's history since the Great Depression and certainly moved forward with an improved regulatory infrastructure in the financial services sector.

It was very clear that our infrastructure had not kept pace with the development of financial products and services, and it was a long-needed reform.

But I am concerned about one of the features in it that would impose heightened capital requirements on the most complex U.S. banking entities and unbanked financial institutions. And I wonder if this SIFI surcharge adopted under Basel III satisfies that requirement, or is this an additional burden that would be on our financial institutions? And what would that impact be?

Also, with the implementation of Basel III and Dodd-Frank, how the implementation schedules are different, how you are coordinating that, how you are working with our European counterparties and other counterparties across the world to make sure that we are moving in the same direction and, hopefully, enacting similar regulations.

I had raised these concerns with Federal Reserve Chairman Ben Bernanke during his annual testimony before our committee. And he had indicated that he thought that we could be at a competitive disadvantage.

I look forward to hearing what your comments are on the capital requirements specifically for entities and complex U.S. entities and nonbanks.

Chairman BACHUS. Thank you, Mrs. Maloney.

Mrs. MALONEY. Thank you.

Chairman BACHUS. Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

One of the most important dynamics of implementing regulatory reform is to keep our U.S. financial industry competitive. Without a strong financial sector that can issue loans and supply capital to help businesses grow and create jobs, our economy will continue to falter. More jobs will be lost.

If we unnecessarily constrain American financial institutions through unlevel standards to those of their international competitors, businesses will migrate to the international competitors. And if we restrict our financial institutions from providing innovative and competitive products to consumers, consumers will look elsewhere.

It is counterproductive if the most stringent regulation of our U.S. financial institutions drives businesses overseas and shifts risky behavior to unregulated sectors of the economy. We must find the right balance. U.S. jobs and our economy depend on it.

And I would like just for a moment to also talk about Sheila Bair. I think you have done a wonderful, wonderful job in your role during this financial crisis, and I know that whatever you do next is going to be very important, and I know that will also help all of us in this country. We thank you so much for all that you have done.

Thank you.

Chairman BACHUS. Mr. Scott for 2 minutes?

Mr. DAVID SCOTT. Thank you, Mr. Chairman.

Welcome, panel.

And I would like to also convey my deep appreciation to Ms. Bair for her excellent work.

I want to talk about the international aspects of this, but there is no more important deal for us to in our financial system to take care of a pressing issue at home.

And so I want to start off by putting on the table—hopefully, your comments will reflect—I am certainly going to ask a question—on our failure of our financial system right here at home to deal with this extraordinary problem of home foreclosure and the downward turn of home values. I think our standing in the world is going to go down with our failure to address this.

We have a problem with our loan servicers and our banking establishment. They are good people, but we have to figure out a way to get them, our financial system, to be more responsive to the issue of home foreclosures. It is the core that will drag our economy down and we are not responding. So I hope that as we move on in some of our comments, we can get that.

But I also want to mention that the Dodd-Frank measure in terms of international aspects, the measure included requirements for increased transparency of derivatives by mandating that they be traded on transparent exchanges and by pursuing legal recourse against banks that violate this condition.

And although the provisions of the Dodd-Frank Act are a needed reform to the derivatives market, parts of the financial industry have expressed concern regarding the application of these regulations in foreign countries, particularly their effect on competitiveness.

The rules would require international branches of U.S. banks to collect margins from financial end-users for uncleared swaps, thus potentially jeopardizing their ability to compete with foreign entities.

And in addition, it is unlikely that foreign jurisdictions will adopt similar laws as that within the Dodd-Frank law, since the issue was not addressed as part of the G-20 accords.

So I would like for us to, as we move forward in the question-and-answer period, both address that and certainly reflect here what is happening at home with foreclosures, and particularly, as I am putting together a major event in Atlanta, Georgia, this weekend, to address that.

So your comments will be very much appreciated on those two issues—derivatives and home foreclosures.

Thank you very much, Mr. Chairman.

Chairman BACHUS. Thank you.

Mrs. Capito for 1 minute?

Mrs. CAPITO. Thank you, Mr. Chairman.

I think there are many lessons that we learned from the recent financial crisis, but few are more clear than that we are in a global financial system that is more interconnected than ever before.

On the one hand, we see technological and communication advances that allow companies from around the world to interact. But on the other hand, we have seen in the last few financial crises, problems in one part of the globe can flow throughout the entire financial system.

Whether we supported Dodd-Frank or not, it set a new regulatory benchmark across the entire financial services industry. The regulators before this committee today are going to bear a considerable burden on writing hundreds of rules and regulations.

I would encourage you all to move forward with caution, and to work with your counterparts from around the globe to ensure that America remains a financial leader.

We have the opportunity today to bring an important discussion in front of the committee about the cumulative effects of Dodd-Frank on financial institutions. I think failing to examine the aggregate cost of compliance with Dodd-Frank could lead to job losses and, in the worst case, a downgrade of the United States as a financial center.

I look forward to hearing from our witnesses today, and I thank the chairman for holding this hearing.

Thank you all.

Chairman BACHUS. Thank you.

Mr. Garrett for 1 minute?

Mr. GARRETT. Thank you, Mr. Chairman.

So as far as international coordination of financial reform is concerned, I guess we are a long way from the solidarity that we had back in 2009, back in Pittsburgh, with the G-20 to where we are today.

I guess that is because there are some substantial differences beginning to emerge between Dodd-Frank financial reform and what we are seeing in the rest of the world.

Back then, it was more like, "Well, you lead here in the U.S., and we will follow," for the rest of the world. Now, it is, "You lead here in the U.S., and we will sort of pick and choose as to what we are going to follow with."

That is because: Dodd-Frank has the Volcker Rule, and they don't; Dodd-Frank requires multi-dealer exchange trading of swaps, and they don't; Dodd-Frank wants pension funds to tie up more retirement money as collateral for trades, and they don't. Those are just a few examples.

So because of that, this country now risks capital and jobs fleeing this country, going overseas, and impairing our economy and our competitiveness.

The overreaching policies that were codified in Dodd-Frank have basically incentivized other countries to do what we would think they would do—increase their taxable revenues through basically strategic regulatory arbitrage.

And so, the cumulative impact of all these new regulations may be hard to measure, but that is precisely what the FSOC must undertake to do. What is the total cost of all this additional regulation in the form of jobs and economic growth? Which of these regulations actually address real problems and which ones simply add cost?

This type of economic and cost-benefit analysis must be done now. Why? Because the stakes are just too high to do it otherwise and get it wrong.

With that, I yield back.

Chairman BACHUS. Thank you.

Mr. Neugebauer?

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

I am putting a chart up, and I apologize; it is a small chart. But basically, these are the 50 top financial firms by country by market cap. And over on the far right-hand side in 2003, the United States had 51 percent of the total capitalization.

You move into 2006, it dropped to 35 percent of total market capitalization. And then U.S. companies in 2010 moved to 24 percent of market capital, with China going from 1 percent in 2003 to 22 percent in 2010. You also see a little bit of a shrinking in the E.U. and the U.K.

And so when we talk about how important market harmonization is, and regulatory harmonization, it is extremely important that we accomplish that goal, because already we are seeing a migration of capital to these other countries.

And for those of you who maybe don't understand jobs creation, capital is a primary driving force for that, and that is the reason, if we are trying to create jobs, we need to make sure that capital is in the United States of America.

What I am extremely concerned about—and I appreciate the chairman holding this hearing today—is that if we do not make sure we get this right, we will see further deterioration of capital formation in the United States of America. And that is going to mean more unemployment and less jobs for American families.

With that, Mr. Chairman, I yield back my time.

Chairman BACHUS. Mr. McHenry for 30 seconds?

Mr. MCHENRY. Thank you, Mr. Chairman.

I am deeply concerned that the cumulative effect of all these regulations will be a vacuum, and that will be the huge sucking sound of capital out of our market into other markets across the globe. And this is at a very time when we have companies that are starved for capital in order to create jobs.

This week, the head of Japan's second-largest bank predicted that our stringent regulations on Western banks will help double their lending. This is a great example of the loss of competitiveness, and I hope that the regulators will understand this, that our folks are starved for capital, and we need to get more capital on the street so we can actually create jobs.

I look forward to this hearing from the panel.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you.

Mr. Manzullo?

Mr. MANZULLO. I thank the chairman for calling the—

Chairman BACHUS. Oh, 30 seconds, Mr. Manzullo.

Mr. MANZULLO. It is ironic that you talk about the international context when still I have companies back home, factories with orders, business people who are unable to get their lines of credit renewed because of capricious and arbitrary actions on the part of the examiners.

This has to stop.

For years, I have been complaining that these people, who are in the process of trying to create jobs, who are solvent, who have never had a problem, are suddenly having their loans classified and have complained bitterly to the OCC, the FDIC, and the Fed.

It always falls upon deaf ears: "We will check into it. We will talk to our examiners." But there has been no change in policy.

There had better be a change in policy on the U.S. side before we worry about the international side.

Chairman BACHUS. Mr. Grimm?

Mr. GRIMM. Thank you, Chairman Bachus, for holding this hearing.

And thank you to our witnesses.

I think most of it has been said, so I will be very, very brief. Obviously, we are concerned that the implementation of Dodd-Frank is going to hurt the U.S. market competitiveness. But I think we need to emphasize, it is U.S. competitiveness as a whole, these markets that provide capitalization for the businesses to grow and to entrepreneurs.

Everywhere you go, you hear about job creation. We are not going to be able to do that if we are at a competitive disadvantage that moves industry, capital and jobs overseas.

So I am very interested in hearing the panel today and how the implementation process will go with respect to our competitiveness throughout the world.

Thank you. I yield back.

Chairman BACHUS. Thank you.

Our last statement will be 30 seconds from Mr. Schweikert.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

And to our witnesses today, I appreciate this. This is potentially just a fascinating discussion.

On occasion, we will visit the comments of regulatory arbitrage. I am trying to get my head around how much of that is folklore, it actually exists, how much of that is actually rule-for-rule where you have variations, perception of stability of the rulewriting. But also, there is that other fundamental out there, actual enforcement.

We may have equal rules, but this particular government, this particular sovereign entity, has a bad habit of never really looking at that capital reserve. And that actually either puts us at quite a disadvantage or actually creates a greater instability, and that is a concern.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you.

And at this time, I would like to welcome our esteemed panelists. Several of the members have acknowledged the challenges you face, and we commend you for your hard work and industry.

Our first witness, from my, I guess, left to right, is the Honorable Lael Brainard, Under Secretary of the Treasury for International Affairs. Our second witness is the Honorable Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System.

Our third witness is the Honorable Sheila Bair, Chairman of the Federal Deposit Insurance Corporation. And you will be leaving, so we wish you well in your new endeavor.

Our fourth witness is the Honorable Mary Schapiro, Chairman of the Securities and Exchange Commission. Our fifth witness is the Honorable Gary Gensler, Chairman of the Commodities Futures Trading Commission.

And our last witness is Mr. John Walsh, the Acting Comptroller of the Currency.

We welcome our panelists.

And we will start with Under Secretary Brainard.

STATEMENT OF THE HONORABLE LAEL BRAINARD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

Ms. BRAINARD. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee. I appreciate the opportunity.

There are some who would argue that the United States is moving too fast on financial reform, that we should slow it down, and wait to see what other countries implement.

I don't agree. By moving first and leading from a position of strength, we are elevating the world's standards to ours. For financial markets that are more globally integrated than ever, we need financial reforms that are more globally convergent than ever.

While we don't need to synchronize across all issues, there are a few key reforms that must be global in scope if they are to succeed.

The risk of regulatory arbitrage carries real impacts. It means a race to the bottom for standards and protections. It means the potential loss of jobs in the American financial sector if firms move overseas.

And it may increase the possibility of future financial instability, if riskier activities migrate to areas with less transparency, looser regulation, and laxer supervision.

Acting in concert is the best way to address the potential for regulatory arbitrage and the concerns of American firms about competing fairly. The sooner we level the playing field, the better.

Let me just briefly touch on the four priority areas that are most relevant.

The first priority is to strengthen capital liquidity and leverage. These standards can make the difference between the success or failure of firms and the jobs and livelihoods they are lending support, confidence or contagion in the markets, and the protection of taxpayer dollars.

The new capital framework known as Basel III will help ensure that banks hold significantly more capital, that the capital will be able to absorb losses of a magnitude associated with the crisis without relying on taxpayers, and that the definition of "capital" will be uniform across borders.

But full international convergence will be achieved only if supervisors in all major financial jurisdictions ensure that banks across the world measure risk-weighted assets similarly. That is why the United States has called on the Basel Committee to pursue greater visibility across borders and to supervise their scrutiny of how banks measure risk-weighted assets. And we are pleased that is now on the committee's agenda.

In addition, Basel III includes a simple check, called a mandatory leverage ratio, to protect against the possibility of weak international implementation.

A second vital issue is reducing the systemic risk from large interconnected financial firms, so-called SIFIs or global SIFIs. Prior to the crisis, many of these firms held too little capital, putting the global financial system at risk and necessitating significant government intervention.

To make sure that does not happen again, Dodd-Frank requires that the Fed subject our largest firms to heightened prudential standards. And G-20 leaders adopted a parallel commitment to develop additional capital requirements for these firms across borders.

In those negotiations, the United States has been very clear about our priorities. First, additional capital must consist of high quality and loss-absorbing common equity. Second, the surcharge must be well calibrated to balance the imperatives of financial sector stability and of macroeconomic stability. And, third, it must apply to a wide range of the large interconnected banks across the globe and be mandatory and comparable across jurisdictions to promote a level playing field.

The third area is resolution. Dodd-Frank established a special robust resolution regime that provides Federal authorities with strong authority to resolve the largest institutions.

But the best national regime in the world is not going to be adequate if other countries do not adopt robust resolution toolkits and complementary authorities. The United States is working actively in the FSB to implement an international framework.

The U.K. and Germany have already passed resolution legislation, and we will continue working to encourage other financial jurisdictions to do the same.

And finally, international convergence is critical across derivatives markets. In the run-up to the crisis, few understood the magnitude of aggregate derivatives exposures in the system, because derivatives such as credit default swaps were traded over the counter on a bilateral basis and without transparency.

As we learned from the crisis, we must require greater transparency, move trading onto exchanges or platforms, and require them to be centrally cleared. But, of course, if we do not have alignment across borders in these rules, firms will move activities to jurisdictions with lower standards, which will increase risk to the system. For this reason, G-20 leaders set forward principles that are in full alignment with Dodd-Frank.

Both the United States and the European Commission are developing margin requirements for OTC derivatives that are not central cleared. We think it is important for those requirements to be developed internationally, and our regulators have agreed to work with international regulators to do so.

If we don't have a consistent margin standard for uncleared trades, we run the risk that activities will migrate to jurisdictions that do not provide incentives for central clearing.

In sum, we are making great strides to ensure that the financial system is stronger so that future generations can avoid a financial crisis of the type that we have just witnessed. And we appreciate the leadership of this committee on these key challenges.

[The prepared statement of Under Secretary Brainard can be found on page 90 of the appendix.]

Chairman BACHUS. Thank you.

Governor Tarullo?

STATEMENT OF THE HONORABLE DANIEL K. TARULLO, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, and members of the committee.

I want to try to make four points in 5 minutes. First, it is important to remember why we have strengthened minimum capital standards and introduced liquidity standards, both the three banking agencies in front of you and regulators around the world.

The financial crisis revealed that the amount of capital held by many banking institutions under prevailing capital requirements proved quite inadequate in both quantity and quality.

Firms with substantial reliance on wholesale funding markets found that those sources of funding dried up quickly, at times almost overnight, as market concerns rose.

Back in 2008, the prospect of the failure of the most systemically important institutions raised in turn the prospect of a collapse of the financial system, to which none of these large complex financial institutions would have been immune.

And that, of course, is what led to TARP. I think it is fair to say, as we sit here today, that no one wants another TARP—not those who reluctantly supported it 2½ years ago, and certainly not those of you who opposed it.

If we are to avoid another Hobson's choice between a TARP-like mechanism on the one hand or a collapse of the financial system on the other, we have to ensure that financial firms have adequate loss absorption capacity and can sustain stresses in funding markets.

Second point: In a global financial market, serious problems in any major financial center can spread, sometimes very quickly. That is why it is important to negotiate good capital and liquidity requirements for all internationally active banks. That is what Basel III was about.

And that is why it is important to ensure that the most systemically significant institutions around the world have an additional capital buffer in light of the impact that their failure would have on the financial system.

Third point: There are a number of additional areas where there is need for more international cooperation. Several of you have mentioned derivatives, and I wholeheartedly agree.

Fourth point—and this is the one where I want to spend most of my time—the financial stability benefits of Basel III and other international reforms will be realized only if they are implemented rigorously and consistently across jurisdictions.

And here I want to distinguish between implementation in the sense of incorporating the agreements into domestic legislation and regulation on the one hand, and on the other hand ensuring that those standards are in practice observed by firms in all the Basel Committee countries.

The first step—getting the agreement into laws and regulations—is obviously necessary, but it is not sufficient. Yet, historically, that is about all that the Basel Committee implementation efforts have been able to achieve.

As effective, external monitoring of international capital and now liquidity agreements becomes harder, it is all the more important to take the second step.

For example, there has been considerable external analysis in recent months of the apparent divergence in risk-weighting of traded assets across institutions and countries. A number of reports issued by financial analysts both in the United States and in Europe suggested that, generally speaking, it appears as though risk-weighted assets and similar portfolios are more risk-weighted here than in at least some European countries.

These analyses raise significant questions, but their authors don't have access to the models and processes of the financial institutions in question, so they cannot provide definitive answers to those questions.

That is where an effective international monitoring mechanism comes in.

We have raised this issue in the Basel Committee. I raised it just last week at the Financial Stability Board steering committee meeting. And as we move to the implementation phase of Basel III, we will be putting forth detailed proposals for how international agreements can be effectively monitored at the firm level.

I have provided some ideas along these lines in my testimony this morning and would be happy to discuss them further with you.

The key point, though, is that much more needs to be done for at least three reasons: first, as I said earlier, to ensure that the financial stability benefits of the agreements are realized; second, to avoid a situation in which firms from some countries, including the United States, are competitively disadvantaged; and third, because the effectiveness of these rather complex standards will benefit from the very concrete sharing of perspective and problem solving among supervisors from all the Basel Committee countries that will be entailed when such a monitoring mechanism is in place.

Thank you very much for your attention, and I am, of course, pleased to answer questions.

[The prepared statement of Governor Tarullo can be found on page 191 of the appendix.]

Chairman BACHUS. Thank you.

Chairman Bair?

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you. Good morning, Chairman Bachus and Ranking Member Frank.

I am pleased to testify about how current regulatory initiatives will affect the economic health and international competitiveness of the United States.

This morning, I want to focus in particular on the importance of strengthening capital regulation.

A strong and stable financial system is a precondition for a vibrant and competitive U.S. economy. Unfortunately, in the years leading up to the crisis, some large financial institutions strayed from their core mission of providing credit intermediation to support the real economy.

Instead, they exploited regulatory gaps and weaknesses to reap huge fees through complex securitization structures and esoteric derivative instruments that did little to support real economic growth and productivity.

Fueled by the market perception of too-big-to-fail, many were able to access low-cost debt financing which they funneled into high risk lending and investment strategies, misallocating economic resources into unstable financial activities instead of more productive uses such as manufacturing, energy, technology, and infrastructure.

The full costs of the financial crisis are not yet known. We know that we have lost almost 9 million payroll jobs in 25 months, homeowners have suffered a one-third decline in house prices since 2006, and over 9 million foreclosures have started over the past 4 years.

Lending by insured banks alone contracted by $750 billion since the start of the crisis, and loan commitments have declined by $2.7 trillion. Trillions more in credit availability have been lost with the collapse of the so-called "shadow banking sector."

A healthy and competitive U.S. economy requires a financial system that is stable and supports the credit needs of the real economy. This is not the system we had prior to the crisis.

As we debate the needed improvements, there is much discussion, as there should be, of how financial reforms will impact the overall competitiveness of the U.S. economy.

U.S. economic competitiveness is a broad concept, of which financial industry competitiveness is only one part. The short-term profitability of financial institutions should not be confused with our international competitiveness.

Many of the regulatory gaps and lapses which occurred pre-crisis were rationalized as the way to strengthen our international competitive position. What we discovered was that sacrificing safety and soundness in the name of global competition made both the financial institutions themselves and the broader economy worse off.

A prime example is capital regulation during the pre-crisis years, which in retrospect gave undue weight to the desire of financial institutions to boost the return on equity with leverage. Capital requirements were repeatedly and materially weakened in the pre-crisis years. As a direct result, the leverage of large financial institutions steadily increased to the point where capital was inadequate entering the crisis.

Insufficient capital skews incentives. Shareholders and management reap the upside when times are good and bets are paying off, but the costs of the subsequent unraveling are borne by the broader economy. We are still paying the price as a country for accommodating the pre-crisis appetite for leverage of some of our largest institutions.

With Basel III and an important provision of the Dodd-Frank Act known as the Collins Amendment, we have an historic opportunity to strengthen the capital of our banking system. The Basel III agreement strengthens capital in a variety of ways and is a marked improvement over the current regulation.

The numerical Basel III ratios are probably on the low end of what is needed for banks to weather a severe crisis. This is especially true for the largest banks. We saw in 2008 the substantial external costs associated with the failure of large interconnected financial institutions. I strongly support the need for additional common equity buffers for such institutions.

It seems self-evident that capital requirements for the largest financial institutions should be higher, not lower, than the general standard that applies to smaller banks. Yet, prior to the crisis a number of large European banks were allowed to implement the so-called Advanced Approaches under Basel II, which allowed them to significantly increase their leverage by using their internal models to set capital requirements.

Large U.S.-insured banks and their holding companies were also on a course to take on additional leverage by using their risk models to drive risk-based capital requirements.

On Tuesday of this week, we corrected the situation. The FDIC board approved a final rule, joint with the OCC and the Federal Reserve, to implement Section 171 of the Dodd-Frank Act. This provision of the Act, the Collins Amendment, says simply that the capital requirements of our largest banks cannot be less than the capital requirements community banks face for the same exposures. Thus, models under Basel II can be used to increase, but not reduce, capital requirements.

Unfortunately, large banks in Europe and elsewhere are still allowed to effect their own capital requirements. This concerns me greatly, for all the reasons that Governor Tarullo has also indicated, and I look forward to discussing that more with the committee.

I think we need, as we strengthen capital standards here, to make sure that Europe follows suit, and I will be glad to work with this committee for as long as I can, which is not much longer, and I hope my fellow colleagues will continue this course to maintain very strong capital standards in the United States.

Thank you.

[The prepared statement of Chairman Bair can be found on page 59 of the appendix.]

Chairman BACHUS. Chairman Schapiro?

STATEMENT OF THE HONORABLE MARY L. SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee. I appreciate the opportunity to testify today on behalf of the Securities and Exchange Commission regarding the international implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Act establishes a host of new reforms that will have implications for U.S. companies that compete internationally. My written testimony discusses a number of these reforms, as well as the SEC's efforts to coordinate with foreign regulators and to limit regulatory arbitrage.

I would like to focus in particular on the over-the-counter derivatives marketplace. Today, the OTC derivatives marketplace has a global notional value of just over $600 trillion. Yet, OTC derivatives were largely excluded from the financial regulatory framework by the Commodity Futures Modernization Act of 2000.

Title VII of the Dodd-Frank Act would bring this market under the regulatory umbrella requiring that the SEC and CFTC write rules relating to, among other priorities, mandatory clearing, the operation of execution facilities and data repositories, capital and margin requirements, business conduct standards for dealers, and greater transparency of transaction information.

These rules are designed to greatly improve transparency, facilitate centralized clearing, enhance regulatory oversight, and reduce counterparty risk. By promoting transparency, efficiency, and stability, this framework should foster a more nimble and competitive market.

Because this marketplace already exists as a functioning global market with limited regulation, international coordination is critical as we seek to limit opportunities for regulatory arbitrage, eliminate competitive disadvantages, and address duplicative and conflicting regulations.

Domestically, the SEC is working closely with the CFTC, the Federal Reserve Board, and other Federal prudential regulators to coordinate implementation of Title VII, while recognizing relevant differences in products, entities, and markets.

Working closely domestically also bolsters our efforts internationally. The Act specifically requires the SEC, the CFTC, and the prudential regulators to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards, and we are working closely with international regulators in this regard.

While the United States is the leader in this area, a significant international consensus exists around core components of OTC derivatives reform. While progress is being made internationally, other nations do lag behind U.S. efforts.

To address differences in scope and timing, the SEC has been extremely active in bilateral and multilateral discussions with regulators abroad. We have been engaged with international market regulators both bilaterally and through participation in and leadership of various international task forces and working groups to discuss the full range of issues surrounding the regulation of OTC derivatives.

Rather than addressing the international implications of Title VII of Dodd-Frank piecemeal, we are considering addressing the relevant international issues holistically in a single proposal. This approach should generate thoughtful and constructive comments for us to consider in the application of Title VII to cross-border transactions.

In addition, after proposing all of the key rules under Title VII, we intend to consider seeking public comment on a detailed implementation plan that will permit a rollout of the new security-based swap requirements in an efficient manner while minimizing unnecessary disruption and cost to the market.

I also would note that last Friday, the SEC announced that it would be taking a series of actions in the coming weeks to clarify the requirements that will apply to security-based swap transactions as of July 16th, the effective date of Title VII, and provide appropriate temporary relief.

And yesterday, in the first such action, the SEC provided guidance making clear that many of Title VII's requirements applicable to security-based swaps will not go into effect on July 16th and granted temporary relief from compliance with many of the new requirements that would otherwise apply.

We took this action to avoid market disruption as we work expeditiously to finish rule writing and adopt our rules.

While derivatives are a key focus of the international efforts of the SEC, other policy areas also demand our attention. For example, accounting and financial reporting standards are essential to efficient allocation of capital by investors everywhere in the world.

The SEC is continuing its work on the important issue of whether to incorporate international accounting standards into the U.S. financial reporting regime. Our primary consideration in these activities is the best interests of U.S. investors.

In conclusion, the SEC continues to work closely with regulators in the United States and abroad and members of the financial community and investing public to conduct rulemakings with international implications in a manner that supports the interests of U.S. markets, investors, and firms.

Thank you for the opportunity to share my thoughts with you. And of course, I am happy to respond to questions.

[The prepared statement of Chairman Schapiro can be found on page 146 of the appendix.]

Chairman BACHUS. Thank you.

Chairman Gensler?

STATEMENT OF THE HONORABLE GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION (CFTC)

Mr. GENSLER. Good morning, Chairman Bachus, Ranking Member Frank, and members of the committee. I thank you for inviting me to today's hearing on the international context of financial regulatory reform.

I thank Ms. Bair, because this might be the last of five or six times we have testified together, and I wish you the best in everything you do.

It has now been more than 2 years since the financial crisis, when both the financial system and, I would say, the financial regulatory system failed America. So many people throughout the world who never had any connection to derivatives or exotic financial contracts had their lives hurt by the risks taken by financial actors.

All over the world, we still have high unemployment, homes that are worth less than their mortgages, and pension funds that have not regained the value they had before the crisis. And we still have very real uncertainties in our economy.

And though the crisis had many causes, and I would agree with many of the members' statements on that, it is clear that the swaps market did play a central role in the crisis. They added leverage to the financial system where more risk could be backed with less capital.

They contributed, particularly through credit default swaps, to an asset bubble in the housing market, and I believe also accelerated the financial crisis as we got nearer to it. They contributed to a system where large financial institutions were not only thought to be too-big-to-fail, but we had a new phrase called "too-interconnected-to-fail."

The swaps, which do help manage and lower risk for many end users, actually concentrated and heightened risk in the economy by concentrating it amongst these large financially important firms.

And as capital and risk knows no geographical boundaries, we really need to have international oversight that ensures that these markets, these swaps and derivatives markets, function with integrity, transparency, openness, and competition.

Transparency, openness, and competition have been found since the great reforms of the 1930s to benefit the securities markets and the futures markets and to benefit the economy and job growth and creation.

To address the real weaknesses in the swap markets, the President and the G-20 leaders in Pittsburgh in 2009 laid out a framework for regulation of the swaps market. The United States and Japan both have passed reform through legislatures and are working on implementation. The European Council and the European Parliament currently are considering their swaps proposal, and Asian nations, as well as Canada, are working on their reforms.

As we work to implement Dodd-Frank, we are actively coordinating with international regulators to promote robust and consistent standards, and the Commission participates in numerous international work groups.

But we are also sharing our work product. At the CFTC, we actually started last July and August sharing our memos and term sheets and draft work products with international regulators both in Europe and in Asia. We have found this to be a great benefit, because we get comments even before we put some of the proposals out, and then, consistent with the Administrative Procedures Act, as we put proposals out, we have gotten more comments.

Specifically, we are coordinating with regard to the scope of the derivatives regulation—central clearing, capital, margin, which has been raised by many members here, data reporting, business conduct standards, and the transparency initiatives, including trading on electronic trading platforms.

Furthermore, a very important feature of the Act was a section called 722(d). I have learned so much now. But it states specifically that the Act relating to swaps shall not apply to activities outside the United States, unless those activities have a direct and significant connection with the activities of the commerce here.

We are developing a plan for the application, as I said, 722(d), and expect to receive public input on that plan. And we are working closely with the SEC on the similar work that they are going to be doing there.

Before I close, I will address the issue related to what occurs on July 16th. The Commission, 2 days ago, had a public meeting on this matter. First, a substantial portion of Title VII actually only becomes effective once we finalize rules. So, a majority of Title VII is not effective on July 16th.

But for the provisions that are not dependent on a final rule—they are sort of self-executing—we proposed exemptive relief until December 31st of this year. This will provide relief from most of title VII. We look forward to hearing public comment on it. To the extent that we need to tailor additional relief towards the end of the year, we would look for additional relief at that time as we move forward.

Effective reform requires comprehensive international response, and yes, consistency, but I thank you and I look forward to your questions.

[The prepared statement of Chairman Gensler can be found on page 96 of the appendix.]

Chairman BACHUS. Thank you.

Comptroller Walsh?

STATEMENT OF THE HONORABLE JOHN WALSH, ACTING COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. WALSH. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee. I appreciate this opportunity to discuss the work that the OCC and the other banking agencies have under way to revise bank capital and liquidity requirements, consistent with the Dodd-Frank Act and Basel III.

This is a complex undertaking, and we believe it is important to determine not only how individual requirements of Basel and Dodd-Frank will impact U.S. firms and their international competitiveness, but the cumulative impact of the provisions as well.

The invitation letter raised the issue of an international race to the bottom, but I don't think this is a serious concern when regulatory requirements are becoming more stringent around the world. The concern, instead, is that standards are being raised both significantly and comprehensively, and so much so that we could unnecessarily restrict financial intermediation and economic performance.

At the same time, it is certainly true that if the same high standards are not adopted by all countries and enforced with the same vigor, U.S. institutions could be left at a competitive disadvantage. Our challenge, then, is to address the problems that led to the financial crisis without undermining the ability of banking institutions to support a strong national economy or placing U.S. institutions at an unfair competitive disadvantage internationally.

Both the Dodd-Frank Act and Basel III aim to promote a more resilient banking sector by imposing stronger capital and liquidity standards. They raise the amount of regulatory capital and, just as important, the quality of that capital is improved significantly by placing much greater reliance on common equity and raising capital charges on risky asset classes.

Banks will also be required to hold substantially more liquidity in the form of short-term, low-risk assets, and to increase their reliance on more stable long-term debt and core deposits.

The Basel III standards were designed around the crisis experience of the largest internationally active U.S. banks. So while the OCC has also supported a capital surcharge of common equity for a small number of the very largest banks, that add-on should be modest, given where capital requirements have already moved.

This is not to argue that surcharges should not be higher in countries where large institutions represent a greater risk to the national economy, particularly where the assets of the largest banks exceed national GDP, like Switzerland or the U.K. The United States, on the other hand, has imposed statutory caps on the size of our largest firms, and even the largest firms are only a fraction of GDP.

While 27 countries reached general agreement on the policies and standards outlined in Basel III, the details of its implementation will likely vary from country to country. U.S. implementation is likely to be more complex and impose additional constraints than in other countries, owing to its interaction with Dodd-Frank.

For example, the Collins Amendment set the floor on capital based upon current Basel I standards, a dual capital calculation that non-U.S. banks will not face. And with the simpler Basel I framework still used to determine capital, large U.S. banks will have far less incentive to rigorously pursue the complex and costly task of implementing the Basel II framework.

The Dodd-Frank Act's prohibition against the use of credit ratings also will impede our efforts to achieve international consistency in the implementation of Basel III since Basel III, the Basel II framework upon which it is built, and Basel I for that matter make use of internal ratings in several areas, including securitizations, assessment of counterparty credit risk, and trading book positions.

Given capital already raised by large banks, a return to profitability and the extended phase-in period for the higher capital standards of Basel III, U.S. banks should be able to transition to the 7 percent standard without causing undue stress on the economic recovery.

However, I am concerned with how much further we can turn up the dial without negative effects on lending capacity. A very real risk is that lending will fall, will become more expensive, and will again move from the regulated banking sector into the less regulated shadow banking sector. Certainly, a lesson of the financial crisis is that risk can migrate to and accumulate in the unregulated shadow sector with undesirable consequences.

The fact that so many Dodd-Frank and Basel III reforms are occurring at once, with combined effects we cannot measure, is cause for caution. Before contemplating substantial further increases to capital and finalizing liquidity requirements, we need to take account of all the reforms being introduced, to increase the ability of the financial system to absorb losses, and to reduce the probability and potential impact of the failure of large institutions.

The goal of all these changes is to improve the system's resilience, but taken too far, we may limit the availability of credit that is needed to support economic growth.

Thank you, and I welcome your questions.

[The prepared statement of Acting Comptroller Walsh can be found on page 203 of the appendix.]

Chairman BACHUS. Thank you.

I think we all agree that banks should be sufficiently capitalized, particularly all the banks, but our global SIFIs, because we want to avoid bailouts. We want to avoid taxpayer funding and the shock that it does to the economy. And I think the same is true about overleveraging and borrowing overnight, which some of our investment banks were doing.

Having said that, I think Comptroller Walsh has an important point. As we raise capital, and I know, Governor Tarullo, you actually had talked about 700 basis points on some of our SIFIs, how does that affect our lending? And do you think that will have any negative effect on our economy?

Mr. TARULLO. Mr. Chairman, let me say a couple of things here.

First, it is important to understand that the rationale for a surcharge on systemically important institutions—

Chairman BACHUS. Yes, that is what we are talking about, the surcharge.

Mr. TARULLO. Right. It complements the rationale for Basel III, which is essentially a micro-prudential or firm-by-firm analysis. So for the Basel III capital standards, we will look at each firm and, basically on the basis of its balance sheet and its balance sheet alone, say what is the riskiness of the various assets on your balance sheet and relevant off-balance sheet assets.

It doesn't take into account the correlation of risk among firms that hold similar assets. In a financial crisis, what happens, of course, is that those assets, particularly traded assets, are the ones that come under the most stress, the ones for which the market is most imploding. And that is why these systemic effects that we saw in 2008 are of such concern to us.

So the motivation for the surcharge is one that takes into account the size, interconnectedness, and associated systemic consequences of the failure of such an institution. That is the first point.

Second point: There has been a fair amount of attention to the numbers I cited in that speech I gave about a week-and-a-half ago. What I said in that speech is that when analysts here and abroad have applied some analyses or some modes of analysis as to how much the surcharge should be in order to try to contain that systemic risk, there is a range that everybody comes up with, within which you have to make a certain set of assumptions.

And that range, which I indicated was some variant on a certain number of percentage points as high as maybe 7 percentage points above Basil III, is just what different studies have produced. That is not to say that this is the amount that gets eventually adopted.

There are reasons to calibrate any such range. You have to choose a number somewhere, and that is what is going on right now in the international process, and domestically it is what will go on when the Federal Reserve does its rulemaking on the enhanced prudential standards.

So I absolutely agree, Mr. Chairman, that you have to take into account the cost for the firms and the benefits to the firms, and we have done a cost analysis. We have used the analytic tools we have available to us. But what is important is not to lose sight of the cost of not acting here.

Chairman BACHUS. I understand. Yes, and I understand there is a cost to not acting, but if you—for instance, Comptroller Walsh is concerned, as I am, and I know that Chairman Bair takes a different approach, but under Basel III, I think it is called the advanced approach to risk management, other countries will be using this approach to sort of refine their approach, and the Collins amendment takes that off the table for us.

I would ask Under Secretary Brainard, are you concerned about that? Are you concerned about that, Governor Tarullo?

Mr. TARULLO. Sir, as you probably know, my concerns about the implementation of Basel II pre-dated my arrival at the Federal Reserve. That related to a lot of the academic work I was doing before I came to the Fed.

And yes, I am concerned. I am particularly concerned about the way it has been implemented. One would think that if you put a procyclical capital regime into place in the middle of the biggest recession since the 1930s, that capital requirements ought to go up. But they didn't, and that is why I think it is important to make the kind of proposals on compliance that I made in my testimony.

Chairman BACHUS. Under Secretary?

Ms. BRAINARD. I think it is very important as we are looking at this SIFI surcharge. Because these institutions are competing internationally, it is absolutely critical that whatever is agreed is comparable across countries and mandatory in every jurisdiction.

And that is why we have put such an emphasis on having common equity, which is, of course, the strongest, most loss-absorbing kind of capital. We would like to see an international agreement that has common equity and where it gives very little discretion to supervisors.

The other thing that I think is important just on the issue that you raise, risk-rated assets and how they are assessed, I think our institutions are concerned and we share those concerns. And that is why, as I said earlier, and as Governor Tarullo said, we are trying to put in place monitoring mechanisms for the first time so that we will be able to have some visibility into how supervisors are actually assessing risk weights.

The simple leverage ratio that was agreed to in Basel III will be helpful. It doesn't go as far as the Collins amendment, but it is another way of trying to create a floor.

Chairman BACHUS. Thank you. And I think we are all concerned about rules that are on the books that aren't enforced by some of these other countries.

Ms. BAIR. Mr. Chairman, if I could just add, I think I want to reiterate what Governor Tarullo indicated, that these Advanced Approaches have not worked. They allowed European banks implementing them to significantly reduce their capital levels. They were overleveraged going into this crisis.

And then, as the recession hit, when you expect the capital levels to go up because the probability of default on loans is going up in a recession, capital kept going down.

Capital is still going down. There is a recent Barclay's report which we are happy to share with you. Investors have no confidence in the Advanced Approaches. It is a very large issue, but all the effort in the Basel Committee is to try to put more objective constraints on the ability of these individual banks to essentially set their own capital standards.

The United States is very strongly pushing that. I think that is the direction to go.

I must say, in terms of easing regulatory burden on large institutions, given the tremendous flaws in the Advanced Approaches, it is very expensive to implement. I would just get rid of it. It is harmful, and it is not helpful. And I think we can improve the current Basel I standard. But if we are going to try to decrease compliance costs, I think one way to do that would be to just get rid of the Advanced Approaches altogether.

Chairman BACHUS. Thank you.

Mr. Frank?

Mr. FRANK. I want to begin by joining my colleague, Ms. Waters, in saying good-bye to Sheila Bair. I will say that my working relationship with Chairman Bair has been an extraordinarily beneficial one for me, and I just wanted to make a prediction now to Chairman Bair that she will be missed, even by people who don't know that now. But I think that her tenure will stand out as an extraordinary example of the right kind of public service.

I am not sure I will be able to get back. I would like to give credit where it is due. Mr. Zubrow, from JPMorgan Chase, I just want to read a little bit from what he says, because we tend in hearings, obviously, to focus on differences. But we ought to understand the commonality that we come from.

On page 3, he has a quick—recent initiatives designed to reduce risk taken by U.S. financial firms. And it is Federal Reserve supervision, off-balance sheet activity being reduced, margins reporting and supervision of derivatives, centrally clearing derivatives, risk retention, prohibition on proprietary trading.

Here is what he says, "As a result of these post-financial crisis changes, Lehman Brothers would have been subject to the same Federal Reserve capital and prudential supervision as JPMorgan Chase, including extremely high capital charges for collateralized debt obligations and other exotic securities.

"AIG would have been required to register as a major swap participant, report on its positions and subject itself to Federal supervision.

"Countrywide and Washington Mutual would have been subject to the same mortgage underwriting standards as national banks and would have been either significantly limited in making subprime loans or required to retain the risk of these mortgages.

"And the FSOC and the Office of Financial Research would have been gathering data. These are important changes."

I appreciate this acknowledgement. Those are all things that are in this bill and, as he notes, would have substantially lessened the likelihood of those institutions that were major failures and, as he notes, apply all of the restrictions in the banking system to the unregulated. This is where the shadow bank system came in.

He also then, on page 5, talks about what we did in terms of resolution of large institutions, which I continue to believe should be called dissolution. That is a euphemism too far.

And what he says in summary of the listing of these is, "The United States is ahead of the rest of the world. The FDIC's new authorities are already in place. Most countries have no plans for orderly resolution. Some have prospectively acknowledged that their banks should be bailed out at taxpayer expense, should a crisis occur.

"The U.S. is doing the hard work to make orderly resolution of large financial institutions a viable option. And JPMorgan Chase and other banks are devoting extraordinary resources to this unheralded project."

It is very clear from the context that this is not a case where he is complaining that America is different from the rest of the world. It is a case where he is boasting that together with the financial institutions, with Congress and the regulatory agencies, we are ahead of the rest of the world.

And on page 6, he has a heading, "Further Insulation for Taxpayers." And Mr. Zubrow says, "Aside from decreasing the risk of trouble at large financial institutions, Dodd-Frank also reduces the risk that a large institution's failure would impose costs on taxpayers."

So, Mr. Zubrow, I thank you for that. And we have some differences, but I think we ought to be clear where they are.

Mr. Tarullo, one point, because it goes on too-big-to-fail. On the imposition of a capital charge, I noticed that one of the contributory factors you said could be considered would be an increase in the capital charge to offset the perceived advantage of being too-big-to-fail.

I differ with that, because I do not think we ought to be reinforcing it. Rather than charge people for what I believe is an increasingly inaccurate perception—even Moody's, my own view is on the rating agencies, when Moody's finally gets it, it has to be pretty clear-cut—what we have now, I think, is an increasing recognition that is not the case. And I think that is one area where, and I understand that we don't want to charge banks excessively.

I would hope you would reconsider that. It does not seem to me—and rather than charge the bank for inaccurate perception, let us all make sure that we dissolve the inaccurate perception. And I would hope that would drop out.

Finally, to Mr. Gensler, there have been concerns about margin requirements on sovereign wealth funds. Margin requirements, my New York colleagues have noted, when the non-U.S. subsidiary of a U.S. bank is dealing with a non-U.S. entity, that there could be a margin requirement.

My own view is that is a very legitimate area of competitive advantage. Do you, under the statute, have the authority to take that into account? And can you and your fellow Commissioners adjust with regard to margins so that in those very particular cases where there would be an international setting, a competitive disadvantage, make it go away?

Mr. GENSLER. We are working along with the prudential regulators, because they actually have authority under Dodd-Frank to set the margins for the banks. We just have the non-banks. But we are, along with the SEC, initiating dialogues with international colleagues to try to get—

Mr. FRANK. But do you have the existing statutory authority collectively to adjust, if it looks like there might be a problem?

Mr. GENSLER. I think that we have the existing authority. It has to be based upon rational reasons, along with how the Administrative Procedure Act has us do it. Yes.

Mr. FRANK. I understand. I am assuming rationality, but you do have sufficient statutory authority to deal with those specific situations that we are talking about?

Mr. GENSLER. Along with other regulators who actually have the auuthority, because we are not—

Mr. FRANK. I appreciate that. Let me then ask you—may I have just 30 seconds—do the other regulators who would have that authority concur that in those very specific situations where we were talking about a competitive disadvantage, the authority would be there to take that into account?

Mr. Tarullo?

Mr. TARULLO. Generally, I think that is true.

Mr. FRANK. Ms. Bair?

Ms. BAIR. Yes, we have the authority.

Mr. FRANK. Thank you.

Thank you, Mr. Chairman.

Oh, I am sorry. Mr. Walsh?

Mr. WALSH. Yes.

And you agree also?

Okay. Waving doesn't quite make it into the record.

Mr. WALSH. I didn't know you wanted to hear, but, yes, absolutely.

Mr. FRANK. That I wanted to hear. I don't always want to hear, but that I wanted to hear.

Chairman BACHUS. Thank you.

Was JPMorgan Chase's testimony inside a Valentine card?

Mr. FRANK. Yes, but there was no box of candy with it, so I didn't have to report it to the Ethics Committee.

Chairman BACHUS. Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

Certainly, there is wide agreement that capital and liquidity standards were most inadequate going into the financial panic of 2008, and clearly there is a convergence of opinion they must be raised.

But I think the question, particularly in this hearing, that has to be addressed, is what is the cumulative impact of raising those capital standards under Basel III? What will be the impact of the extra capital standards to be assessed against the SIFI institutions just imposed in the 2,000-plus pages of Dodd-Frank?

I am uncertain that we know the answer to that question. I have heard many testify that we must have stability in our capital markets. I agree that stability is a good thing. But we have had stability in our employment markets for almost 2½ years. Unemployment has stabilized at roughly 9 percent. So stability as a macroeconomic virtue may be somewhat overrated.

And, clearly, I think we have to look at the balance, again, of what ultimately will be the impact of this extra stability on our job creation.

Secretary Brainard, you confused me with one part of your testimony, and perhaps I am going to give you an opportunity to explain it.

What I thought I heard you say is that it was critical that the United States essentially be the first mover in regulatory reform. But at the same time, I believe I heard you and almost every other panelist talk about their fears of essentially a race to the bottom in what we know as regulatory arbitrage.

So I am having a little trouble understanding why it is mission-critical to move first and why we should not move concurrently. I cannot reconcile the two. Did I misunderstand part of your testimony?

Ms. BRAINARD. Let me just address both points that you raised.

First on all, on the capital standards, there was a great deal of consideration in the development of the Basel III capital standards to the macroeconomic impacts of those capital standards.

Our regulators did a lot of impacts here on the United States, and it was also done internationally. There was a broad agreement—I have seen the analysis—that the transition timelines, which are quite generous in the Basel III framework, give our institutions plenty of time to earn their way to meeting those capital standards without having any adverse impact.

And so, I don't think we are actually choosing between stability and growth. In fact, I think the real point here is that we will have much healthier growth if, in fact, we put in place a safe and sound financial system.

With regard to the advantages—

Mr. HENSARLING. Let me interrupt here, if I could. Chairman Bernanke, I guess about 10 days ago, spoke before the International Monetary Policy Conference in Atlanta. When asked about the cumulative impact of Basel III, Dodd-Frank, SIFI charges, he said, "Has anybody done a comprehensive analysis of the impact on credit? I can't pretend that anybody really has. It is just too complicated."

So I think what I am hearing from you, Secretary, is that you may know something that the Chairman doesn't.

Ms. BRAINARD. With regard to the capital standards in particular, within Basel III—

Mr. HENSARLING. So you are looking solely to the capital standards?

Ms. BRAINARD. Yes, there has been quite a bit of analysis of that. Secondly, with regard to moving first, really, I think, we have a choice, and we have chosen as a nation to put in place very strong standards and then to work internationally to get other countries to agree on those standards.

Mr. HENSARLING. But what assurance for convergence—

Ms. BRAINARD. But in terms of implementation, we actually agree—

Mr. HENSARLING. If I could, Madam Secretary, what assures the convergence of these standards? Many of you have come before this committee to say that Basel II had disparate interpretations, disparity of compliance. And that was with Basel II. What assurance is there that there is going to be this uniformity of compliance and timing? What is the mechanism?

Ms. BRAINARD. What we have done is, first of all, we have gotten agreement in the G-20 and the FSB and the Basel Committee around the same standards, the same set of reforms, the same principles in all of the three areas that were under discussion today.

Second, there are implementation deadlines for most of those areas. And third, there are processes put in place that permit supervisors to have peer review and to hold other jurisdictions to account for those implementation deadlines.

Mr. HENSARLING. I just would say, in the remaining time I do not have, that Michael Barnier has said, "Europe is not going to be under American supervision." And they seem to be on a different timeline.

I am out of time. I will—

Chairman BACHUS. Thank you.

Ms. Waters?

Ms. WATERS. Thank you very much, Mr. Chairman.

I would like to engage the Honorable Sheila Bair.

Chairman Bair, as you know, so many bad practices and a considerable amount of fraud has proliferated throughout the mortgage servicing industry in the years following the financial crisis. And to be honest, I think the response of regulators could have been much quicker and stronger.

For example, I was dissatisfied with the Federal interagency foreclosure review released by regulators in April. And since you have been leading the charge for sustainable loan modifications, I think the FDIC was likewise disappointed.

Let me read from the FDIC's press release: "The interagency review was limited to the management of foreclosure practices and procedures and was not by its nature a full-scope review of the loan modification or other loss mitigation efforts of these servicers. A thorough regulatory review of loss mitigation efforts is needed to ensure processes are sufficiently robust to prevent wrongful foreclosure actions and to ensure servicers have identified the extent to which individual homeowners have been harmed."

So, first, it seems you believe that another regulatory review is needed. Is that what we need to deal with this, Chairman Bair?

Ms. BAIR. I just wanted to make sure it was clear what the scope of the review was. I don't think there was disagreement among any of the regulators in describing the scope.

Right now, pursuant to the consent orders that are being discussed, there needs to be a look-back. These major servicers need to do a thorough review of servicing errors retroactively, and identify harmed borrowers and provide appropriate redress for that, as well as some type of complaint process.

We are in discussions with our fellow regulators on that right now. I would defer to Mr. Walsh, who is the lead regulator for most of the servicers and has been playing a key role in this.

But I do think it is important for the public to explain what was and was not covered. This is also being coordinated with the Justice Department and the State AGs on the law enforcement end. There is some hope that this can all be packaged together so that there is one set of standards for both the prospective reforms, to make sure we don't have these errors going forward, as well as the look-back to make sure that borrowers who were harmed receive appropriate redress.

Ms. WATERS. So this recommendation about letting the servicers hire outside consultants to investigate them is of concern to, I suppose, many of us. Do you believe that outside consultants can do the job that is needed to be done, instead of a regulatory review?

Ms. BAIR. There needs to be a robust validation process. So, yes, we would like to see an interagency examination team reviewing sizable samples of the reviews that the independent consultants are doing to validate the work.

I think everybody is operating in good faith here, but an extra set of eyes, given the importance of this project, would be helpful.

Ms. WATERS. Mr. Walsh, you testified to the Senate Banking Committee in March that only a small number of wrongful foreclosures took place. Do you still think that? And if the Federal interagency review was limited, how would we know that?

Mr. WALSH. I think the key there will be the look-back that Chairman Bair was referring to. The sampling that was done in those exams was to establish whether there were sufficient grounds to determine that the servicers had failed in significant ways and that remedial actions, cease-and-desist orders, remediation plans, were needed.

And the result of that sampling was to determine that was indeed the case. Now, having done that, we have enforcement orders in place that will require significant follow-up, both implementation plans and also, again, this look-back process that Chairman Bair referred to and that we are working on, on an interagency basis.

And that will establish the wider scope of problems, if there are more substantial problems. The reference was only made to the sample.

Ms. WATERS. In that review, how could it be determined if a foreclosure was improper, if the review didn't look at how servicer software applied to borrower payments or to look to see if the fees servicers charged borrowers were proper or otherwise verify that servicer records were in fact correct?

None of that was looked at in the review. Is that right?

Mr. WALSH. Certain of those elements were looked at. Fees and other things were checked, but the task will now be to look at those things in the context of this look-back review, where you will drill down deeper.

Ms. WATERS. Thank you, Mr. Chairman, and I yield back.

Chairman BACHUS. Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

I wanted to ask Chairman Bair and Mr. Tarullo on a point here, and it goes to Tom Hoenig, the president of the Kansas City Fed's, commentary on this very thing you are struggling with, and that is, as he says, "The funding advantages the too-big-to-fail organizations have over others amounted to $250 billion for the 28 largest banks in 2009."

"At the Federal Reserve Bank of Kansas City," he says, "we estimate the ratings and funding advantage for the five largest U.S. banking organizations during the crisis, and in 2009, these organizations had senior long-term bank debt that was rated four notches higher on average than it would have been based on just the actual condition of the banks, with one bank given an eight-notch upgrade for being too-big-to-fail. Looking at the yield curve, this four-notch advantage translates into 160 basis point savings for debt, with 2 years to maturity and over 360 basis points for 7 years to maturity."

This is huge. And it has a highly distorting influence on the market.

I also notice, Mr. Tarullo, you argue, "An ancillary rationale is that additional capital requirements could help offset any funding advantage derived from the perceived status of such institutions as too-big-to-fail."

We had a hearing yesterday regarding too-big-to-fail. And I think some very well-meaning people believe that the problem is solved by this new Orderly Liquidation Authority.

And, of course, according to their logic, because of the new authority, the institutions will not be perceived as being bailed out, and the rating agencies will downgrade those institutions, which is going to lead to higher borrowing costs, thus eliminating that status.

But I don't believe many of the Fed Governors believe this, and I don't believe many in the market believe it.

I will start with you, Chairman Bair, and ask you for your perception on this, and how do you believe the Orderly Liquidation Authority impacts the size and scope of this global surcharge in the future and this global systemically important financial institution surcharge?

Ms. BAIR. I would say too-big-to-fail was a problem pre-crisis. There were bump-ups there. The problem is that the bailouts reinforce the perception, and so we have seen widening disparities in funding costs between small and large institutions.

We are making progress already. Moody's has announced that for a number of banks on negative watch for downgrade, they are actively considering removing the bump-up.

Mr. ROYCE. You said they may—

Ms. BAIR. They may; that is right. As we have described before, the FDIC and the Fed, through implementation of the living will requirement, and thus through our liquidation authority, has a case to make and will make that. Yes, this can work, it will work, and bailouts will be a thing of the past.

Too-big-to-fail was well-ingrained into market thinking pre-crisis. It has been with us for too long. It is going to take some time to get rid of it. But I do think Title II and Title I give us the authorities to take the steps to get rid of it over time. It is going to take some time, but I do believe that.

Also, I don't see any alternative.

Mr. ROYCE. But let me then go to Mr. Tarullo for his thoughts.

Mr. TARULLO. Mr. Royce, as Sheila—I will say Chairman Bair for the next 22 days, every time I address her—I think Chairman Bair has already made the point that it is not an off/on switch. That is, we have the orderly resolution authority in place now, which the FDIC is implementing.

As I have suggested, the capital standards are a complement to the orderly resolution authority. And in order to get to market discipline, I think, actually, both of these things are going to change.

If you think about it, if you end up in a situation in which counterparties truly believe that there is not going to be a bailout forthcoming, those who advance credit to very large organizations are going to demand higher levels of capital than existed in the past.

So I have regarded the resolution authority and the SIFI capital surcharge as complementary, self-reinforcing mechanisms which can move us along the road to what I think everybody on the committee and everybody on this panel agrees should be the end, which is eliminating any too-big-to-fail reality or perception.

Mr. ROYCE. I agree that should be our end goal. And the one concern I have is the way in which the legislation was written. I am afraid, in some ways, we may have reinforced it.

And I say that because counterparties—you can see it right now in the market. Clearly, at the moment, things have not changed, in terms of the way too-big-to-fail is being perceived, and you see it by the basis point spread in the market.

But my time has expired, and thank you.

Chairman BACHUS. We will take one more on each side, and then, when we come back, we will start with the other members who haven't—

Mr. FRANK. Right. Yes, Mr. Chairman, I think we both agreed on that. For our members, when we return, it may be a different panel, but we will start the questioning with the—those of us who have already asked will not go again. We will start with those who haven't asked.

Chairman BACHUS. And after one witness on each side here, we will discharge this panel, so you can look forward to lunch off the Hill.

Mrs. Maloney?

Mrs. MALONEY. Thank you.

I would like to ask all the panelists about the capital requirements and whether or not they will have a disadvantage on American firms.

Specifically, I would like to start with Chairwoman Bair. Section 165 of the Wall Street Reform Act requires the Fed to impose heightened capital requirements on the most complex U.S. banking entities. In your opinion, should any SIFI charge adopted under Basel III satisfy that requirement? Or should American banks be subject to a surcharge in addition to what is required under Basel III?

Ms. BAIR. I would defer to Governor Tarullo because the Fed does have the authority, but I believe he has said that the Fed is going to be taking this up with Basel III. At least for capital, we have all made a very, very conscientious effort to make sure that the standards are harmonized internationally.

Mrs. MALONEY. And, Governor?

Ms. BAIR. I am sorry—the SIFI surcharge would be on top of Basel III. Yes. I thought your question was whether the Fed would have something in addition to Basel III.

Mrs. MALONEY. No, the SIFI charge.

Ms. BAIR. Whatever the SIFI charge is that the Basel Committee and the Group of Governors and Heads of Supervision agrees to will be what the Fed implements here. Is that correct? Yes.

Mrs. MALONEY. So in other words—maybe the Fed should answer.

Ms. BAIR. Yes, the Fed.

Mrs. MALONEY. The Fed should answer. In other words, are you going to put an additional charge? Wouldn't that be a disadvantage for our banks?

Mr. TARULLO. It would, Mrs. Maloney, it would be an additional charge on top of the Basel III standards. But as Chairman Bair just noted, it is one that we are working on in the Basel Committee to get agreement on internationally so that comparable institutions in all the major financial markets would have a comparable surcharge.

Mrs. MALONEY. That is definitely a good goal. Otherwise, I feel that we would be disadvantaged.

May I ask you and the other panelists whether you believe that there is a risk of regulatory arbitrage with the requirements that we have in our country? And whether there is any risk that U.S. markets and our financial institutions could be placed at a competitive disadvantage?

Mr. TARULLO. Shall I start?

Mrs. MALONEY. Yes.

Mr. TARULLO. Yes, there is always a risk of that. And I think you have heard from several of us and a number of your colleagues on both sides of the aisle that in the derivatives and margin areas in particular, I think a number of us are concerned about that, which is why there is a need to accelerate work to get basic convergence on that proposition.

Mrs. MALONEY. Would anyone else like to comment? Mr. Gensler, since derivatives is your area, could you comment on competitiveness, whether or not we will be at a disadvantage—

Mr. GENSLER. It is a concern shared with every regulator and even Treasury here, but I think that there is always that challenge. It was one of the reasons why I think this nation didn't regulate this market. It was one of the five or six key assumptions before the crisis, well, the markets will just go overseas.

I do think there is international coordination on and good consensus on central clearing, on capital, because that is part of Basel III. I think we are going to work together on the margining approach. I think there is good consensus on risk mitigation techniques. There is, frankly, a greater challenge on some of the transparency initiatives.

We have swap execution facilities. Europe is looking at something called OTFs, but those OTFs might be a little different than what we are doing here on swap execution facilities.

Mrs. MALONEY. And Chairman Schapiro?

Ms. SCHAPIRO. Thank you. I would just add, I agree there is, of course, always a risk of regulatory arbitrage, but there are also very significant incentives among the G-20, among the Financial Stability Board members who have put forward the recommendations to implement the G-20 commitments, about what needs to be done in the OTC derivatives space.

And while we have a lot of consensus around a lot of issues, there are a few, as Chairman Gensler notes—trading platforms and transparency regimes I would speak to in particular—where we are not exactly in the same place. That is why it is so important for us to continue to push, to lead task forces and working groups of international regulators, and to persuade others to come to very consistent requirements along with the United States.

Mrs. MALONEY. And Mr. Walsh?

Mr. WALSH. I guess I would just add to what the others have said, that commitments have been made to achieve consistency. And if we succeed in achieving consistency in the derivatives area and the capital area, and, as Governor Tarullo pointed out, if people actually deliver on those commitments in comparable ways, then there should not be an arbitrage or a race-to-the-bottom problem. But of course, it is challenging to do that in an international context and we will have to work at that.

We also have to be careful here at home that as we integrate some of the Dodd-Frank requirements specific to us and the international commitments, that it works well also.

Mrs. MALONEY. My time has expired. Thank you very much.

Chairman BACHUS. Thank you.

Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

I would note that there is not a representative of the insurance industry on this panel. So I will ask Ms. Brainard, do you know when the President plans to finally nominate an independent insurance expert who will have a vote on FSOC?

Ms. BRAINARD. In fact, we have our new Director of the Federal Insurance Office, Michael McRaith, in place; I think it has been 3 days.

Mrs. BIGGERT. You have him, but you don't have the insurance expert who has the vote on FSOC, as you all do.

Ms. BRAINARD. I don't have the answer for you on the timing on that, but I will get that for you.

Mrs. BIGGERT. All right. Then, critical to the U.S. competitiveness is the FIO person, and I am glad, and he also—I happen to be from Illinois, so I am very happy that he is there—but so he will proceed right away—3 days he has been there now?

Ms. BRAINARD. That is right, and I can get you the information on the expert as well.

Mrs. BIGGERT. Okay. Because certainly with what is happening in USTR on the trade agreements, it is important that he be there.

And then to all of you, since all of you represent Federal agencies that are a part of FSOC, can someone explain their understanding of how FSOC's proposed rules could impact insurance businesses, which are regulated by the States? We have no insurance person to really let us know.

Ms. Brainard?

Ms. BRAINARD. I think, first of all, the insurance commissioners from the States will be represented on FSOC, and as they go through the designations process, will be part of that process.

The other thing that we are working hard on just because this hearing is very focused on achieving international consistency, is that we already have a representative, the NAIC, on the international body, the IAIS. And we are looking forward to having FIO represented there as well.

Mrs. BIGGERT. Okay. So your resources and staffs are devoted to ensuring that the FSOC rules when they are finalized, that taking into consideration the uniqueness of the insurance and—

Ms. BRAINARD. Absolutely. I think given the importance of the State insurance commissioners, that FSOC will proceed in a way that takes into account the unique nature of this market and the way that it is regulated in the United States.

Mrs. BIGGERT. So looking at the Volcker Rule, which several of you have addressed here, would insurance businesses be allowed to continue to invest in private equity?

Ms. BRAINARD. I cannot speak to how the Volcker Rule will be applied. As you know, that process is yet to come, and in particular how it will applied, but that is something that is still under consideration.

Mrs. BIGGERT. Mr. Tarullo?

Mr. TARULLO. The key issue, though, with the Volcker Rule is whether or not the depository institution is engaged in the activity and then whether any insured institution that is affiliated with that entity engaged in the activity. If an insurance company is itself not the owner of a depository institution, then it is not going to be covered.

Mrs. BIGGERT. Okay.

Chairman Schapiro, would you agree with that?

Ms. SCHAPIRO. Yes, I would. The Volcker Rule applies to banking entities, and so it would depend upon the structure of a particular insurance company.

Mrs. BIGGERT. Okay. And I would note that before the August recess, the Subcommittee on Insurance, Housing and Community Opportunity will hold an insurance oversight hearing to further examine these related insurance issues. And I hope that by then we have a representative on FSOC, which would be helpful.

With that, I yield back.

Chairman BACHUS. Thank you.

And Under Secretary Brainard, that is something I think many of our members are concerned about, that that position is filled. And I know that the Administration has put some ethical considerations out, but one of them was that they had not been involved in insurance operations, which sort of rules out a lot of people with experience.

At this time, the first panel is discharged. We appreciate your testimony. And the fact that the hearing was not a long hearing doesn't mean that—we have your testimony, which will be of great value to us. And we look forward to working with you in the coming months as we try to implement Dodd-Frank.

Thank you.

The committee stands in recess until votes are over.

[recess]

Chairman BACHUS. I want to welcome our panelists. The hearing will come to order.

Our second panel is made up of: Mr. Stephen O'Connor, managing director of Morgan Stanley, and chairman of the International Swaps and Derivatives Association, testifying on behalf of the International Swaps and Derivatives Association; Mr. Tim Ryan, president and CEO of the Securities Industry and Financial Markets Association, SIFMA, and we welcome you, Mr. Ryan; Professor Hal Scott, Nomura professor and director of the Program on International Financial Systems at Harvard Law School; Mr. Barry Zubrow, executive vice president and chief risk officer of JPMorgan Chase; and Mr. Damon Silvers, associate general counsel of the AFL-CIO.

So, Mr. O'Connor, we will start with you.

STATEMENT OF STEPHEN O'CONNOR, MANAGING DIRECTOR, MORGAN STANLEY, AND CHAIRMAN, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, ON BEHALF OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION (ISDA)

Mr. O'CONNOR. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee, for the opportunity to testify today.

I would like to begin by making five key points.

First, ISDA represents more than 800 members from 56 countries. Our broad membership includes corporations, asset managers, governments, supranational entities, exchanges, and clearinghouses, as well as global and regional banks.

ISDA and our members squarely support the goals of Dodd-Frank and global financial regulatory reform. We have worked proactively with policymakers in the United States and around the world to this goal.

Second, we have made and continue to make substantial progress in implementing the most important aspects of reform, those relating to systemic risk mitigation, such as central clearing and trade repositories.

Third, further improvements can and will be made. And I would like to note here that there is a high degree of consistency between U.S. regulators and regulators in other major jurisdictions on the systemic risk rules relating to clearing and regulatory reporting. This is very helpful for market participants.

On the other hand, there is far less consensus between the United States and overseas jurisdictions regarding matters outside the systemic risk area. These issues relate primarily to OTC derivatives market structure, and they are critical to the viability of U.S. markets.

Finally, in addition to the potentially substantive policy differences between the United States and other regulatory regimes, there are equally significant timing differences between jurisdictions, differences that will go a long way in determining the competitiveness of our country's markets.

Turning to some of the key policy differences, we believe that the application and effect of U.S. law and regulation should be as even-handed as possible with respect to both U.S. and non-U.S. institutions. And, regrettably, at this point, it seems that there will not be equal treatment of U.S. and foreign firms at the institutional level.

In addition, our members are concerned about the potentially divergent approaches at the jurisdictional level. It appears that other regulatory jurisdictions are likely to adopt regimes that differ from our own in meaningful and material ways.

As I have mentioned, these policy differences are not generally in the area of systemic risk mitigation, the primary driver of regulatory reform. Instead, they are in the area of market structure.

Here are some examples of the differences.

Banks operating in the United States will be forced to comply with Section 716 of the Dodd-Frank Act, the so-called "push-out" provision, which has no counterpart in proposed European or Asian regulations.

ISDA supports the removal of Section 716 to resolve the inefficiencies, competitive challenges, and increased systemic risk that will surely result from such a requirement.

Another area of difference is with regard to electronic trading venues or SEFs. At this point, critical components of the CFTC rules for SEFs have no regulatory parallel in Europe or other major jurisdictions.

As I have noted in great detail in my written testimony. these rules could adversely impact U.S. competitiveness and the depth and liquidity of U.S. markets. And ironically, they will likely harm the intended beneficiaries of the new rule, the commercial end-users of derivatives.

Another important point of divergence relates to the proposed business conduct rule. The CFTC's proposal seems to ignore the institutional nature of the OTC derivative market. Moreover, the standards far exceed the protections required by the statute and go well beyond the regulatory framework contemplated in other jurisdictions. These rules will further impair the viability of U.S. markets.

Another key issue is the issue of extraterritorial jurisdiction. Today, there are serious concerns about the reach of the Dodd-Frank Act outside of the United States and into activities undertaken overseas. Extraterritorial reach exacerbates the problems created by asymmetric rules. Furthermore, it is inconsistent with congressional intent in limiting the territorial scope of the new regulatory framework for derivatives.

As I mentioned, there are also meaningful differences in timing between the various jurisdictions. It appears that the U.S. financial markets will be subjected to a new regulatory framework well before other jurisdictions. This will create an uneven playing field and could cause capital to leave our shore, and will be harmful to U.S. markets.

To summarize, there are large and growing differences in regulatory reform efforts in the United States and abroad. These differences have less to do with systemic issues—risk issues—and more to do with the structure of markets.

Policy differences that impose significant costs but offer few, if any, offsetting benefits, may lead to decreased liquidity, a reduction in growth of capital, and the erosion of U.S. competitiveness. These losses will be measured in jobs and tax revenues.

The best way to avoid the issues that I have discussed and to protect the competitiveness of U.S. markets is to work with Europeans and other overseas policymakers to ensure strong, yet harmonized, rules that are implemented along the same timeline. This will reduce the impact of any temporary or permanent regulatory differences between markets and mitigate the damages these differences will cause to the United States.

Thank you, and I would be happy to answer your questions.

[The prepared statement of Mr. O'Connor can be found on page 110 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Ryan?

STATEMENT OF T. TIMOTHY RYAN, JR., PRESIDENT & CEO OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. RYAN. Thank you, Mr. Chairman, and members of the committee.

In my written statement, I have responded to the questions you asked in your invitation. So in my oral statement, I want to focus on three major issues that significantly warrant special attention.

It is our hope that Congress will agree with me and press for answers to questions I will raise through a combination of further hearings by this committee and additional study by policymakers here and globally.

First, who are the global systemically important financial institutions, the so-called G–SIFIs? This is a very difficult question which frames subsequent debate, including the capital surcharge debate you had this morning, and impacts what actions should be taken with respect to such firms.

Most of us think we know the firms pre-ordained to make the list, but at this moment, no such public list exists. We do know there is a long list of firms who do not want to be in the G–SIFI club.

There are related questions that need to be asked on this topic. One, who decides whether a firm should be on the list? Two, is this a domestic decision or a global decision?

Three, should countries without a G–SIFI have a say in the process? Four, what will be the criterion factors used to make these determinations? Five, will this process be transparent, fair, and subject to review and appeal?

None of these questions have been publicly answered.

A second major question we would like to pose, and you talked about this all morning, regulators have spent a lot of time focused on the need and size of a special additional capital surcharge on G–SIFIs to mitigate systemic risk.

Like the first question, this one has several related questions associated with it, such as how large should the surcharge be? What types of capital should qualify to meet the surcharge? And will there be any mitigating factors or actions which might lessen the need for a surcharge?

Since the financial crisis occurred, policymakers, regulators, the financial services industry and consumers have all changed their behavior. We have been very busy making the systems changes. But the industry and government have failed, really, to understand or assess the total aggregate impact of all of these actions.

It is important for you to understand the enormous amount of change taking place in our financial markets today. Other witnesses will provide you with definitive figures, but it is really important to note that in the United States, we have raised more than $300 billion of common equity, while repaying TARP with a $12 billion profit. The largest banks have significantly reduced their average leverage. And loan reserves have increased by over 200 percent.

Now, I can go through a long list, but you all know the list of Dodd-Frank actions which we are now trying to implement. SIFMA alone has filed over 100 comments during this regulatory process.

While we are working through the Dodd-Frank changes, which significantly modify the banking activities in the United States, we are also faced with comparable changes in Basel which we are trying to work through.

One point I would like to make that is important, I want to echo a comment made yesterday by the General Counsel of the FDIC, Mr. Krimminger, which was also discussed this morning, about the question of resolution of large systemically important institutions, certainly in the United States.

We worked very hard with this committee to make sure that legislation was done in an appropriate fashion, and we are hopeful that both in the United States and outside the United States, that resolution scheme is recognized as something that is viable.

So as to question two, we would like Congress and the regulators to postpone any decision on G–SIFI capital surcharge until the industry has had time to implement all of the regulatory changes making their way through the system and the affected parties, which includes the private sector and government, conduct a study to see what impacts this surcharge has actually on the financial institutions and on the economy.

Now, Mr. Chairman, one last comment. In your letter, you asked us to specifically comment on accounting convergence. I can say that, from a SIFMA standpoint, we are supportive of the convergence of US GAAP and international accounting standards.

We are concerned with the application of IEFC standards on offsetting, and we welcome the recent pronouncements by the U.S. standards setter, the FASB, supporting the US GAAP standard that allows netting.

Again, thank you for holding this hearing and asking me to testify.

[The prepared statement of Mr. Ryan can be found on page 121 of the appendix.]

Chairman BACHUS. Thank you.

Professor Scott?

STATEMENT OF HAL S. SCOTT, NOMURA PROFESSOR AND DIRECTOR OF THE PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, HARVARD LAW SCHOOL

Mr. HAL SCOTT. Thank you, Chairman Bachus, and members of the committee.

I am testifying in my own capacity and do not purport to represent the views of any organizations with which I am affiliated, although much of my testimony is based on work of the Committee on Capital Markets Regulation. Indeed, for the last 6 years, the committee has been tracking and making recommendations to strengthen the competitiveness of our capital markets.

Let me address the issues you called on us to comment on.

Let me begin with the Volcker Rule. The Volcker Rule was passed with the hope of Chairman Volcker that other nations would follow us. None have.

This rule was ill-advised from the start, because proprietary trading was not responsible for the financial crisis. Indeed, it was a source of profitability.

Now, it could have the effect of making U.S. firms less competitive internationally. There is still time to dampen its potential effect, however, because defining the precise boundaries of the prohibition falls to regulators. They can, and should, take a narrow approach in defining proprietary trading to preserve our competitiveness.

For the derivatives rules, there are major areas in which the U.S. proposals diverge from the proposals of the E.U., our major competitor in this area. The differences include standards for membership in and ownership and control of clearinghouses, the scope of the end-user exemption, and possibly accounting standards.

We should put aside for now the initiatives we are taking that are in conflict with the E.U. These areas can be defined in concert with the E.U. and should be the subject of efforts to harmonize our approaches.

In the meantime, we can implement the non-conflicting initiatives on an appropriate timetable. And, as you know, the CFTC has called for comments on proper sequencing. We may have to make some compromises, as will the E.U. But it is not credible for us to say, "our way or the highway."

For capital requirements, we are now in the third version of the capital accord, the Basel Capital Accord. Although it is very difficult to precisely quantify the economic impact of Basel III, we know it will affect GDP in only one direction—down, perhaps up to $951 billion in the U.S. alone, between 2011 and 2015, according to one estimate.

Although Basel III is an international initiative, it has differential impact in different countries. Testimony earlier today by Acting Comptroller of the Currency Walsh and of Governor Tarullo frankly acknowledges this problem. But beyond the uniformity problem, we should have learned a big lesson from our experiences with Basel I and Basel II.

The ability of Basel to determine the right amount of capital for a given risk is highly questionable. Basel III is not a silver bullet. Far from it. In my view, we should use the long full phase-in in time provided by the Basel III rules to re-examine how these rules can be more effective and implemented in a fashion to minimize differential impact.

Next, I want to discuss designating SIFIs, or systemically important financial institutions. Dodd-Frank requires FSOC to designate non-bank firms as systemically important and thus subject to Fed supervision, along with the $50 billion-plus banking organizations which are already subject to Fed supervision under Dodd-Frank.

Other countries are going through a similar designation process. Different approaches to designation and different SIFI surcharges could have a major competitive impact. Thus, we should have a global approach here. Our national process should be tightly coordinated with the work of the Financial Stability Board, the operational arm of G-20.

Finally, resolution of failed financial firms remains an important and difficult issue with competitive implications. Chief among these is that divergent positions on bailouts will alter the cost of capital. Countries more willing to bail out banks will lower their cost of capital.

We learned this from our competition with Japan before its lost decade. Furthermore, many large banks have significant cross-border operations, and their failures can affect all the countries in which they operate. Some countries ring-fence the assets of their local banks to protect local creditors. Those banks could get a competitive edge as well.

We should continue to work with the FSB to achieve as internationally coordinated approach to these resolution issues as possible.

Thank you, and I look forward to your questions.

[The prepared statement of Professor Scott can be found on page 156 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Zubrow?

STATEMENT OF BARRY ZUBROW, EXECUTIVE VICE PRESIDENT AND CHIEF RISK OFFICER, JPMORGAN CHASE & CO.

Mr. ZUBROW. Thank you, Mr. Chairman, and members of the committee. My name is Barry Zubrow, and I am the chief risk officer of JPMorgan Chase.

In the wake of the financial crisis, numerous steps have been taken to reduce system risk in U.S. banking. Since some of my testimony was quoted so extensively earlier today, I won't repeat those portions now. However, the important lesson to draw from all the actions taken in the last few years is that capital is one tool, but certainly not the only tool, nor is it a cure-all for ensuring that there is not a recurrence of a financial crisis.

JPMorgan Chase is not trying to avoid regulation, but we do have serious concerns that the regulatory pendulum has swung to a point that risks hobbling the competitiveness of our financial system and of our economy.

Basel III is a dramatic increase in capital standards, focused exclusively on the largest banks. It focuses particularly on trading and other assets likely to produce systemic risk.

At this point, the best course for the system is not adding a surcharge on top of the Basel III standards, but rather ensuring that liquidity, derivatives, and other rules are written right and applied globally.

One year after Dodd-Frank, other countries are still debating whether to follow suit. And there are indications they will not, in many areas. Lack of international coordination on derivatives and the potential for extraterritorial application of the U.S. rules could prevent U.S. firms from serving our clients overseas.

There is already evidence that Basel III will not be enforced as stringently abroad as it is here. Nowhere has change been more profound than in the area of capital, where U.S. banks face a dramatic increase under Basel III.

And I should emphasize that these increases effectively apply only to the largest banks. To illustrate, JPMorgan Chase entered the financial crisis with capital sufficient not only to weather the crisis but also to make acquisitions and to continue our lending activities.

The new Basel III rules would require us to hold as much 45 percent more capital than we did during the crisis.

Let me be clear. JPMorgan Chase supports Basel III capital standards. However, we believe that a G–SIFI surcharge on the largest U.S. banks would be excessive and could impede economic growth.

Draconian capital requirements come at a cost for U.S. competitiveness and economic growth. Requiring capital at a level above Basel III will force large banks to either reduce their balance sheets, increase prices or abandon more capital-intensive activities.

For example, we estimate a hospital requesting a standby letter of credit could see its costs go up by as much as 30 percent. Or a small mid-market client could see increases of as much as 20 percent on a revolving line of credit.

In conclusion, our holistic approach to risk management was one of the key reasons JPMorgan weathered the financial crisis as well as we did.

My responsibility as chief risk officer is to look at all of the bank's activities across all markets. We believe the FSOC was intended to serve in effect as the chief risk officer for the financial system, analyzing and coordinating the impact of regulation on safety and soundness, but also on economic growth and competitiveness.

We believe that before any capital surcharge is imposed, the FSOC should review and report on the global regulatory reforms that have already been enacted and their impact on competitiveness, whether existing capital standards are being evenly applied, and the cumulative impact of existing regulations on safety and soundness as well as economic growth.

We would expect that such an analysis would demonstrate that a G–SIFI surcharge is unwarranted.

Thank you very much, and I look forward to answering your questions.

[The prepared statement of Mr. Zubrow can be found on page 222 of the appendix.]

Chairman BACHUS. Thank you, Mr. Zubrow.

Let me say that Ranking Member Frank acknowledged that he only read small inserts which were most favorable to him. And we pointed out some of the things that were not so in line.

Mr. ZUBROW. We appreciate that. And I am sure that he and others on the committee will take my testimony in its entirety.

Chairman BACHUS. And, actually, since he likes your testimony so much, I don't think we will have any problem getting him to go along with some of these suggestions.

Mr. ZUBROW. We certainly hope that he will be as enthusiastic about the conclusions as about the premise.

Chairman BACHUS. Thank you.

Mr. Silvers?

STATEMENT OF DAMON A. SILVERS, POLICY DIRECTOR & SPECIAL COUNSEL, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS (AFL–CIO)

Mr. SILVERS. Yes, thank you, Mr. Chairman. Good afternoon. I appreciate, on behalf of the AFL–CIO and Americans for Financial Reform, the opportunity to testify. The Americans for Financial Reform is a coalition of over 250 organizations which represent well over 50 million Americans.

In an age of global markets, any serious effort to ensure that we do not repeat the experience of 2008 must include the establishment of an international regulatory floor. Otherwise, every country's financial institutions are vulnerable to contagion from radically unregulated markets, as Iceland, Ireland, the United Kingdom, and the United States proved in 2008.

However, minimum standards are inevitably weaker than more effective national efforts. That is why they are called minimum standards.

The United States, for example, has moved more rapidly on derivatives regulation than Europe has, but has been less aggressive with private pools of capital like hedge funds and private equity. And we have been faulted by European regulators for the weakness of our approach to regulating executive pay in financial firms.

And so while we hear this afternoon about the possibility that business would leave the United States because of the strength of our regulatory effort, over in Europe, parallel threats are being made about financial activity moving to the United States as a result of the strength of European regulatory efforts.

Nonetheless, today the big banks have come seeking help from Congress yet again. They say that Dodd-Frank is too tough compared to foreign regulation.

It seems odd that a group of firms that the American public so recently rescued from imminent bankruptcy now, amid 9 percent unemployment and after 7 million foreclosures, after record bonuses and amid rising CEO pay, think that they are the people whom Congress needs most to help right now. Nonetheless, here we are, and so I will now address the banks' specific arguments.

On derivatives, we have heard that by requiring that capital be posted and that there be disclosure on pricing, we will drive derivatives trading away from U.S. institutions.

This type of argument has been used to oppose virtually every effort to regulate finance for at least the last century and perhaps longer. It sounds plausible, but it is historically wrong.

As a general matter, capital markets activity flows through well-regulated markets, where market participants have confidence in their counterparties and can benefit from transparent pricing. Radically deregulated markets attract brief bubbles before their inevitable comeuppance.

In addition, there are some kinds of derivatives businesses that we do not want. We do not want the next AIG, the next seller of bond insurance without any capital to back it to be a U.S.-based firm. We should not want the United States to retain a dominant position in derivatives by guaranteeing that derivatives dealers' monopolistic profits at the expense of our real economy.

We have heard today that the Volcker Rule in Section 716 of Dodd-Frank will impair the competitiveness of U.S. financial institutions, apparently by lowering their rates of return.

This argument ignores the basic principle of investing that seeking higher returns exposes a firm to greater risk. Moving up the risk-return curve is not a good idea for a too-big-to-fail institution, though it is in the interest of the executives of those firms with stock-based compensation who benefit from the heads-I-win, tails-you-lose nature of allowing systemically significant FDIC-insured firms to place bets in the securities markets.

On capital requirements, the Basel III process envisions basically a one-size-fits-all risk-based capital requirement system back-stopped by an absolute leverage limit of 33:1, an extraordinary high level.

Here, Congress should ask, do we want the United States to have a robust, size-based system of capital requirements for our banks, or do we want to be no better than the global minimum standard that does not impose higher capital requirements on larger institutions, thereby not addressing the problem of too-big-to-fail?

Finally, we hear that we cannot implement the resolution authority process envisioned in Dodd-Frank until we have a comprehensive international resolution authority.

This argument is a red herring and will be used in the future to promote new bailouts. It is a red herring, because the resolution process in Dodd-Frank is fundamentally focused on the parent company, not its foreign subsidiaries. The breakup and wind-down of the failed U.S. parent occurs entirely within U.S. law.

Now, real progress has been made toward a global financial regulatory floor. Great credit goes to the witnesses in the first panel, particularly to Governor Tarullo and his colleagues at the Fed for their work on Basel III.

But a minimum standard is just that, a minimum.

The measure of U.S. financial regulatory policy should not be whether we manage to meet the global minimum. The measure should be whether we have ensured that the financial system is a contributor to sustained, balanced growth in our real economy.

International deregulatory whipsawing and infinite delay of the kind recommended today by my fellow witnesses may temporarily increase some bank profits, but the price will be another cycle of economic crisis and job loss.

Thank you.

[The prepared statement of Mr. Silvers can be found on page 183 of the appendix.]

Mrs. BIGGERT. [presiding]. Thank you.

And thank you all for being so patient as we left this morning to go vote and finally came back. The chairman and the ranking member had agreed that we would not start at the top again, but would go to those who are here who did not have the opportunity to ask a question this morning.

So we will go to Mr. Luetkemeyer from Missouri, who is recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Mr. Ryan, with regard to the Foreign Account Tax Compliance Act, FATCA, I was going to talk to Ms. Brainard about it, but since it is affecting you and your industry, I would like to pose a question to you with regards to under FACTA, the firms will be required to report to the IRS on U.S. clients or face a heavy withholding tax on U.S. assets and treasury bonds.

As a response, many have indicated that they will either sell all of their assets, form subsidiaries that will not touch U.S. assets, or stop buying U.S. bonds. This will undoubtedly hurt companies not only in my State but across the Nation. And we are curious as to what steps that you see that the Treasury Department needs to do to prevent FATCA from having a negative impact on U.S. capital markets.

Mr. RYAN. And I will be able to move quickly on this issue, because we have multiple committees working on this issue, and we have not come to a conclusion. So what I would like to be able to do is to submit our views for the record after the hearing.

Mr. LUETKEMEYER. Okay.

It could have a major impact on the ability of investments being made by foreign entities and Americans who are purchasing through their foreign entities into this country. And that can have a dramatic impact on the amount of capital that is available in the marketplace if suddenly the foreign entities stop purchasing. So I think it is a pretty pertinent question to the title of the hearing today, and I appreciate that.

With regard to the fiduciary rule that is coming out of DOL, of all places, with regards to the ability of some securities folks to be able to sell different types of securities, what do you think we need to do with that one?

Mr. RYAN. You probably look at my resume, because I have repotted myself many times in my—during the Reagan Administration, I was solicitor of labor so I have had a lot of experience with ERISA and a lot of experience with the DOL.

We have spent quite a bit of time with the Department of Labor and other bureaus of the government, basically, trying to get the Department of Labor to withdraw their proposal and re-propose. We would like to see it better coordinated with other similar work that is taking place now with the Securities and Exchange Commission as a result of Dodd-Frank.

And we are especially concerned about their effort to, for the first time ever, regulate at the Department of Labor IRAs.

Mr. LUETKEMEYER. Okay, Professor Scott, you deal a lot with—you are director of the program on international financial systems at Harvard. I am just kind of curious, what is your thought process on the—with Dodd-Frank, it seems as though we have a lot more connectivity between all the different larger institutions. They have gotten bigger, and by putting other weaker institutions that absorb—to me, they have gotten bigger and weaker.

In discussing this with a number of panels over the last several months, we have seen the connectivity between our banks here and those countries over in Europe, especially some that are in trouble.

And this morning we saw that Greece—the headlines in the paper, anyway, with Greece indicates—one article had a 50/50 chance that they would default. I think Moody's made the comment this morning that there was a 50/50 chance they would default.

What do you see as the impact of that? I know we are talking about regulations here going in that direction, but the impact of them coming this direction, our ability with this Dodd-Frank bill, which has caused the connectivity of all these banks to be even greater and now connected over there, how is that going to impact everything? Can you kind of shed some light on it?

Mr. HAL SCOTT. You are focused on the issues going on in Europe and what their impacts are here.

Mr. LUETKEMEYER. Right. We also have some regulatory issues here that have, I think, impacted that by tying everybody together even to a greater extent.

Mr. HAL SCOTT. I think American banks hold a lot of sovereign debt of the countries that we are talking about, directly or indirectly, or have derivatives of such debt. While I have not studied this in depth, I believe that there would be—if we were talking about any kind of restructuring or default of that debt, which, of course, is in the midst of argument at the moment—that we could expect that it would have some impact on our banking system.

That being said, it would have a lot more impact on European banks in terms of their holding of this debt. So, overall, whether it would rise to the level of real concern, I don't know, because I haven't looked at the statistics enough. But I would think we would have some concern with the impact on our banking system. Whether it is severe or not, I don't know.

Mr. LUETKEMEYER. I see my time is over.

But I would think it would have a pretty significant impact when you have—I think the latest figure I saw was $1.3 trillion worth of investments from our banks in those countries' bonds. That is pretty significant. And if the domino effect keeps going, we are going to be at the end of this line of dominoes.

So thank you, Madam Chairwoman.

Mrs. BIGGERT. Thank you.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you.

Mrs. BIGGERT. Five minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you.

I joined this committee in 2003, and I remember that by the end of 2006, certainly early 2007, it was very apparent that there was an enormous problem in subprime mortgages, that there would be an enormous number of defaults, an enormous number of foreclosures, that because house prices had stopped appreciating, it would not be possible for homeowners to sell their homes or refinance their homes.

And we were assured by the financial industry throughout 2007, really through September of 2008, that there was nothing to worry about, everything was under control.

Because of that experience, I have not always known who to believe since then. And I may very well have disbelieved some things that people told me that were true as a result of that experience. But it is very hard to tell what the liability of some of the banks really is for what is going on in mortgage securitization.

Mr. Silvers, if you may change hats for a second, the Congressional Oversight Panel said in November of last year that the potential liability for the chain of title issues for mortgages that ended up in securitized pools was sufficiently serious and uncertain that it could threaten solvency of the banks. Sheila Bair said roughly the same thing just a month ago.

And within the last few days, it appears that the New York attorney general is investigating Bank of America, at least, for those very violations or potential violations.

Mr. Silvers, what is your current estimation of the potential liability of the securitizers, which were the biggest banks, for chain of title issues?

Mr. SILVERS. As you said, the Congressional Oversight Panel's report on this matter, the panel which I was the vice chair of, found that there were certain key issues that we could not answer, partly because we did not have the investigative authority and partly—somewhat complex legal issues.

However, the statements that you were quoting, which I believe is still the case, is that if it turned out to be true that systemically title was not properly conveyed to the liens on the properties that had been securitized, and that if it was also true as a matter of law that the lien did not follow in some equitable fashion the note, then that would implicate a series of very significant issues associated with the REMIC doctrine in our tax code. And it would also implicate some questions in New York trust law.

If all those things went wrong—meaning wrong from the perspective of causing liability—and it turned out that effectively the properties in the securitization trust did not have—that the trust did not have liens—

Mr. MILLER OF NORTH CAROLINA. Instead, they were mortgage-backed securities. They were unsecured debts.

Mr. SILVERS. Right. They were mortgage-backed. If it turns out that the mortgage-backed securities were not mortgage-backed and it turned out that could not be cured as a result without incurring vast tax liabilities for breaching the REMIC structure, then potentially between the tax liabilities involved and the possibility that the holders of the mortgage-backed securities would be able to call upon their right to repurchase the loans at face value, that you would be talking about liabilities back to the securitizers, the institutions that put those trusts together in the multiple hundreds of billions of dollars, well in excess of the numbers that were cited by my fellow panelists in terms of new capital raised by the banks.

Mr. MILLER OF NORTH CAROLINA. Mr. Zubrow, how has JPMorgan Chase reserved for that potential liability?

Mr. ZUBROW. I think, as Mr. Silvers responded to your question, there is a long chain of different things that might have to have happened in order for that liability to actually have come about. And so, we certainly do not think that whole long series of events actually did occur. And I would say if—

Mr. MILLER OF NORTH CAROLINA. So you see it as a long shot, and you have reserved it. If at all, it is a long shot.

Mr. ZUBROW. That would be correct.

Mr. MILLER OF NORTH CAROLINA. Okay.

Let me ask you about other pending litigation. There are a couple of insurers of the bond, AMBAC, another that has sued JPMorgan Chase really for conduct of Bear Stearns, that Bear Stearns sold mortgage-backed securities, but then pursued claims against the originators of the mortgages to buy the mortgages back, and instead of making them buy it back, took monetary damages.

Even though they no longer had equitable—excuse me—beneficial ownership of the mortgages, they kept that money and said not a word to the investors. That lawsuit appears to be pending. It is perhaps moving to trial this fall.

How has JPMorgan Chase reserved for that litigation?

Mr. ZUBROW. I am generally familiar with some of the litigation in that area. I don't know off the top of my head the exact way that we have assessed the potential or possible liability under that case, which as you noted, originated originally with activities that Bear Stearns pursued. But we would certainly be happy to get back to you and give you a specific answer.

Mr. MILLER OF NORTH CAROLINA. Okay.

Mrs. BIGGERT. The gentleman's time has expired.

The gentleman from Arizona, Mr. Schweikert, is recognized for 5 minutes.

Mr. SCHWEIKERT. Thank you, Madam Chairwoman.

I don't know if any of you were able to hear some of the testimony this morning, but one of our current pop culture phrases is "regulatory arbitrage." And I was going to actually start with Mr. Scott, since I thought we will go from the academic.

Will you give me, first, some international, but also even some domestic examples?

Mr. HAL SCOTT. Yes, examples of regulatory arbitrage. We have had many in our history. When the United States imposed very tough requirements on banks in this country in the 1970s, we spurred the creation of London as an international banking center.

When the United States, in my view, overregulated its equity capital markets, and our committee has documented this extensively, a lot of the business in those capital markets, in the equity capital markets moved abroad, and particularly to London again.

And the severity of this is once you get whole businesses moving someplace, even if we readjust our policies or London gets more aggressive on theirs, people don't come back. They kind of stay where they are. So I think we have had a number of very important examples of regulatory arbitrage in the history of our financial system.

Mr. SCHWEIKERT. Okay.

Madam Chairwoman, to the panel, and actually it was Congressman—is it Miller?—who was just speaking, who actually just kicked off one of my heads. And I can actually sort of think of something domestically, and tell me if this is actually true. And this might be appropriate for my friend from Chase.

If I am in a State that has a 91-day deed of trust default, compared to a State that may use a mortgage document that has a 6-month right of redemption, should there not be a difference in the pricing of those loans, a 30-year home loan between those two jurisdictions? If both of those actually have a regulatory arbitrage, just in the—might threaten my cost of a foreclosure and my liability.

Mr. ZUBROW. I think that you are certainly correct that, given the application of individual State laws, and in some instances individual county laws, to the home financing marketplace can have an impact upon how we assess risk and ultimately would expect that risk to be reflected in the marketplace.

I think in addition it is worth noting that, going back to your question about historical examples of regulatory arbitrage, there certainly was a significant amount of regulatory arbitrage in the

United States through the disproportionate oversight of different financial institutions.

And certainly one of the things that we now have is the fact that the Federal Reserve Board has overall responsibility for oversight and supervision of the large financial institutions in order to avoid that sort of arbitrage.

I would cite on the international side that one of the things that we are very concerned about is a form of regulatory arbitrage between different countries, where different supervisors and regulators will apply different standards for measuring risk-weighted assets under the Basel III accord such that the application of models and analysis of risk-weighted assets may result in a lower rating or lower ranking of risk in some jurisdictions than what we would anticipate will be applied here in the United States.

Mr. SCHWEIKERT. Okay. If I have that different risk ranking, how much of that is also in the quality of, we will call it enforcement? If I have, whether it be a derivative trade or a home mortgage, if I have a different enforcement of the rules in Greece or someplace in Europe compared to if I do in Iowa, how much will you look into, when you are doing risk analysis, not only saying, “Okay, we lined up on Basel III rulemaking, but we believe there is a failure of enforcement?”

Mr. ZUBROW. I think that is a very good question, Congressman. And certainly that does need to be a factor in our analysis of how we assess risks that we take in different jurisdictions and certainly, in the potential for enforceability of contracts around the world.

Mr. SCHWEIKERT. Okay, if anyone else has something to educate us in our—

Mr. RYAN. I don’t want to take anybody’s time, but could I make one comment, Madam Chairwoman?

Mrs. BIGGERT. Mr. Ryan, yes.

Mr. RYAN. Thank you.

For us, I think this is not specifically regulatory arbitrage, but we are in the middle now of trying to implement Dodd-Frank, which is a massive assignment for the government and for the industry. And disparate application of Dodd-Frank by various U.S. agencies is a real issue.

We have recently sent a letter to Secretary Geithner outlining over 20 absolute dead-bang conflicts in regulation that are now being offered by various U.S. agencies.

And to Mr. Zubrow’s comment about FSOC, we actually thought that. That is why FSOC was created within Dodd-Frank, to resolve those types of issues. So you don’t have to go beyond the borders of the United States to find conflicting application of the same law.

Mr. SCHWEIKERT. Okay. Thank you, Madam Chairwoman. Thank you for letting me—

Mrs. BIGGERT. The gentleman’s time has expired.

Mr. Carney from Delaware is recognized for 5 minutes.

Mr. CARNEY. Thank you very much, Madam Chairwoman. I just joined the hearing. I just walked in, so I missed all the lead-up to this.

But I was present here this morning when we had the panel of regulators and the discussion. Most of the discussion this morning was on the cumulative effect of Dodd-Frank regulations and so on, capital and liquidity requirements.

And Sheila Bair in particular said that she thought that the capital requirements were on the low end, and the Governor from the Fed, Mr. Tarullo, I spoke with afterwards, and he suggested that he agreed. We had some back-and-forth on that.

And I would like to know—this question may not be germane to the discussion that preceded my arriving, but we have some expertise at this panel and I would like your view on that question, if I could.

Please?

Mr. SILVERS. The answer to this question is not simple, in part because of the exchange that just occurred. If your capital requirement—if you are looking at risk-weighted capital requirements and you get into the interstices of that and it turns out that risk-weighting is being used essentially to pretend that you don't have risks that you do have, as we saw under Basel II around mortgage-backed securities, for example, then you may look like you have really strong capital requirements, but you don't. Okay?

With Dodd-Frank, some of this is still being put in place. There are some very important principles in Dodd-Frank that are very good. One of them, for example, is at least Dodd-Frank embodies the principle of size-based capital requirements, that we have just learned that we tend to like to bail out large institutions, so we charge them a higher capital rate.

That counterbalances for the fact that their cost of capital is subsidized by the market perception that they are going to get bailed out. So it is a good thing.

Mr. CARNEY. If I could stop you there, one of the questions that I had of Governor Tarullo was just that—those SIFIs that are on the borderline, and whether or not they would be subject to the same capital requirements of the big, big SIFIs, if you will.

And the answer was no, that there was a gradation there, and it seems to me that you are addressing that.

Mr. SILVERS. I think sliding-scale capital requirements are a really, really good idea. I think that a cliff structure or a binary structure, you get into this argument of, "I am on the line."

Mr. CARNEY. Right.

Mr. SILVERS. And the sad thing about people who are on the line is is that when they are setting the rules, they are likely to be exempted. And then when the crisis comes, they are likely to be bailed out.

If you have more of a continuous approach—the kind Governor Tarullo, I think, spoke to you about—then you are more likely to have a consistent approach.

Mr. CARNEY. Others? Please?

Mr. ZUBROW. So I think that the—

Mr. CARNEY. By the way, your name and your paper was quoted profusely by the ranking member, I might say. And somebody asked whether it came on Valentine's Day with a box of chocolates. And he said, "No, the candy didn't come with it." I say that in a complimentary way, if I might.

Mr. ZUBROW. We did have some comment about that with Chairman Bachus earlier when the panel started. And I think that it was acknowledged that the ranking member selectively quoted from the paper, and we hope that he will also endorse the conclusions of the testimony, as well as the premise of it.

I do think that the question of capital is a very important one. And as we tried to say in the written testimony, and as I said here earlier this afternoon, capital is one tool in the overall framework of how large, systemically important institutions have to be regulated and managed.

But it is not the only tool. And the Basel III capital levels that are being enacted at a 7 percent level of tier one common equity are much larger than what any of the financial institutions operated under, going into the financial crisis.

For JPMorgan Chase, that would be an increase of roughly 65 percent to meet the Basel III standards above what the prior minimum standards were. And, in fact, we think that the Basel Committee and the implementation of Basel III has done an enormous amount to both increase the amount of capital in financial institutions, but also the quality of that capital, which is equally important.

And, our view is at this point in time to add an additional SIFI surtax on top of that is both unnecessary, but also has the opportunity to threaten growth in the economy, which we think would be very dangerous to the financial system.

Mrs. BIGGERT. The gentleman's time has expired.

The gentleman from Illinois, Mr. Manzullo, is recognized for 5 minutes.

Mr. MANZULLO. Thank you, Madam Chairwoman.

By a showing of hands, could you tell me how many of you here agree with this statement? Proprietary trading and private equity and hedge fund investing were not responsible for the financial crisis, and, indeed, were the source of profitability to banks during the crisis. The losses to banks resulted from bad housing loans and investments in pools of those loans, traditional banking activity.

How many would agree with that statement?

Mister—

Mr. HAL SCOTT. I am glad they are endorsing my position.

Mr. MANZULLO. You got it.

Mr. ZUBROW. I was going to say—

Mr. MANZULLO. Those are your words on page 4.

Mr. ZUBROW. It sounded familiar from prior testimony.

Mr. MANZULLO. And did you notice how deliberatively he raised his hand?

Mr. RYAN. It is really a payoff. We all hoped we could get a degree from Harvard—

Mr. MANZULLO. Is that what it is?

But, Professor Scott, that is a very simple answer to a very complex issue, and I agree with that 100 percent.

If the Fed had exercised appropriately its jurisdiction over instruments and underwriting standards and not waited until October 1st of 2009 to set forth the rule that requires written proof of a person's earning, would we be in this mess now?

Mr. HAL SCOTT. I am not really prepared to answer that specific question, but I think the thrust of it is that the standards for making loans were low. People got caught up in the bubble.

This has happened over and over in the history of banking. People get enthusiastic, they lower the standards, they think things are going to keep going on as they are, and, boom, there is a burst, people are caught short—and almost always in lending, which is the core function of banks.

So the point I was making is this is still anther crisis about lending, really, not a crisis about private equity, hedge funds or proprietary trading.

Mr. MANZULLO. And you state that so correctly. I am sorry, you are in a—no, go ahead.

We had before this committee and before the House in 2000 a GSE reform bill, and it didn't go anywhere. In 2005, we had a GSE reform bill with the Royce amendment that really would have tightened things up with regard to lending. That didn't go anywhere. It passed the House, but didn't go into the Senate.

We had numerous hearings here with the president of Fannie Mae showing how they cooked the books in order to make themselves eligible for the pensions down to two or three mils to come within that particular window.

It just appears to me that the evidence was out there. Both Presidents Bush and Clinton encouraged the GSEs to buy up subprime and Alt-A loans into these packages.

And the reason I quoted your statement—and I am glad you recognized that you are indeed the author of that sentence on page 4—is the fact that that really is the core reason for why we are in this financial crisis today.

Dodd-Frank addresses a lot of issues, and that is fine and they are interesting. But do you believe that the power existed within the Federal agencies that they could have stopped these bad loans from taking place in the first place, without any further legislation?

Mr. HAL SCOTT. I definitely think they had the power to maybe not stop them, but certainly raise the standard for making loans. That is the essence of bank supervision.

So if a bank supervisor feels that the bank is taking too much risk, is not controlling its risk, his job is to go to that bank and say so. And the bank works with the regulator to try to address it. They didn't do that.

On the other hand, Congressman, we were all in a housing price euphoria. So, looking back it is obvious, okay, but at the time, if you really believed housing prices were going to keep going up, which almost everybody did, the pressure to raise those standards was not very high, and there would be political push-back, in any event, if you tried to lower the standards in a way that deprived certain people from getting loans.

So I think that was the reality of it.

Mr. MANZULLO. I appreciate that.

Wasn't that a great answer?

Mrs. BIGGERT. The gentleman's time has expired.

The gentleman from Texas, Mr. Canseco, is recognized for 5 minutes.

Mr. CANSECO. Thank you very much, Madam Chairwoman.

Mr. O'Connor, you mention in your testimony the divergence in rules between the European Union and the United States in regards to inter-affiliate derivatives transactions.

If I understand it correctly, as it currently stands in the United States, a financial institution helping one of its affiliates hedge their risk through derivatives would essentially have to post margin to itself. Is that correct?

Mr. O'CONNOR. That is currently the case with the proposed rule set. In the E.U., currently the commission is considering exemptions for certain types of inter-affiliate transactions. So, these are effectively two subsidiaries of the same parent company.

In the United States, such an exemption has not yet been given, which could result in two parts of the same firm having to clear trades between them or post margins between themselves, yes.

Mr. CANSECO. So what we could end up with is that derivatives trades, instead of being conducted between a company and its affiliate, they are conducted between non-related companies if the case is where an affiliate has to post a margin with its parent company, thus increasing systemic risk and flying in the face of what Dodd-Frank was intended to do. Is that correct?

Mr. O'CONNOR. It certainly would increase costs and not directly affect systemic risk. But if such a margin had to be segregated, for instance, then that would be taking money off the institution's balance sheet that could ordinarily be put to other uses, such as lending or other things that would have a beneficial effect on the economy.

Mr. CANSECO. In your opinion, is this worthwhile?

Mr. O'CONNOR. No.

Mr. CANSECO. Okay. And does this rule make sense?

Mr. O'CONNOR. This rule needs—no, this rule does not make sense to me.

Mr. CANSECO. Thank you.

Mr. Ryan, do you feel the same way, or do you have another opinion?

Mr. RYAN. No, I agree totally with Mr. O'Connor.

Mr. CANSECO. Okay.

Mr. Zubrow, is that your answer also?

Mr. ZUBROW. Congressman, that is correct. I think that rule does not make sense.

I would also point out that I think your example of how it could lead to an increase in systemic risk was really predicated on the assumption that instead of having a firm engage with transactions with affiliates, that instead a firm might have to in effect do a three-legged transaction where it goes outside of its affiliates in order to lay off certain risks as a way of transferring risks amongst its different entities, which would obviously increase the overall exposure to risk and credit risk across the system.

In addition, I think, as you are aware, there are also proposals that are competing between what the United States has proposed and what it appears Europe is likely to propose as to the types of collateral and margin that could be posted for different transactions, and the U.S. proposals limit the amount of margin that could be posted to instruments that are basically denominated in U.S. dollars.

And so therefore, if there is extraterritorial application of the U.S. rules to foreign entities, be they affiliates or end customers, we would be asking European clients to be posting U.S. dollar securities as opposed to European bond collateral or government collateral or currency, which would obviously be the natural currency in which they would have their assets.

Mr. CANSECO. Let me just clarify what you just said. So even if these rules were harmonized across borders, is the restriction and cost increase on affiliate trades worthwhile, in your opinion?

Mr. ZUBROW. If they are harmonized in a way that requires posting of margin in between affiliates, then we would not think that that was worthwhile.

Mr. CANSECO. Thank you very much.

And I yield back my last 9 seconds.

Mrs. BIGGERT. Thank you.

I will recognize myself for 5 minutes.

This question is for Mr. O'Connor, and I think Mr. Ryan has had some part of this in his statement.

Does the swap push-out provision decrease market liquidity? And does it impair safety and soundness, increase systemic risk, and make it harder for the large banks to evolve?

And are you aware of any country besides the United States with a sophisticated derivative market that is planning to adopt such a push-out requirement?

Mr. O'CONNOR. Thank you for the question, Congresswoman Biggert.

Answering the second question first, no, I am not aware of any jurisdiction that is adopting a rule that would be similar to the push-out rule.

And, yes, I agree with those points that you make, namely, that requiring banks to move parts of their businesses outside of the bank into differently regulated entities adds to systemic risk in the sense that these two entities now need to be managed by the bank from a liquidity and a capital point of view, and also customers of the bank who typically would engage in derivative transactions under one agreement, the netted credit exposure, would now have to trade across two master agreements, and therefore they are paying an increase in counterparty credit risk within the market, which adds to systemic risk.

Mrs. BIGGERT. But wouldn't this put us then at a real disadvantage in the global economy?

Mr. O'CONNOR. In my testimony, I included that as one of the examples, that it puts the United States at a competitive disadvantage against, yes.

Mrs. BIGGERT. Thank you.

Mr. Ryan, would you like to comment on that?

Mr. RYAN. I concur totally with Mr. O'Connor. It is interesting that the end result here—not only Dodd-Frank, but some of the things that are going on in Basel—that in effect we are pushing risk out of the highly regulated, highly capitalized environment and into shadows, and it is predictable that in the future, that will be an issue.

So to answer your question, could it or will it increase systemic risk, it is entirely possible.

Mrs. BIGGERT. So should it be repealed?

Mr. RYAN. We are not pushing for any repeal of Dodd-Frank right now. The industry is really concentrated—

Mrs. BIGGERT. I mean this section, not—

Mr. RYAN. Section 716?

Mrs. BIGGERT. Yes.

Mr. RYAN. We were against it totally during the enactment of the statute. So if it disappeared, we would probably be very happy.

Mrs. BIGGERT. All right.

Then, Mr. Zubrow, your testimony was made a lot of this morning. I would just—on page 2 of your testimony, you talk about how the regulatory pendulum has swung to a point that the risks are hobbling our financial system and our economic growth.

And you say that U.S. policymakers should focus on how much the regulations they propose collectively reduce risk taken by financial firms and how this collective impact is likely to result or reduce the economy and job growth and how many of these regulations are being rejected or deferred by other countries.

What is putting U.S. firms at a competitive disadvantage? Does FSOC have anything to do with this? Is the fact that the FSOC members are not coordinating or thinking in the context of the global marketplace causing problems?

Mr. ZUBROW. Madam Chairwoman, I think that you are exactly correct, that the FSOC has a very important role to play here. And it is really within their purview to be able to analyze and assess what is the cumulative impact of all the regulations that are being proposed under both Dodd-Frank, but also the additional regulatory activities that the different supervisory agencies as well as the Basel Committee are imposing upon the financial system.

And so, I think that it is very important that the FSOC do a study in order to really be able to assess what that cumulative impact is and have we accomplished enough already in order to feel comfortable that we have a much safer and sounder banking system?

Obviously, it is all going to be in how the rules are ultimately promulgated and implemented, but so it is very important that we constantly step back and look at what that cumulative impact and how it is impacting the economy.

Mrs. BIGGERT. Thank you.

And with that, I would ask unanimous consent to enter into the record a statement for the record by the Institute of International Bankers.

Without objection, it is so ordered.

And I think that we will give you a rest here. I think that you have been here for a very long time. Unfortunately, we haven't had probably as much time as we would have liked. I think we will remember that maybe sometimes having such an important hearing not in what we call getaway day is not the best idea. But we are thankful that you stayed and gave such great testimony. We really appreciate all that you had to say.

So I would note that some members may have additional questions for this panel, which they may wish to submit in writing. And without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

And with that, this hearing is adjourned.

[Whereupon, at 3.18 p.m., the hearing was adjourned.]

A P P E N D I X

June 16, 2011

Congressman Stephen Fincher
"Financial Regulatory Reform: The International Context"
June 16, 2011

Opening Statement:

Thank you Mr. Chairman. Today we're talking about the impact Dodd-Frank will have on the U.S. ability to compete on an international scale. From my point of view, it seems like we're about to shoot ourselves in the foot with some of these regulations. The United States is speeding forward on establishing and implementing financial regulations that the rest of the world is sitting on. Perhaps we need to consider a valuable lesson from Aesop's Fable about the Tortoise and the Hare: Slow and steady wins the race. Right now, it looks like we're trying to set ourselves up to lose by sprinting ahead of the rest of the pack. I'm interested in hearing your perspectives about how certain regulations may or may not hurt our nation's ability to compete with other financial institutions across the world. Our number one priority should not be to cripple our financial institutions in the name of security and playing it safe, but to find the happy medium of making sure we can prevent a crisis while maintaining a competitive edge in the international financial arena. I thank each of you for being here today and look forward to hearing your testimony and whether or not you think the regulations are necessary to prevent future financial crises.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

FINANCIAL REGULATORY REFORM: THE INTERNATIONAL CONTEXT

before the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

June 16, 2011
2128 Rayburn House Office Building

Good morning Chairman Bachus and Ranking Member Frank. I am pleased to testify about the implications of current regulatory initiatives for the economic health and international competitiveness of the United States. My testimony will describe how strengthening capital requirements and implementing key provisions of the Dodd-Frank Act will lay the foundation for a stronger U.S. economy.

Introduction

A strong and stable financial system is vital to the economic and fiscal health of the U.S. and our competitiveness in the global economy. A well-functioning financial system supports economic growth by channeling savings into productive investment, allows consumers, businesses, and market participants to engage in financial transactions with confidence, and is a source of credit to the broader economy even in times of stress.

The crisis exposed the vulnerabilities of an unevenly regulated and highly leveraged U.S. financial system that proved to be anything but strong and stable. Rather than channeling savings into productive investment, many of our large financial institutions packaged and sold to investors, on a massive scale, securities backed by mortgage loans that could never be repaid. The experience with these and other financial products did not foster confidence, but caused a loss of confidence and widespread litigation. Rather than serving as a source of strength to the economy during difficult times, our financial system virtually collapsed. To sum up in language that is harsh, but unfortunately accurate, some financial firms fueled and profited from a housing bubble during the good times, then turned to the federal government for a bailout while millions of Americans lost their jobs and homes.

The excesses that led to the crisis were permitted and tacitly encouraged by our laws and regulations. Capital requirements were repeatedly and materially weakened in the pre-crisis period. Regulatory gaps encouraged building risks in the shadow banking system and in securitization structures. Regulators widely accepted the hedging benefits of derivatives without consideration of how large interlinked exposures could magnify risk. Leverage steadily increased in the financial system to the point where capital was inadequate entering the crisis.

The crisis was international in scope, and efforts to strengthen financial regulation are underway in major jurisdictions around the world to implement agreements reached by the leaders of the G-20 countries. This process is under intense pressure as sovereign governments watchfully monitor each others' progress in implementing reforms, and financial institutions press regulators and legislators to soften proposed regulatory changes, citing concerns about economic growth and international competitiveness.

At times in the past when regulations were debated, some tended to equate our nation's competitive advantage or disadvantage to the ability of our financial institutions to grow revenue and employ leverage to boost return-on-equity (ROE). This is a fundamental conceptual error that has had grave consequences when used as the basis for regulation. Heightened leverage benefits financial institution shareholders in the good times, but increases the risks of an eventual financial unraveling whose costs are borne by the economy at large. We are a less prosperous and less competitive country now as a result of the appetite of our largest institutions for leverage.

The economic health and fiscal stability of the U.S. will require a financial system and regulatory approach that performs better than the previous system. That is why, when we compare our regulatory approaches with those of other countries, we should not embrace the lowest common denominator. Instead we should take a leadership role by setting a high standard for the strength and stability of our financial institutions and encouraging other countries to do the same.

The Concept of International Competitiveness

The international competitiveness of the U.S. is a concept with more than one dimension. These include the ability of the economy to grow, create jobs and attract capital, the performance of our stock-market, and our ability to export goods and services. Financial institutions think about competitiveness in terms of their own ability to grow revenue and earn returns for shareholders. Financial institution competitiveness is a part of an economy's overall competiveness. Pursuing financial institution competitiveness as a policy goal in a way that compromises safety-and-soundness, however, will ultimately harm both our financial institutions and our economy.

It is clear in retrospect that, during roughly ten to fifteen years preceding the crisis, regulators around the world gave too much weight to promoting competitiveness as it was viewed from the perspective of financial institutions without sufficient regard to the resulting potential for broad economic harm. Repeatedly during these years, significant regulatory changes were introduced that allowed for greater financial institution leverage. Regulators typically justified such new rules on the basis that they would improve institutions' ability to compete with international or domestic competitors or reduce burden, and argued that risks to the safety and soundness of the banking system were not significant.

This progressive easing of regulatory requirements, specifically for capital standards as described in more detail below, allowed large bank holding companies and investment banks to significantly increase their leverage, benefitting those institutions in the pre-crisis years but ultimately leaving the U.S. economy worse off.

In the first few years of the past decade, the tangible equity to assets ratios of the ten largest bank holding companies in the U.S. ranged between 5.5 percent and six percent. This ratio dropped below five percent through 2004 and 2005 and dipped below four percent in 2006. By the end of 2007, the aggregate tangible equity to assets ratio of the top 10 bank holding companies stood at just 2.97 percent. Large U.S. investment banks followed a similar path; by year-end 2007, the aggregate tangible equity to assets ratio of the top five investment banks was 2.84 percent.

By contrast, at the end of 2007 the ten largest FDIC-insured depository institutions, which faced higher leverage requirements under Prompt Corrective Action and were not allowed to include certain subordinated debt instruments in core capital, had tangible equity capital equal to 6.46 percent of assets, for an average tangible equity to asset multiple less than 16 times.

Fueled by leverage and financial engineering, the performance of financial institutions in the pre-crisis years far outstripped the performance of the real economy. For example, from 2000 through 2006, the growth of the Dow Jones Large Cap Bank Index was over seven times faster than the growth of the S&P 500 (52 percent growth versus 7.4 percent growth over the period), while the average compensation of financial sector employees grew about 33 percent faster than the compensation of employees outside the financial sector.

But although the real economy did not profit to the same degree as financial institutions did during the boom years, it shared heavily in the cost of the subsequent crisis. During and just after the recession, the U.S. economy lost some 8.75 million payroll jobs in just 25 months. Average U.S. home prices declined by one-third in a three-year period starting in 2006. Over nine million foreclosures were started over the past four years.

The excessive leverage in the financial system entering the crisis forced a massive deleveraging. Loans and leases held by FDIC-insured institutions have declined by nearly \$750 billion from peak levels, while unused loan commitments have declined by \$2.7 trillion. This deleveraging illustrates another danger of insufficient financial institution capital: it can deprive the broader economy of an important stabilizing source of credit during a downturn.

The pattern of excessive leverage and subsequent financial collapse is not unique to the recent U.S. financial crisis but has been repeated many times, in many places. To cite just two prominent examples, debt expanded rapidly in the U.S. during the years prior to the Great Depression, with the value of urban mortgages outstanding increasing nearly 150 percent from 1920 to 1929.[1] Similarly, in the ten years leading up to Japan's 1990 real estate crash and the "lost decade" that followed, total private sector debt outstanding in Japan grew by more than 375 percent.[2]

Invariably, the economic and fiscal toll of such episodes on the real economy is heavy. A recent comprehensive literature review summarizes the results of 12 studies of the effects of financial crises on gross domestic product (GDP). The studies uniformly report substantial negative effects of financial crises on GDP. The estimates of the cumulative lost economic output in these studies range from 16 percent to over 300 percent of pre-crisis GDP. The median cumulative loss of output reported in the studies

[1] Bernanke, Ben S. "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression." *American Economic Review*, Vol. 73, No. 3 (Jun., 1983). p. 261.
[2] See "Debt and Deleveraging: The Global Credit Bubble and its Economic Consequences," McKinsey Global Institute, January, 2010, p. 43.

is over 60 percent of pre-crisis GDP.[3] Put another way, a household earning $50,000 per year pre-crisis loses about $30,000 in lifetime income as a result of the crisis.

Moreover, the studies that focus on lost GDP probably understate the true costs of crises because their cost estimates do not include the government support that is typically extended to buffer the effects of financial turmoil. In the U.S., the stimulus packages of 2008 and 2009 and the special liquidity programs put in place by the Federal Reserve Board, FDIC and the U.S. Treasury Department (Treasury) most likely prevented a severe recession from turning into a deep economic depression. Stimulus programs and lost revenue have, however, added substantially to the federal deficit. The decline in economic activity caused by the crisis has reduced both federal and state tax revenues, while plummeting home prices have affected property tax revenues. These fiscal costs of the financial crisis are of concern not just because of their bottom-line impact on government deficits, but because they reverberate back to the real economy. State and local governments, for example, have reduced services and cut over 400,000 jobs between January 2009 and February 2010.

The experience outlined in this section tells us that the revenue growth and ROE of financial institutions do not measure an economy's health. Consequently, in developing regulatory policy we must be careful about how we promote competitiveness as viewed purely from the perspective of financial institutions. During periods of prosperity, when bets are paying off, financial institution shareholders and management

[3] Basel Committee on Banking Supervision, "An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements," August, 2010, page 11 and Annex 1. Time periods for analysis of lost GDP in these studies range from a few years to "infinite horizon" approaches.

reap the full rewards of those bets, and do not wish their share in the upside to be diluted by calls for higher capital. The opportunity to lock-in outsized short-term compensation available to traders and some top management at many of the largest financial institutions reduced their focus on the long-term health of the companies. This perverse incentive led in some cases to a drive for short-term profits at the expense of the company's future. When institutions become non-viable, however, the shareholders and highly compensated employees do not bear the full costs. These costs are shared with creditors and other stakeholders, including the Deposit Insurance Fund (DIF) and higher premiums on the industry or other government programs. This external or social cost of heightened bank leverage is significant. Capital is the shock absorber that protects the interests of these other stakeholders. From a public policy standpoint, it would not be appropriate to place the interests of financial institution shareholders ahead of the protection of taxpayers, creditors and the broader economy.

The ramifications of overreliance on financial leverage extend far beyond financial institution regulation. Our tax system rewards debt financing of business relative to equity financing, encouraging some corporations to lever themselves imprudently. The tax deductibility of mortgage interest encourages households to take on debt. The fiscal machinery of government in many countries around the world has relied on debt issuance as a way to deliver services without the immediate cost of paying for those services. A country that relies on borrowing to pay its current bills will eventually find that its economic health and competiveness suffer as a result.

Overreliance on leverage by financial institutions is, in my view, problem one that contributed to the financial crisis and its severity. The next sections of my testimony will discuss how capital regulation went wrong in the years leading to the crisis, current initiatives to strengthen capital adequacy, and some of the concerns that have been expressed about increasing bank capital requirements.

Capital Requirements: What Went Wrong?

The single most important element of a strong and stable banking system is its capital base. Capital is what allows an institution to absorb losses while maintaining the confidence of its counterparties and continuing to be able to lend. Supervisory processes will always lag innovation and risk-taking to some extent, and restrictions on activities can be difficult to define and enforce. Hard and fast objective capital standards, on the other hand, are easier for supervisors to enforce, and provide an additional cushion of loss absorbency when mistakes are made, as will inevitably be the case.

At the end of the U.S. banking crisis of the 1980s and early 1990s, Congress embarked on important banking system reforms just as we are doing today. This included a Prompt Corrective Action system with mandated objective restrictions on bank balance sheet leverage. Also, the U.S. joined with other countries in implementing Basel I, a risk-based capital system based on fixed risk-weights. There was a commitment to promote a well-capitalized banking system. However, by the mid-1990s, regulators began to implement several fundamental changes in capital requirements that allowed for greater leverage.

One regulatory change to capital requirements was the 1996 decision to permit Trust Preferred Securities, a form of subordinated debt, to meet a portion of a Bank Holding Company's tier 1 capital requirements. Since these securities are debt obligations, they cannot absorb losses while the issuer operates as a going concern. The use of Trust Preferred Securities in holding company capital allowed those organizations to operate with less loss absorbing capital than they had before. Experience with these instruments during the crisis is that they impeded recapitalizations and that institutions relying on them were generally weaker and engaged in higher risk activities.

Another significant change was the Market Risk Rule in 1998 that allowed banks to compute their risk-based capital requirements for trading book assets using Value at Risk models, rather than using the former fixed risk weights. The Market Risk Rule substantially lowered the capital requirements of trading book assets, the rationale being that trading book assets were marked to market daily, and supposedly could be sold readily at or near their carrying value. Over time, banks put more and more illiquid assets into their trading books in order to benefit from the low Market Risk capital requirements. In the early part of the crisis, the largest and most destabilizing losses came precisely from banks' trading books.

Also in 1998, the Federal Reserve Board lowered its minimum tier 1 leverage requirement for bank holding companies using the Market Risk Rule from four percent to three percent. This development in conjunction with the inclusion of Trust Preferred Securities in bank holding companies' tier 1 capital meant that banking organizations could operate with considerably more leverage than was permitted for insured banks.

In 2001, regulators implemented the recourse rule, which among other things lowered the risk-based capital requirements for securitization tranches that were well-rated by the credit ratings agencies. Financial institutions soon developed a cottage industry creating and distributing well-rated asset backed securities including subprime private label mortgage backed securities and collateralized debt obligations. The rapid expansion of the securitization market – without sufficient transparency or other structural components to properly align incentives – and the growth of other parts of the shadow banking system were important drivers of the crisis.

In 2004, the Basel Committee on Banking Supervision published its Basel II capital standard that included the so-called Advanced Approaches. The Advanced Approaches allow banks to set their own risk-based capital requirements by feeding their internal estimates of risk into preset formulas. Banks around the world had pressed vigorously for the Advanced Approaches, and not surprisingly. Quantitative surveys conducted in the U.S. with 26 large banks found a median reduction in tier 1 capital requirements of 31 percent using the advanced approaches, including a median reduction in capital requirements for residential mortgages of 73 percent. Different banks estimated widely divergent capital requirements for similar exposures in these tests, highlighting the inherent subjectivity of the Advanced Approaches.

Other countries implemented the Advanced Approaches with dispatch. With very few exceptions, risk-based capital requirements for banks in these countries have been dropping, often to levels much lower than the old Basel I requirements. Today, analysts are increasingly coming to recognize that the Advanced Approaches produces risk-based capital calculations that are suspect.[4] In the U.S., large banks' adoption of the Advanced Approaches has been subject to significant restrictions, largely at the insistence of the FDIC. Without these restrictions, the capital of banks entering the crisis would have been much lower and the cost of the crisis to the federal government and the broader economy would have been much higher.

Shortly after the Basel Committee published the Advanced Approaches capital framework, the Securities and Exchange Commission (SEC) in 2004 adopted its Consolidated Supervised Entity (CSE) Capital Requirements. These allowed the largest investment banks to apply for an exemption from using the standard SEC net capital rule and instead submit regular reports describing their internal risk models and what the models stated the capital requirements should be. Provided the SEC was satisfied with its models, the investment bank's self determined capital requirements would be accepted. Using this approach, the top five investment banks rapidly increased their leverage during the years preceding the crisis.

[4] "The Shrinking European Bank Sector," Barclay's Capital Equity Research, May 23, 2011.

To summarize the situation at the beginning of the crisis, the minimum tier 1 risk-based capital requirement was four percent of risk-weighted assets.[5] Tier 1 capital had to be "predominantly" equity, that is, at least half. This meant that equity could comprise as little as two percent of risk-weighted assets. That equity, moreover, could include deferred tax assets that are unavailable to absorb loss when the bank is unprofitable, mortgage servicing rights and other intangible assets whose values are sensitive to assumptions, and equity in other financial institutions that increases inter-linkages and contagion risk during a crisis. In addition, the risk-weighted assets that determine how much capital the bank needs underweighted market risk, underweighted capital needs for mortgages and for many highly rated securities, and assigned no capital at all to certain off-balance sheet exposures (such as some Structured Investment Vehicles or SIVs) to which banks had *de facto* exposure.

As described earlier in this testimony, large institutions took advantage of the opportunity these regulatory changes gave them to increase their leverage substantially. With thin capital cushions and their liquid assets mostly shed to maximize yield, many of these institutions were unequipped to deal with the crisis out of their own resources. The U.S. government was forced to inject capital and provide liquidity on a massive scale to avoid a financial and economic catastrophe.

Strengthening Capital Requirements

[5] For insured banks, the tier 1 capital to risk-weighted asset ratio needed to be "Well Capitalized" for Prompt Corrective Action purposes was, and is, six percent.

With Basel III, and an important provision of the Dodd Frank Act known as the Collins Amendment, we have an historic opportunity to put our banking and financial system on a firmer footing. The Basel III capital and liquidity reforms respond to the calls by the leaders of the G-20 countries for building high-quality capital. Beginning with the Washington Summit in 2008, through the Seoul Summit at the end of 2010, the G-20 leaders repeatedly called for restoring the resiliency of individual banks and the financial system through stronger capital requirements. At the Seoul Summit, the leaders committed their members to adopt the Basel III standards.

Basel III has several important elements. First, it creates a new measure of regulatory capital, "tier 1 common equity," that is much closer to pure tangible common equity than the present tier 1 definition. Debt instruments such as Trust Preferred Securities migrate over time out of tier 1 and into tier 2 capital status. Meeting minimum requirements for tier 1 common equity will provide a much more meaningful assurance of the bank's ability to absorb losses.

Next, Basel III increases the numerical minimum capital ratios. For the new concept of tier 1 common equity, the agreed minimum ratio was 4.5 percent of risk weighted assets. For tier 1 and total capital the Basel III minimums are 6 percent and 8 percent respectively. Capital buffers comprising common equity equal to 2.5 percent of risk-weighted assets are added to each of these minimums to enable banks to absorb losses during a stressed period while remaining above their regulatory minimum ratios. The Basel Committee's analysis of bank loss experience in the most recent, and previous crises, supported the need for high-quality capital at these levels to absorb losses in severe scenarios. Indeed, a number of considerations in the analysis suggested that even higher capital levels were supportable.

Basel III, along with other standards the Basel Committee published in 2009, also requires capital for certain risks that the old rules did not adequately address. This notably includes capital for the risk of deterioration in the credit quality of over-the-counter (OTC) derivatives and additional capital to cover risks of trading assets.

Basel III includes an international leverage ratio that, while it is numerically lower than the U.S. ratio, includes capital for some off-balance sheet exposures. The leverage ratio is an important tool to ensure a base of capital exists to cover losses that the risk-based rules may have erroneously categorized as minimal. When I called for an international leverage ratio in Merida, Mexico in 2006, the reaction from regulators and bankers alike was dismissive. That such a ratio is now part of an international agreement reflects the recognition of the importance for financial stability of hard and fast constraints on leverage.

Another important landmark in capital regulation is Section 171 of the Dodd-Frank Act—the Collins Amendment. In my view, this is the single most important provision of the Act for strengthening the capital of the U.S. banking system and leveling the competitive playing field between large and small U.S. banks. Section 171 essentially says that risk-based and leverage capital requirements for large banks, bank holding companies and nonbanks supervised by the Federal Reserve Board may not be lower than the capital requirements that apply to thousands of community banks nationwide. Without the Collins amendment, our current rules set a course to allow the risk-based capital requirements of our largest banks to be governed by the assumptions of bank management regarding the riskiness of their own exposures. I cannot imagine a surer way to lead us into another leverage-driven banking collapse.

On June 14, the FDIC Board approved an interagency final rule to implement the risk-based capital floors on the Advanced Approaches that are required by the Collins Amendment. This rule is a significant event that will safeguard the capital adequacy of our largest banks in the future, when the lessons of the crisis may no longer be fresh in our minds, and the banks' internal models once again are enticing us to believe that risks and needed capital are minimal.

In addition, the Basel Committee is developing capital standards for the most systemically important institutions that would augment the standards announced in December, 2010. I believe these standards should be met with the same tangible common equity that Basel III requires for the new minimum standard for common equity capital. Allowing convertible debt to meet these standards suffers from a number of potential problems. Conversion in a stressed situation could trigger a run on the institution, downstream losses to holders of the debt, and potentially feed a crisis. Reliance on innovative regulatory capital is something that has been tried with Trust Preferred Securities. During the crisis, those securities did not absorb losses on a going concern basis and served as an impediment to recapitalizations. Regulators should avoid such devices in the future, and instead rely on tangible common equity.

The Basel Committee announced Basel III would be phased-in starting in 2013 over a five- year period. We believe that large U.S. banks are well positioned to meet the Basel III capital standards far ahead of the Basel timeline and mostly with retained earnings.

Concerns about strengthening capital requirements

Some observers have expressed concern that higher capital requirements will curtail credit availability and hurt economic growth. The consensus of recent academic literature, however, is that increases in capital requirements, within the ranges currently being discussed, have a net positive effect on long-term economic growth. The reason for this conclusion is that the costs of banking crises for economic growth are severe, as outlined earlier in this testimony, so that reducing their frequency and severity is highly beneficial. On the other hand, the literature suggests that the cost of higher capital requirements in terms of lost economic output is modest.

Capital does not consist of dollars that banks must "set aside" and not lend. Instead, capital is simply the portion of a bank's funding that must be supplied by owners rather than creditors. Since the owners are entitled only to what is left of a bank's profits after the creditors are paid, their stake is riskier and that is one reason the cost of equity exceeds the cost of debt. Debt is also subsidized by our tax system, since business interest expense is deductible but dividends paid to shareholders are not.

The idea that more equity in a bank's funding structure will materially increase its cost of making loans is not well founded. The cost of funding a loan depends on the overall cost of funding, of which equity is only a small part. Moreover, for a bank to hold more equity in its funding structure should result in lower costs of both debt and equity over time by reducing the risk of failure. The effect on a bank's overall cost of funds for every one percentage point increase in equity is estimated in a recent study to be only a few basis points.[6] This study specifically looked for a connection between lending costs and bank equity ratios but failed to find it. Other studies use a variety of analytical methodologies to conclude that optimal (in the sense of balancing broad economic costs and benefits) bank capital ratios are in the range of 10 percent to 20 percent.[7]

For a fixed dollar amount of capital a bank holds, that bank's capital requirements do place an upper bound on the size of its balance sheet, and therefore checks its potential growth. This is, of course, the main point of capital requirements, to avoid excessive

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[6] Hanson, Samuel, Anil Kashyap and Jeremy Stein, "A Macroprudential Approach to Financial Regulation." Working paper (draft) July 2010. http://www.economics.harvard.edu/faculty/stein/files/JEP-macroprudential-July22-2010.pdf
See also Admati, Anat, Peter M. DeMarzo, Martin R. Hellwig and Paul Pfleiderer. "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive." Stanford Graduate School of Business Research Paper No. 2065, March 2011.
http://www.gsb.stanford.edu/news/research/Admati.etal.html
[7] Marcheggiano, Gilberto, David Miles and Jing Yang. "Optimal Bank Capital." London: Bank of England. External Monetary Policy Committee Unit Discussion Paper No. 31, April 2011.
http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031revised.pdf
See also Basel Committee, op.cit..

leverage at individual firms and system-wide. Arguments that balance sheet constraints associated with higher capital requirements reduce banks' ability to lend typically assume, explicitly or implicitly, that banks simply cannot raise new capital. By this argument, the industry's fixed dollar amount of capital can support less lending the higher the capital requirement. It is the FDIC's experience that most banks can and do raise capital when needed, even banks in extreme financial difficulties. The most important obstacle to raising capital is often banks' reluctance to dilute existing shareholders.

Other concerns about higher capital requirements relate to how U.S. requirements compare to foreign requirements. The question arises, what if other governments are willing to subsidize their banking systems more heavily by requiring less capital? Won't this give foreign banks an advantage in competing with our U.S. banks, and if so, how concerned should we be from a public policy standpoint?

Ultimately, each country must establish its own tolerance for coming to the aid of its banking system with state support in a crisis. In the U.S., the announced capacity of Federal Reserve Board, FDIC and Treasury programs to support the financial sector during the crisis exceeded $14 trillion.[8] After the adoption by Congress of the Dodd-Frank Act, U.S. law prohibits future bail-outs of financial companies. While broad-based liquidity assistance to the U.S. economy is permitted subject to new controls, solvency support for financial companies is barred. In Europe, financial institutions also benefitted

[8] See "A Year in Bank Supervision: 2008 and a Few of Its Lessons," FDIC Supervisory Insights, Vol. 6, Issue 1, Summer 2009, p.4.
http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum09/si_sum09.pdf

from government support and, while other countries have not adopted the strong ban on bail-outs enacted in the U.S., European governments have taken steps to strengthen their ability to resolve financial companies without resorting to bail-outs and have joined in support of Basel III and other reforms.

Notwithstanding these developments, the European banking system continues to be viewed as more interlinked with, and dependent on, its governments. State equity ownership in banks is not uncommon in Europe. The "uplift" that credit ratings agencies assign to European banks based on the likelihood of sovereign support is substantial and shows no sign of diminishing, as compared to the U.S. where ratings agencies are reassessing the likelihood of federal support. European regulators have historically allowed greater use of financial leverage by their banks, perhaps reflecting a greater tolerance for state support of their banks as needed.

Highly leveraged banks that are state owned, state subsidized or "too big to fail" is not the model we want for the U.S. banking system. As the Wall Street Journal noted, "The more capital banks have to absorb losses, the lower the risk those losses will be dumped on taxpayers."[9] A greater tolerance for financial leverage by European banks should not be taken as the basis for allowing U.S. banks to operate with excessive leverage.

Indeed, I am very concerned about the potential for the European banking system to become a future source of financial instability, and not just because of the well-

[9] "We'll Always Have Basel," Wall Street Journal, September 10, 2010, page A. 16.

publicized issues about the credit quality of some sovereigns and banks' exposure to the system. Just as troubling is that European banks continue to effectively set their own capital requirements using internal risk-estimates, unconstrained by any objective hard limits. Meanwhile, representatives of some major European governments go out of their way to express public misgivings about following through to implement the internationally agreed leverage ratio. With risk-based capital determined by bank management assumptions, and no leverage constraints on the horizon for several years, the prospects for further banking problems are unsettlingly high.

Liquidity

The crisis also highlighted that many large institutions had insufficient liquidity, and Basel III addresses this issue as well. Mandating liquidity ratios is a relatively new concept, and the lack of an existing base of regulations from which to build upon makes the development of global liquidity standards a challenging task. The Liquidity Coverage Ratio and Net Stable Funding Ratio required in Basel III mark a significant step in ensuring our large banks will not be forced to turn to the government for liquidity in a future crisis. That being said, I do have some concerns with what I see as puzzling results of these ratios in some cases. Institutions with business models that exhibited the most extreme liquidity problems in the crisis sometimes report better liquidity ratios according to these metrics than do institutions whose business models weathered the crisis more successfully. The observation period that the Committee established for these ratios will provide an important opportunity for identifying unintended consequences and refining the approaches as needed.

Other Important Mandates in the Dodd-Frank Act

Most of my testimony has discussed the importance of strong capital requirements for the health of the financial system and the broader economy. But as important as capital requirements are, they will never be sufficient by themselves to ensure a well functioning and stable financial system. The crisis exposed a number of weaknesses in our financial regulatory system that need to be corrected and that the Dodd-Frank Act set out to address. In the remainder of my testimony I will highlight a few of the more significant mandates in the Dodd-Frank Act.

Ending Too Big to Fail - In the wake of government bailouts of banking organizations around the world, significant international attention has been devoted to improving resolution mechanisms for troubled institutions. This includes both formal and informal coordination under the auspices of the Basel Committee, the Financial Stability Board (FSB), and bilateral and multilateral communication across jurisdictions. The FSB and the G-20 have endorsed the resolution framework embodied in the Federal Deposit Insurance Act and the Dodd-Frank Act as the international standard. Many countries are moving forward to implement those powers—but much remains to be done.

No one would disagree that the U.S. has taken a far more aggressive stance in seeking to explicitly put an end to taxpayer support of large banking organizations. Over time, this will serve our economy well. A financial system that is dependent upon taxpayers for support is not a source of strength to the economy, it is a source of weakness. The perception that large banks will be bailed out if they get into difficulties saps the market discipline of external stakeholders and incentives within those banks for disciplined risk-taking, while the reality of such support drains the fiscal resources of government. Bailouts also necessarily bring government involvement and micromanagement of bank activities, and this rarely turns out well.

For these reasons, I believe that a precondition for a revival of a truly strong banking and financial system in the U.S. is to put an end to Too Big to Fail. Titles I and II of the Dodd-Frank Act give regulators the tools to do this.

Title I includes a requirement for Systemically Important Financial Institutions (SIFIs) to maintain satisfactory resolution plans that demonstrate their resolvability in a crisis. Further, the FDIC and Federal Reserve Board can require, if necessary, changes to the structure or activities of these institutions to ensure that they meet the standard of being resolvable.

Under Title II, if a SIFI is not resolvable through a bankruptcy framework, the FDIC can resolve the institution in a manner that strictly avoids a bailout. The FDIC can conduct advanced planning, temporarily operate and fund the institution under government control to preserve its value as a going concern, and quickly pay partial recoveries to creditors through advance dividends, as the FDIC has long done in failed-bank receiverships. The result will be a faster resolution of claims against a failed institution, smaller losses for creditors, reduced impact on the wider financial system, and an end to the cycle of bailouts.

Timely and effectively implementation of these reforms will help lay the foundation for a U.S. financial system that can stand on its own and support our national economy in times of stress. Therefore, I am pleased to report that the implementation of these reforms is proceeding in a timely manner. Most recently and significantly, the FDIC and the Federal Reserve Board have issued a Notice of Proposed Rulemaking (NPR) to establish a framework for banks to develop the resolution plans required in Title I. The comment period for that rule closed on June 10. Final rules on resolution plans as well as other provisions related to the FDIC's Orderly Liquidation Authority under Title II of the Dodd-Frank Act are scheduled to be considered at our July 6 Board meeting.

OTC Derivatives Reform - At the June 2010 G-20 Summit in Toronto, the leaders reaffirmed a global commitment to trade all standardized OTC derivatives contracts on exchanges and clear through central counterparties (CCPs) by end-2012 at the latest. Further, the leaders agreed to pursue policy measures with respect to haircut-setting and margining practices for securities financing and OTC derivatives transactions to enhance financial market resilience. Through the Dodd-Frank Act derivatives legislation, the U.S.

is taking a leadership role in proposing concrete and actionable measures to accomplish these international commitments.

Making good on these commitments is important to avoiding another derivatives-related crisis. During the decades leading up to the crisis, the perceived wisdom in the regulatory community was that OTC derivatives reduced risk in the financial system. The use of these essentially unregulated financial products grew exponentially pre-crisis but, particularly in the case of credit derivatives, these products proved to hide and concentrate risks rather than mitigate them.

The ability of large financial institutions to place massive volumes of credit derivatives with AIG, without any exchange of initial margin, contributed directly to the federal bailout of AIG in September, 2008. The exchange of initial margin would have placed some check on AIG's ability to present itself as a guarantor of an impossibly large volume of subprime collateralized debt obligations (CDOs) and would have discouraged institutions from relying unquestioningly on the AIG guarantee.

Leading up to the crisis, the large institutional participants in the CDO credit derivatives machine profited enormously. When the crisis hit, the federal government bore the cost of the failed bets. This skewed sharing of costs and benefits is a simple but important reminder that when considering the competitive implications of the Dodd-Frank Act derivatives regulation, the broad economic and fiscal health of the U.S. needs to be foremost in our minds.

In this respect, we are committed to preserving access to prudent hedging by commercial end users of derivatives. We strongly endorse the sentiment expressed in the invitation letter to this hearing, that internationally consistent rules are desirable to avoid a regulatory "race to the bottom." As emphasized throughout this testimony, regulation that is excessively focused on preserving financial institutions' market share can often run counter to maintaining financial stability.

Securitization reform - One of the most remarkable and troubling features of the pre-crisis years in the U.S. was the way a number of large institutions aggressively packaged, marketed and sold subprime-backed securities with apparently no regard for the quality of the underlying loans.

Almost 90 percent of subprime and Alt-A originations in the peak years of 2005 and 2006 were privately securitized. During this period, the originators and securitizers seldom retained meaningful "skin in the game." These market participants received immediate profits with each deal while assuming they faced little or no risk of loss if the loans defaulted. As a result, securitizers had very little incentive to maintain adequate lending and servicing standards.

The economic devastation caused by these practices has been immense. More than half of the privately-securitized subprime loans made in 2006 have now defaulted, along with over 40 percent of the privately-securitized Alt-A loans made that year.

Both the U.S. and the European Union (EU) are attempting to prevent a similar episode from happening again. If an originate-to-sell business model for creating credit is to be part of the financial landscape in the future, that model must be restored to credibility. Both the U.S. and EU have mandates for the retention of an economic interest (skin-in-the-game) by the issuers of securitizations. In both cases, the presumptive amount of risk-retention is five percent. Beyond that, the details differ across the jurisdictions. For example, the EU approach, which, with no exceptions, imposes higher capital requirements on holdings of securities where the issuer has not retained an economic interest, places the burden on the purchaser of asset-backed securities to insist on risk retention. In the U.S., the Dodd-Frank Act requires the issuer to retain an economic interest in the securitization unless the securitized loans adhere to very high underwriting standards that the agencies prescribe.

Risk retention is a simple and commonsense approach that is conceptually sound. At the same time, it is an approach that depends on the details for its successful implementation. The agencies' proposed rule has attracted a great deal of controversy. The review of comments on any proposed rule is important, and in this instance will be especially so.

Compensation reform - At the Pittsburgh summit in September, 2009, the G-20 leaders observed that excessive compensation in the financial sector both reflected and encouraged excessive risk-taking, rather than creating long-term value. The G-20 leaders called for immediate reform of compensation as an essential part of increasing financial stability, and endorsed the standards of the Financial Stability Board (FSB).

The U.S. and EU have responded to the G-20 leaders' directive to reform financial industry compensation practices. The problem being addressed is an important one: the perverse incentives created by incentive compensation practices that reward near-term revenue recognition, with the compensation being unaffected by risks realized at some future time or passed along to some other party.

The U.S. agencies' NPR on compensation broadly conforms to the FSB principles for compensation practices at significant financial institutions. The NPR states that for U.S. institutions with assets exceeding $50 billion, at least half the incentive compensation of named executives' must be deferred for a period of at least three years, and banks' boards must identify and approve the compensation of employees who have the ability to expose the bank to material loss. The comparable FSB principles are for deferral of 40 percent to 60 percent of incentive compensation over a period of at least three years.

Since these compensation principles go to the heart of some of the misaligned incentives that led to the crisis, implementing them should reduce the likelihood of similar problems in the future, thereby promoting the long-term health of the U.S. economy.

The Volcker rule - The traditional function of banks has been to transform shorter maturity or more liquid liabilities into longer-term, less liquid loans. The economic value of this function combined with its inherent susceptibility to depositor runs is the cornerstone of the theoretical argument for why deposit insurance, the discount window, and federal regulation of banking in general is economically justified.

It is harder to explain why the government should subsidize a trading operation with deposit insurance and other support. This question became particularly pointed in the wake of the crisis. Losses in banks' trading books were extremely large in the early part of the crisis. These losses seriously weakened institutions and contributed to a loss of confidence by counterparties, driving the crisis in its early stages.

The Volcker rule bans proprietary trading by banking organizations and limits investments in hedge funds and private equity funds. The statutory definition of prohibited proprietary trading is subject to important exceptions. In addition to risk-mitigating hedging, the most important of these exceptions involve market-making and securities underwriting. Notwithstanding the various permissible activity exceptions in the Volcker rule, in no event may the regulators permit activities that create material conflicts of interest, expose institutions to high-risk trading strategies or threaten the financial stability of the U.S. The regulators have considerable discretion how to interpret and implement the Volcker rule. The agencies' staffs have been working intently at crafting a proposed rule to implement this important mandate in an appropriate manner.

I view the Volcker rule as a conceptually well-founded limitation of the federal government's safety-net support of trading operations by banking organizations, and I do not believe it presents concerns for the competitiveness of the U.S. economy. Any restrictions on activities under the rule will affect where risky trades are housed. Unlike credit intermediation, where a strong conceptual case can be made that a federal safety net plays an important role in correcting an otherwise suboptimal market outcome, there is no conceptual case for the need for government support of trading activities.

We understand the concern of large trading banks that their international counterparts are not subject to similar restrictions. When a rule is proposed to implement this important statutory mandate, the comments that the agencies receive will be very important in helping to ensure that the final rule protects the federal safety net in a way that does not impose needless costs.

Conclusion

In this testimony I have argued that repairing the capital strength of our banking industry is the most import task facing regulators and a pre-condition for restoring a healthy and competitive economy. The system-wide benefits of doing this are substantial, while the system-wide costs appear modest. I would urge that the effort to strengthen bank capital, and to implement other key reforms in the Dodd-Frank Act, be pursued vigorously to completion. These efforts are in the public interest, and will promote a competitive U.S. economy in the broadest sense of the word.

EMBARGOED UNTIL DELIVERY

Testimony of Under Secretary for International Affairs Lael Brainard
U.S. Department of the Treasury
Before the Committee on Financial Services
United States House of Representatives

June 16, 2011

Chairman Bachus, Ranking Member Frank, and members of the committee, thank you for the opportunity to discuss our international financial reform agenda.

Thanks to the leadership of President Obama, Secretary Geithner, and Congress, today the United States is taking the lead in enacting financial reforms and instituting higher standards that protect consumers and taxpayers, strengthen our financial system, and ensure our long-term economic competitiveness.

There are some who would argue that the United States is moving too fast, that we should wait to see what other countries implement.

I do not agree. I would argue that by moving first and leading from a position of strength, we are elevating the world's standards to ours. By leading, we are investing in the future strength and resilience of the global financial system so that it yields results for the next generation of Americans. I would argue there is no country better placed than the United States to strike the careful balance between protecting consumers and investors and promoting innovation and competition.

But while financial reforms must begin at home, in a few key areas they must be global in scope if they are to succeed. With financial markets that are more globally integrated than ever, we need financial reforms that are more globally convergent than ever.

In today's highly-interconnected global financial markets, the risk of regulatory arbitrage carries real impact. It means the potential loss of jobs in the American financial sector if firms seek to move overseas where regulation is weaker. It means a "race to the bottom" for standards and protections. And it may increase the possibility of future financial instability if riskier activities migrate to areas with less transparency, looser regulation, and laxer supervision.

For all of these reasons, the United States is best served by leading in enacting the strongest standards and continuing our active engagement to bring other nations along with us.

Meeting this challenge of promoting cooperation and alignment around the world on strong regulatory policies consistent with Dodd-Frank lies at the heart of the Treasury's daily work with our foreign counterparts – multilaterally in the G-20, the Financial Stability Board (FSB), and the International Monetary Fund, and bilaterally through our extensive dialogues and engagement with the European Union, Japan, China, India, Brazil, and Singapore.

In cooperation with the regulatory agencies represented here today, Treasury is intensely focused on ensuring global convergence on regulation and resolution of large, complex financial institutions and on derivatives markets – the three areas with the greatest potential for small discrepancies in national regulations to create disproportionate dislocations in global markets that could negatively impact our economy and our firms.

Strengthening Capital, Liquidity, and Leverage Standards

We understand that some members of the financial industry have stressed that it would be disadvantageous to U.S. firms if the United States were to apply higher capital standards than regulators abroad impose upon their peers. Let me assure you that we are working intensely to ensure that global firms across the board raise their game because we understand the stakes for our firms and the markets.

But the right answer is to level the playing field up – not to sacrifice safety and soundness at home. Going into the recent crisis, too many financial institutions had too much leverage, too little liquidity, and inadequate loss absorbing capacity. This led to a downward spiral in confidence among counterparties.

In July 2009, as a direct result of lessons learned in the crisis, the Basel Committee issued updates to the market risk framework, known informally as "Basel 2.5". These revisions strengthen standards for measuring market risk and holding capital against those risks, and improve transparency, especially with respect to securitization activities. Basel 2.5 will help banks to better withstand market turmoil such as that experienced in the crisis. The United States is committed to implement Basel 2.5 by the end of the year, as internationally-agreed.

In November 2010, the G-20 Leaders endorsed a new framework for bank capital, known as Basel III. It will help to ensure that banks hold significantly more capital, that the capital will truly be able to absorb losses of a magnitude associated with the crisis without recourse to taxpayer support, and that the level and definition of capital will be uniform across borders. This G-20 action was a direct response to President Obama's call for strengthening both the quality and quantity of bank capital around the world.

Basel III is a serious effort to lay the foundation for a more resilient global financial system and we made rapid and immense progress to secure the agreement. We completed negotiations in just one year compared to nearly one decade for the previous agreement known as Basel II.

Basel III outlines new mandatory leverage and liquidity ratios, designed specifically to allow financial institutions to withstand significant balance-sheet losses in times of stress, while still being able to provide credit to households and business without exceptional government support.

The timeline for Basel III includes phase-in periods, which allow a staged implementation that minimizes risks to economic recovery. The U.S. is committed to full implementation at home and abroad, and we will work through the FSB and Basel Committee to make sure that this happens.

Full international convergence will be achieved only if supervisors in all major financial jurisdictions ensure that banks across the world measure risk-weighted assets similarly. This is essential to maintain a level playing field and to ensure markets and investors can be confident that capital adequacy ratios stated by banks are consistent across borders. We are pursuing comparability by urging greater visibility into supervisors' scrutiny of how banks measure risk-weighted assets. In this regard, the United States has called on the Basel Committee to lead this effort and we are pleased that it is now on its agenda.

In addition, Basel III includes a simple check – called a mandatory leverage ratio – to protect against the possibility of weak international implementation of these new capital rules. This simple leverage ratio will require banks to hold a minimum level of capital against total assets, similar to the leverage ratio long in force in the United States, to prevent firms from gaming the system.

Already, there is evidence of progress across the globe. For example, among the 50 largest global banks, tier one capital adequacy ratios have climbed from 8.1 percent in 2007 to 11.3 percent at end 2010, making the global financial system markedly more stable. Since the end of 2008, the 19 largest financial institutions in the U.S. that were subjected to stress tests have together increased common equity by more than $300 billion. More recently, European banks have raised $121 billion in capital since Europe's June 2010 stress test exercise.

Addressing Large, Interconnected Firms

A second vital issue is reducing the systemic risk from large, interconnected financial firms.

Prior to the crisis, many large, interconnected firms held too little capital relative to their risk-weighted assets, posing risk to the global financial system, and in the end necessitating significant government intervention when their balance sheets deteriorated rapidly.

To guard against a recurrence and to protect American taxpayers, Dodd-Frank created the Financial Stability Oversight Council to coordinate across agencies and instill joint accountability for the stability of the financial system. The Act provides the Council with a leading role in several important regulatory decisions, including designating the largest, most interconnected firms for heightened prudential standards.

Further, G-20 Leaders committed to developing additional capital requirements for Systemically Important Financial Institutions (SIFIs) broadly, and specifically for globally interconnected firms, or G-SIFIs, by the November 2011 Summit.

This parallels the Dodd-Frank requirement that the Fed subject our largest firms to heightened prudential standards. My colleague from the Federal Reserve, Dan Tarullo, is leading the U.S. effort.

The FSB and the Basel Committee are currently discussing how a capital surcharge for G-SIFIs should best be structured. The United States has been clear about our priorities:

First, it is critical that additional capital consists first and foremost of high quality and loss absorbing common equity. Common equity is the strongest defense against financial stress. Shareholders, not taxpayers, must absorb losses that a bank incurs. Lower quality alternative instruments cannot absorb losses as readily in a crisis and pose unlevel playing field concerns depending on how other countries apply the requirements.

Second, it is equally important that the surcharge be well calibrated to balance the imperatives of financial sector and macroeconomic stability.

Third, it must apply to a wide range of the large, interconnected banks across the globe to promote a level playing field. And it must be mandatory and comparable across jurisdictions.

Facilitating Orderly Resolution

The recent financial crisis demonstrated the economic damage to our financial system and the global economy when large, complex financial institutions fail in a disorderly manner. Countries lacked comprehensive national resolution tools and cross-border arrangements for systemically important firms.

Dodd-Frank established a special robust resolution regime that provides federal regulators with strong authorities to resolve financial institutions that pose a systemic threat to the broader financial system. These new authorities extend the resolution powers beyond traditional bankruptcy laws to permit the federal regulators to wind down a firm in an orderly manner that takes account of the impact on the broad financial system and stability.

But the best national resolution regime in the world is not sufficient if other countries do not adopt complementary authorities.

If other countries are unable to resolve their own G-SIFIs in an orderly manner, then the failures of these firms can disrupt global financial markets and impose losses on their counterparties, including our firms. In addition, if the U.S. needs to resolve one of our global firms with operations in other countries, it is critical that those countries have the tools necessary to help resolve the global firm effectively.

That is why the United States successfully urged the G-20 Leaders to endorse a set of principles to develop an effective cross-border resolution system. We recognize that achieving a truly international cross-border resolution regime is complex and will take time. First and foremost, we must lay a foundation for an international framework that requires countries to adopt strong national resolution authorities as a prerequisite for effective cross-border resolution. Consistent with U.S. rules, other countries' rules need to recognize foreign receivers or bridge institutions; eliminate automatic liquidation triggers or cross default upon insolvency of the parent; recognize the transfer of ownership interests of subsidiaries to a foreign receiver or bridge institution; and temporarily override contractual rights of termination and close-out for a brief period (e.g. 24-48 hours) in order to transfer contracts to a solvent entity, including a foreign bridge institution.

But *national* rules are not enough. That is why we are working actively in the FSB to implement a three-pronged *international* framework to: ensure that regulators and G-SIFIs develop recovery and resolution plans (so-called living wills), which provide for advanced planning before a crisis; develop criteria to improve the "resolvability" of G-SIFIs; and negotiate institution-specific cross-border resolution cooperation arrangements with foreign regulators. These institution-specific arrangements should eventually be supported by bilateral and multilateral arrangements between relevant national authorities.

The U.K. and Germany have already passed resolution legislation, and the European Commission is considering proposals. We will continue working to encourage other financial jurisdictions to adopt national resolution powers and tools and implement legal reforms necessary to achieve orderly resolution.

Regulating OTC Derivatives

International convergence is necessary across derivatives markets no less than for the largest institutions. In the run-up to the crisis, because derivatives such as credit default swaps (CDS) were traded over the counter on a bilateral basis and without transparency, few understood the magnitude of aggregate derivatives exposures in the system. Firms themselves, as well as those who supervised them, had no basis to measure the risks embedded in their derivatives exposure.

Lack of transparency in the OTC derivatives markets is an important source of unidentified risk to the global financial system. As we learned from the crisis, we must require greater transparency for the OTC derivatives markets, move their trading onto exchanges, and require them to be centrally cleared. Central clearing will greatly reduce risk by requiring a central clearinghouse to stand in the middle and guarantee the transaction and help market participants better monitor their risk. Mandatory trading on exchanges or trading platforms will improve price discovery and greatly enhance transparency, and reporting to trade repositories will shed light on what was once an opaque market.

If we do not have alignment in these rules, firms will move activities to jurisdictions with lower standards, and we will suffer from a "race to the bottom," which will increase risks to the global financial system. For this reason, G-20 Leaders set forth sound new principles to govern derivatives frameworks. These principles were in full alignment with Dodd-Frank, which requires that swaps be centrally cleared and traded on a regulated platform.

At the international level, work is proceeding in numerous standard setting and regulatory bodies to promote international convergence and develop supervisory cooperation arrangements. In addition, we are actively engaged with our counterparts in Europe and Asia to encourage them to adopt equally robust standards that live up to our G-20 commitments. We coordinate especially closely with Europe to ensure consistency and non-discriminatory approaches to our regulatory rules.

Both the U.S. and the European Commission are developing margin requirements for OTC derivatives that are not centrally cleared. Secretary Geithner recently proposed a global agreement on specific minimum standards for margins on un-cleared derivatives in order to prevent regulatory arbitrage. As part of this initiative, I traveled in the last two weeks to London and to Frankfurt to secure agreement with our foreign counterparts that the international standard setting bodies should start working on a new global margin agreement.

If we do not have consistent margin standards for un-cleared trades, we run the risk that activities will migrate to jurisdictions with lower standards that do not incentivize central clearing. The posting of margin is an important risk management tool that helps counterparties cover current and future exposures to the OTC derivative contract. The net result is reduced risk to the global financial system.

The Agenda Ahead

The examples above highlight areas where international convergence is imperative to preserve global financial stability. In other areas, the international regulatory system has long recognized differences in the institutional structure of national financial systems, reflecting different laws and histories.

As we continue the implementation of historic financial regulatory reform in the United States, aimed at improving the safety and soundness of the system and preventing another banking crisis, we must simultaneously lead a global "race to the top," and work to level the playing field across all major and emerging financial centers. We have been working tirelessly to do so. And we will remain fully engaged with our counterparts in Europe, Asia, and elsewhere to help promote a level playing field in which all firms – U.S. and foreign – can compete fairly.

We appreciate the leadership and support of this Committee on these key challenges, and we look forward to working with Congress as we engage with our international partners, challenging them to match the strength and sweep of American reforms. Together, we can help ensure a more vibrant and competitive U.S. and global economy for future generations of Americans by addressing these critical issues today.

TESTIMONY OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

WASHINGTON, DC

June 16, 2011

Good morning Chairman Bachus, Ranking Member Frank and members of the Committee. I thank you for inviting me to today's hearing on the international context of financial regulatory reform. I also thank my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation.

I am pleased to testify alongside my fellow regulators.

Global Crisis

It has now been more than two years since the financial crisis, when both the financial system and the financial regulatory system failed. So many people – not just in the United States, but throughout the world – who never had any connection to derivatives or exotic financial contracts had their lives hurt by the risks taken by financial actors. The effects of the crisis remain. All over the world, we still have high unemployment, homes that are worth less than their mortgages and pension funds that have not regained the value they had before the crisis. We still have significant uncertainty in the financial system.

Though the crisis had many causes, it is clear that the swaps market played a central role. Swaps added leverage to the financial system with more risk being backed up by less capital. They contributed, particularly through credit default swaps, to the bubble in the housing market and helped to accelerate the financial crisis. They contributed to a system where large financial institutions were thought to be not only too big to fail, but too interconnected to fail. Swaps – initially developed to help manage and lower risk – actually concentrated and heightened risk in the economy and to the public.

At the conclusion of the September 2009 G-20 summit held in Pittsburgh, leaders of 19 nations and the European Union concurred that "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

We now are working across borders to achieve that goal.

Derivatives Markets

Each part of our nation's economy relies on a well-functioning derivatives marketplace. The derivatives market – including both the historically regulated futures market and the heretofore unregulated swaps market – is essential so that producers, merchants and other end-users can manage their risks and lock in prices for the future. Derivatives help these entities focus on what they know best – innovation, investment and producing goods and services – while finding others in a marketplace willing to bear the uncertain risks of changes in prices or rates.

With notional values of approximately $300 trillion in the United States – that's more than $20 of swaps for every dollar of goods and services produced in the U.S. economy – and approximately $600 trillion worldwide, derivatives markets must work for the benefit of the public. Members of the public keep their savings with banks and pension funds that use swaps to manage their interest rate risks. The public buys gasoline and groceries from companies that rely upon futures and swaps to hedge their commodity price risks.

That's why international oversight must ensure that these markets function with integrity, transparency, openness and competition, free from fraud, manipulation and other abuses. Though the CFTC is not a price-setting agency, recent volatility in prices for basic commodities – agricultural and energy – are very real reminders of the need for common sense rules in the derivatives markets.

International Coordination

To address changes in the derivatives markets as well as the real weaknesses in swaps market oversight exposed by the financial crisis, the CFTC is working to implement the Dodd-

Frank Wall Street Reform and Consumer Protection Act's derivatives oversight reforms. Our international counterparts also are working to implement reform.

Japan has acted and is now working to implement its reforms. In September of last year, the European Commission (E.C.) released its swaps proposal. The European Council and the European Parliament are now considering the proposal. Asian nations, as well as Canada, also are working on their reform packages.

As we work to implement the derivatives reforms in the Dodd-Frank Act, we are actively coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC co-chairs with the Securities and Exchange Commission (SEC). The CFTC, SEC, European Commission and European Securities Market Authority are intensifying discussions through a technical working group.

As we do with domestic regulators, we are sharing many of our memos, term sheets and draft work product with international regulators. We have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the UK Financial Services Authority, the new European Securities and Markets Authority, the Japanese Financial Services authority and regulators in Canada, France, Germany and Switzerland. Two weeks ago, I met with Michel Barnier, the European Commissioner for Internal Market and Services, to discuss ensuring consistency in swaps market regulation.

The Dodd-Frank Act recognizes that the swaps market is global and interconnected. It gives the CFTC the flexibility to recognize foreign regulatory frameworks that are comprehensive and comparable to U.S. oversight of the swaps markets in certain areas. In addition, we have a long history of recognition regarding foreign participants that are comparably regulated by a home country regulator. The CFTC enters into arrangements with our international counterparts for access to information and cooperative oversight. We have signed memoranda of understanding with regulators in Europe, North America and Asia.

Furthermore, Section 722(d) of the Dodd-Frank Act states that the provisions of the Act relating to swaps shall not apply to activities outside the U.S. unless those activities have "a direct and significant connection with activities in, or effect on, commerce" of the U.S. We are developing a plan for application of 722(d) and expect to receive public input on that plan.

I will highlight a few broad areas where both regulators in the U.S. and regulators abroad are implementing swaps oversight reform.

Broadening the Scope

Foremost, the Dodd-Frank Act broadened the scope of oversight. The CFTC and the SEC will, for the first time, have oversight of the swaps and security-based swaps markets. The

CFTC's remit is growing from a marketplace that has a notional value of approximately $40 trillion to one with a notional value of approximately $300 trillion.

Similar to the Dodd-Frank Act, the European Commission's proposal covers the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps. It is important that all standardized swaps are subject to mandatory central clearing. We are working with our counterparts in Europe to make sure that all swaps, whether bilateral or traded on platforms, are subject to such mandatory clearing.

Centralized Clearing

Another key reform of the Dodd-Frank Act is to lower interconnectedness in the swaps markets by requiring standardized swaps between financial institutions to be brought to central clearing. This interconnectedness was, in part, the reason for the $180 billion bailout of AIG.

Clearing is another area where the Dodd-Frank Act and the E.C.'s proposal generally are consistent. In both cases, financial entities, such as swap dealers, hedge funds and insurance companies, will be required to use clearinghouses when entering into standardized swap transactions with other financial entities. Non-financial end-users that are using swaps to hedge or mitigate commercial risk, however, will be able to choose whether or not to bring their swaps to clearinghouses.

Capital and Margin

The Dodd-Frank Act includes both capital and margin requirements for swap dealers to lower risk to the economy. Capital requirements, usually computed quarterly, help protect the public by lowering the risk of a dealer's failure. Margin requirements, usually paid daily, help protect dealers and their counterparties in volatile markets or if either of them defaults. Both are important tools to lower risk in the swaps markets.

The Dodd-Frank Act authorizes bank regulators, the CFTC and the SEC to set both capital and margin "to offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared."

In Europe, Basel III includes capital requirements for swap dealers. The E.C.'s swaps proposal includes margin requirements for uncleared swaps to lower the risk that a dealer's failure could cascade through its counterparties.

Data Reporting

The Dodd-Frank Act includes robust recordkeeping and reporting requirements for all swaps transactions. It is important that all swaps – both on-exchange and off – be reported to data repositories so that regulators can have a window into the risks posed in the system and can police the markets for fraud, manipulation and other abuses.

There is broad international consensus on the need for data reporting on swaps transactions. The E.C. proposal includes similar requirements to the Dodd-Frank Act's requirements. Regulators in Japan, Hong Kong and China also have indicated the need for reporting of swaps data.

Business Conduct Standards

The Dodd-Frank Act explicitly authorizes regulators to write business conduct standards to lower risk and promote market integrity. The E.C. proposal addresses similar protections through what it calls "risk mitigation techniques." This includes documentation, confirmation and portfolio reconciliation requirements, which are important features to lower risk. Further, the Dodd-Frank Act provides regulators with authority to write business conduct rules to protect against fraud, manipulation and other abuses.

Promoting Transparency

In the U.S., the Dodd-Frank Act brings transparency to the derivatives marketplace. Economists and policymakers for decades have recognized that market transparency benefits the public.

The more transparent a marketplace is, the more liquid it is, the more competitive it is and the lower the costs for hedgers, borrowers and their customers.

The Dodd-Frank Act brings transparency in each of the three phases of a transaction.

First, it brings pre-trade transparency by requiring standardized swaps – those that are cleared, made available for trading and not blocks – to be traded on exchanges or swap execution facilities.

Second, it brings real-time post-trade transparency to the swaps markets. This provides all market participants with important pricing information as they consider their investments and whether to lower their risk through similar transactions.

Third, it brings transparency to swaps over the lifetime of the contracts. If the contract is cleared, the clearinghouse will be required to publicly disclose the pricing of the swap. If the contract is bilateral, swap dealers will be required to share mid-market pricing with their counterparties.

The Dodd-Frank Act also includes robust recordkeeping and reporting requirements for all swaps transactions so that regulators can have a window into the risks posed in the system and can police the markets for fraud, manipulation and other abuses.

In Europe, the E.C. is considering revisions to its existing Markets in Financial Instruments Directive (MiFID), which includes a trade execution requirement and the creation of a report with aggregate data on the markets similar to the CFTC's Commitments of Traders reports.

Furthermore, in February 2011, IOSCO issued a report on trading that included eight characteristics that trading platforms should have. Many of the IOSCO members participating in the report indicated a belief that added benefits are achieved through multi-dealer trading platforms. The IOSCO report concluded that, beyond the added benefits of pre-trade transparency, trading helps mitigate systemic risk and protect against market abuse.

Japan's swaps reform promotes transparency through mandated post-trade reporting to a trade repository. Hong Kong is examining exchange-trading and electronic platform requirements as it pursues derivatives reform. China intends to mandate electronic trading of RMB FX forwards, RMB forward swaps and RMB currency swaps on trading platforms by the end of 2012.

Foreign Boards of Trade

The Dodd-Frank Act broadened the CFTC's oversight to include authority to register foreign boards of trade (FBOTs) providing direct access to U.S. traders. To become registered, FBOTs must be subject to regulatory oversight that is comprehensive and comparable to U.S. oversight. This new authority enhances the Commission's ability to ensure that U.S. traders cannot avoid essential market protections by trading contracts on FBOTs that are linked with U.S. contracts.

Access to Data

The Dodd-Frank Act includes a provision that generally requires domestic and foreign authorities, in certain circumstances, to provide written agreements to indemnify SEC- and CFTC-registered trade repositories, as well as the SEC and CFTC, for certain litigation expenses as a condition to obtaining data directly from the trade repository regarding swaps and security-based swaps. In addition, the trade repository must notify the SEC or CFTC upon receipt of an information request from a domestic or foreign authority.

After having consulted with staff, SEC Chairman Shapiro and I wrote to European Commissioner Barnier to indicate our belief that the indemnification and notice requirements need not apply to requests for information from foreign regulators in at least two circumstances.

First, the indemnification and notice requirements need not apply when a trade repository is registered with the SEC or CFTC, is registered in a foreign jurisdiction and the foreign regulator, acting within the scope of its jurisdiction, seeks information directly from the trade repository. In such dual-registration cases, we acknowledged our belief that the Dodd-Frank Act's indemnification and notice requirements need not apply, provided that applicable statutory confidentiality provisions are met. Our staff is considering this, along with other recommendations, as it prepares final rules for the Commissions' consideration.

Second, as indicated in the SEC's and CFTC's proposed rules regarding trade repositories' duties and core principles, foreign regulators would not be subject to the indemnification and notice requirements if they obtain information that is in the possession of the SEC or CFTC. The

SEC and CFTC have statutory authority to share such information with domestic and foreign counterparts and have made extensive use of this authority in the past to share information with our counterparts around the world. Furthermore, separate statutory authority exists to allow the SEC and CFTC to obtain information from a trade repository on behalf of a foreign regulator if that foreign regulator is investigating a possible violation of foreign law.

I anticipate that the CFTC staff will make additional recommendations for the Commission's consideration to facilitate regulators' access to information necessary for regulatory, supervisory and enforcement purposes.

Rule-Writing Process

The CFTC is working deliberatively, efficiently and transparently to write rules to implement the Dodd-Frank Act. The Commission on Tuesday scheduled public meetings in July, August and September to begin considering final rules under Dodd-Frank. We envision having more meetings throughout the fall to take up final rules.

The Dodd-Frank Act has a deadline of 360 days after enactment for completion of the bulk of our rulemakings – July 16, 2011. The Dodd-Frank Act and the Commodity Exchange Act (CEA) give the CFTC the flexibility and authority to address the issues relating to the effective dates of Title VII. We are coordinating closely with the SEC on these issues.

The Dodd-Frank Act made many significant changes to the CEA. Section 754 of the Dodd-Frank Act states that Subtitle A of Title VII – the Subtitle that provides for the regulation of swaps – "shall take effect on the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provisions of this subtitle."

Thus, those provisions that require rulemakings will not go into effect until the CFTC finalizes the respective rules. Furthermore, they will only go into effect based on the phased implementation dates included in the final rules. During Tuesday's public Commission meeting, the CFTC released a list of the provisions of the swaps subtitle that require rulemakings.

Unless otherwise provided, those provisions of Title VII that do not require rulemaking will take effect on July 16. The Commission on Tuesday voted to issue a proposed order that would provide relief until December 31, 2011, or when the definitional rulemakings become effective, whichever is sooner, from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This includes provisions that do not directly rely on a rule to be promulgated, but do refer to terms that must be further defined by the CFTC and SEC, such as "swap" and "swap dealer."

The order proposed by the Commission also would provide relief through no later than December 31, 2011, from certain CEA requirements that may result from the repeal, effective on July 16, 2011, of some of sections 2(d), 2(e), 2(g), 2(h) and 5d.

The proposed order will be open for public comment for 14 days after it is published in the Federal Register. We intend to finalize an order regarding relief from the relevant Dodd-Frank provisions before July 16, 2011.

Conclusion

Though two years have passed, we cannot forget that the 2008 financial crisis was very real. Effective reform cannot be accomplished by one nation alone. It will require a comprehensive, international response. With the significant majority of the worldwide swaps market located in the U.S. and Europe, the effectiveness of reform depends on our ability to cooperate and find general consensus on this much needed regulation.

Thank you, and I'd be happy to take questions.

Testimony of Stephen O'Connor
Managing Director, Morgan Stanley
and
Chairman, International Swaps and Derivatives Association
Before the
US House of Representatives Committee on Financial Services
June 16, 2011

Chairman Bachus, Ranking Member Frank and Members of the Committee:

Thank you for the opportunity to testify today. As the Committee's hearing demonstrates, there is significant interest and concern among corporations, asset managers, government entities and financial institutions in the US and abroad regarding the impact of new regulatory frameworks that are being proposed or implemented in key jurisdictions.

In my time today, I will focus on the over-the-counter (OTC) derivatives markets, and will discuss the major differences that appear to be developing between US and foreign regulatory regimes. I will also discuss the potential impact of those differences for US financial markets and the US economy.

I would like to begin by making five key points:

- First, ISDA and our members completely support and are committed to a robust regulatory framework for OTC derivatives – one that creates level playing fields across borders for all market participants, for example for US firms doing business abroad and non-US institutions operating in the US.
- Second, we have over the past three years made substantial progress in implementing the most important aspects of that framework – those that address systemic risk issues, such as clearing and trade repositories.
- Third, while we have made significant progress in addressing systemic risk further improvements can and will be made. I should also note that in this area, the systemic risk rules relating to clearing and regulatory reporting, there is great consistency between the US and other major jurisdictions and this is very helpful for market participants.
- On the other hand, my fourth point is that there is far less consensus in the US and overseas regarding matters outside the systemic risk area. These issues relate primarily to

OTC derivatives market structure. They are the subject of considerable discussion and debate, both within the US, and between the US and other jurisdictions. It appears that there will be significant divergences from the US regulatory approach in international regulatory regimes.

- Fifth and finally, in addition to the potentially substantive ***policy*** differences between US and other regulatory regimes, there are equally significant ***timing*** differences between jurisdictions. Given the scope of US reform efforts, it is virtually impossible to determine how different aspects of the new regulations may interact or conflict with each other. And given the pace of those efforts, it is likely that there will be different playing fields between the US and foreign markets for some time. ISDA believes that the application and effect of US law and regulation should be as even handed as possible with respect to both US and non-US financial institutions. Currently, it appears as though this will not be the case.

To summarize, there are large and growing differences in the pace and scope of regulatory reform efforts in the US and other jurisdictions. These differences have less to do with key systemic risk issues and more to do with the structure and functioning of the OTC derivatives markets. They put US financial markets at a disadvantage by driving up costs and reducing liquidity. And they do so without demonstrating any clear benefit to equal or outweigh the considerable costs they impose.

Finally, ISDA is an international organization, representing the interests of firms across the globe and it is important to recognize that conflicting regulatory requirements will affect both US and non-US firms doing business here, which could limit participation by non-US firms in the US capital markets, potentially resulting in lower liquidity as well as business moving abroad.

* * *

I would like to address each of my points in more detail. But before I do, it's important to note that much of my discussion of the regulatory regimes for OTC derivatives in the US, EU and elsewhere is based on our current reading of the proposals that are under consideration. Those proposals may change. In addition, the rule-making process in the US is in full swing. It will be some months before all of the proposed regulations are finalized and longer still until they are implemented and their impact assessed. Both of these factors make it somewhat more difficult to conduct a precise comparison of the different regulatory frameworks that are being developed.

I would also like to point out that we at ISDA are sensitive to the perceptions that surround any discussions or comments that we or other market participants may have regarding the implementation of the Dodd-Frank Act. The financial crisis was but a few short years ago, and our economy and our markets have still not fully recovered. It would be easy for many to dismiss our views as just another effort to block, impede or delay regulatory reform.

With the memory of the financial crisis so fresh in our minds, let me assure the Committee that we do not undertake our commitments to regulatory reform lightly. We recognize their importance and we understand our responsibility to act and speak responsibly.

That is why it is important to state clearly: The International Swaps and Derivatives Association squarely supports financial regulatory reform. What's more, we have worked actively and engaged constructively with policymakers in the US and around the world to achieve this goal.

This, indeed, is our mission: to make over-the-counter (OTC) derivatives markets safe and efficient. And it's one that we have remained committed to since our founding in 1985. ISDA has, for example, helped to significantly reduce credit and legal risk by developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions. The Association has also been a leader in promoting sound risk management practices and processes.

Today, ISDA has more than 800 members from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers, as well as global, international and regional banks.

In the years leading up to and since the passage of the Dodd-Frank Act, ISDA, the major dealers, buy-side institutions and other industry associations have worked collaboratively with global regulatory supervisors to deliver structural improvements to the global OTC derivatives markets. These structural improvements, which have helped to significantly decrease systemic risk, involve three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure.

One of the important ways that ISDA and the industry have worked to reduce counterparty credit risk is by embracing central clearing of derivatives transactions. Currently over 90% of new eligible credit and interest rate derivatives transacted between clearing house members are cleared on central counterparties. The volume of uncleared interest rate swaps has declined 42% between 2008 and 2010.

Another systemically important area of focus for ISDA and market participants is the establishment of trade repositories for the different OTC derivatives asset classes. Trade repositories collect and maintain a database of all OTC derivatives transactions, such databases being available to regulators at any time. They can play an important role in improving regulatory transparency by providing an unprecedented level of market and firm-wide risk exposures to the appropriate supervisors and regulators. ISDA has helped to establish repositories for interest rate, credit and equity swaps and is in the process of doing so for commodity swaps.

To strengthen the industry's operational infrastructure, ISDA and market participants have improved OTC derivatives processing, resulting in greater automation and reduced confirmation backlogs. Electronic confirmation of transactions is increasing across OTC asset classes.

In these and other ways, ISDA and the industry are demonstrating our long-standing commitment to build robust, stable financial markets and a strong financial regulatory framework. Our work is not done yet. Further progress lies ahead, and in fact we have always recognized that there must be a process of continuous improvement across all areas of our markets.

* * *

Let me turn to address the issues that are the main focus of your hearing today.

Today, OTC derivatives market participants are concerned by the potentially divergent approaches being taken in key regulatory jurisdictions. While it is too early to know for sure what frameworks will be adopted in the EU, EC officials have indicated publicly that it is not their intention to change the structure of the OTC derivatives markets. It appears, rather, that the EC is focusing on the key systemic risk issues arising from the financial crisis that have been identified by the G-20 and the Financial Stability Board -- counterparty credit risk, regulatory transparency and operational infrastructure.

These systemic risk issues are, as you know, also the major drivers behind the Dodd-Frank Act. As I noted before, they are where ISDA and the industry are most heavily focused. There is, however, a significant US regulatory emphasis on areas not related to these systemic risk issues. This emphasis may go beyond the statutory requirements of the Act and will create new rules that will adversely affect the existing swaps markets with little apparent benefit. Requirements for the use and structure of execution platforms, capital and margin requirements, and business conduct standards are among the issues that could differ substantially between regimes.

The proposals regarding electronic trading platforms, which we in the US refer to as swap execution facilities (or SEFs) and those in the EC refer to as organized trading facilitiès (or OTFs) are one example.

In the US alone, there are different requirements proposed by the CFTC and the SEC regarding how derivatives are to be traded on SEFs. Under the CFTC SEF version, swap users requesting price quotes must do so from at least five dealers for swaps transactions that are required to be cleared and possibly traded on a SEF. The SEC SEF rule allows swap users to request a price quote from a single dealer for such transactions.

The CFTC SEF requirement has raised a number of questions among market participants. There is to our knowledge no objective evidence that supports or that indicates why five is the optimal number of dealers from whom quotes should be requested on a SEF. The law itself only specifies that participants have the ability to request quotes from multiple participants. It is widely believed that the requirement will adversely impact the liquidity of OTC derivatives markets and, perhaps most importantly, limit the liquidity available to entities using derivatives to hedge and mitigate risk, such as asset managers and corporate end-users. In addition, it would not offer any significant countervailing benefits. The prices of OTC derivatives transactions that will be cleared -- and which as noted must be traded on a SEF if there is one that makes them available for trading -- are already very competitive. It should be noted that regulatory visibility into trading patterns and risk exposures can already be provided by trade repositories without any downside.

At this point in the process, the CFTC SEF requirement has no regulatory parallel in the EC or other major jurisdictions. Consequently, the proposal could uniquely and adversely impact US markets and US competitiveness.

Similarly, banks operating in the US will be forced to comply with the Section 716 of the Dodd-Frank Act, the so-called "push-out" provision, which has no counterpart in proposed EU or Asian regulations. ISDA supports the removal of Section 716 to resolve inefficiencies, such as loss of exposure netting, that will be created by forcing institutions to conduct their swaps business across multiple legal entities. In addition, non-US firms may have a serious disadvantage with respect to the provision as they do not have the benefit of the Section 716 exemptions now enjoyed by US firms. At a minimum, ISDA believes the Section 716 exemptions should be extended to US branches of foreign banks.

Another important point of divergence relates to new rules regarding business conduct between swap dealers and their customers. The CFTC's proposed rules appear to apply concepts more applicable to the traditional agency role of securities and futures firms and do not recognize that the vast majority of swap counterparties are sophisticated financial market participants or at least have access to sophisticated advisors. The proposed rules would alter the arm's length nature of the relationship between swap dealers and their counterparties, creating confusion regarding the parties' respective responsibilities, and potentially resulting in severe market disruption, at least for certain type of counterparties. For example, in their current form, the new standards could effectively preclude participation in the OTC swap markets by pension plans, municipalities and other "Special Entities;" introduce substantial and unnecessary uncertainty and litigation into the swap markets; and subject market participants to unnecessary costs, execution delays, and risks. Furthermore, these standards go well beyond the protections required by the statute and are counter to Congress' intent of maintaining a robust and competitive US derivatives market. They also go well beyond the regulatory framework contemplated in other jurisdictions.

Another key area of potential divergence relates to clearing rules for transactions between affiliated institutions. Inter-affiliate trades are used for internal hedging and risk management, and do not increase systemic risk as such trades are not executed with external counterparties.

European policymakers are discussing an exemption for transactions between related EU affiliates from mandatory clearing requirements. The current US framework would not. In fact, given the Section 716 requirements of the Act, inter-affiliate trading is likely to increase. This means that two subsidiaries of a single US financial institution, and potentially two subsidiaries of a non-US firm, that engaged in a swap transaction could be required to post margin on that transaction, and potentially be required to centrally clear the transaction. In effect, this means that firms active in the US would need to post collateral and clear transactions with themselves. We believe that these provisions should not apply to inter-affiliate transactions of any financial institution. Inter-affiliate trades should be excluded from most Title VII requirements as their inclusion will only increase costs and burdens for US financial institutions and of trading in the US markets.

The potential solution for these areas of divergence is to build a rational dialogue around consideration and adoption of the well-considered positions of other countries. This would mitigate the negative impact to the US markets described earlier. In other situations where non-US proposals create potentially negative impacts, a solution would be to request harmonization of the non-US rules to US regulator proposals if our proposal causes less detriment and greater protection to the markets.

The final area of divergence that I would like to discuss today relates to the previously obscure issue of extraterritoriality, which has taken on added stature in recent weeks. There are today large and growing concerns regarding the applicability of the Dodd-Frank Act outside of the US. Concerns around the extraterritorial scope of Dodd-Frank are already creating a great deal of uncertainty among market participants about whether and how to implement a new regulatory framework that may duplicate or conflict with that of their parent country. For instance, if derivative transactions between an Italian company and the UK subsidiary of a US bank were subjected to transaction level Dodd-Frank rules, but similar transactions between that Italian company and a UK bank without a US parent were not subject to those same rules, the end result would be that foreign companies would avoid doing business with swaps dealers affiliated with US companies. They would instead transact with financial institutions not covered by the scope of these margin requirements. It could put US markets at a serious competitive disadvantage.

Adding to the uncertainty are new rules issued by federal regulators on margin requirements that included provisions regarding extraterritorial application of those requirements, at least for swap dealers subject to prudential regulation. These rules would create significant issues for swap dealers affiliated with US holding companies and unnecessarily drive up the expense for foreign companies doing business with these swaps dealers.

The extraterritoriality proposals are inconsistent with Congressional intent regarding the territorial scope of the new regulatory framework for derivatives. Congress included provisions in Dodd-Frank that explicitly instruct regulators to impose the regulations outside the US only if there is a "direct and significant connection" with US activities or commerce or as necessary to avoid evasion of Dodd-Frank. These provisions are intended to appropriately balance the protection of the safety of the financial system with the competitiveness of US institutions, which is also necessary for a healthy US banking system.

Disadvantaging foreign institutions and US subsidiaries of such institutions, through divergent capital requirements or otherwise, discourages foreign investment in US subsidiaries, which leads to fewer jobs and to less competition within our shores. Such divergent treatment also creates the potential for retaliatory measures abroad, thus limiting opportunities and creating a hostile market environment for both US- and foreign-based firms.

Unlike the potential solution for the first few issues, the solution here is to recognize rational limits on the extent to which US rules can govern offshore transactions. The goal should be a level playing field and the recognition that other jurisdictions will also have comprehensive and complementary regulatory regimes, even if not the same as ours.

* * *

Each of the issues I have discussed reflects potentially important differences in policy across jurisdictions. These differences could significantly disadvantage participants in the US OTC derivatives markets – be they financial institution dealers (US or non-US), pension funds managing their risk and investment returns, corporations hedging their interest rate exposure, or energy firms managing their exposure to volatile commodity prices.

In addition to these policy differences, there are also important differences in timing that could significantly impact US financial markets. The fact that firms based or doing business in

US markets will be subject to a new regulatory framework well before a complementary framework is established in other key jurisdictions is itself a cause for concern. The potential for that US framework to inadvertently create an uneven playing field for the US markets adds to those concerns. So too does the prospect that some firms active in the US markets may have to comply with two sets of regulatory regimes. Ultimately this could lead to increased costs, decreased liquidity and a reduction in the overall availability of capital in the US markets.

As we all know, the volume of rulemakings in the US is very large, the rules are complicated, and there are significant interdependencies among many of them. Dealers and swaps market participants will need to devote significant resources to adapting to and implementing these new rules over the next few years. To make matters worse, many market participants do not yet know whether or how or when the new rules will apply to them. The scale of change required in the swaps market by the Dodd-Frank Act, including new trading, reporting and clearing requirements, registrations, compliance regimes, and documentation requirements cannot be overstated.

It's clear that additional time is required to review and evaluate the full mosaic of the proposed new rules. The CFTC's decision to reopen Title VII comment periods for 30 days is a step in the right direction. However, simply re-opening the comment period does not provide any insight on how the extensive prior comments on the original proposals may have influenced the Commission's thinking in crafting final rules. The comment period re-opening cannot replace the value of allowing consideration of how the thousands of comments will be incorporated into the rules, and how such re-proposed rules will interact and come together in an overall framework for market infrastructure. So it is essential that market participants have an opportunity for additional review and comment on the entire revised set of rules which the Commissions will publish after evaluating comments received.

In addition to the need for a second or subsequent comment period on rule proposals, there is also a significant need for a rational, appropriate phase-in of implementation of the rules across markets and market participants. The former will be essential so that rules are appropriately tailored, work in tandem, and avoid unduly impairing market liquidity or adversely impacting investors. The latter is about enabling market participants to implement the changes most effectively. Both issues are, however inter-related: it is not enough to phase-in implementation if the final rules themselves are unworkable or in conflict.

ISDA supports efforts to provide policymakers and market participants with additional time needed to weigh the individual and cumulative impact of the proposals, as well as their costs and benefits. This would help to ensure that US markets and their competitiveness are not unintentionally harmed by any aspects of the proposed rulemakings.

We have developed, and have discussed with the Commissions, suggested approaches that would phase in the implementation of new rules. Our approach is based on a series of key principles that we believe should govern the implementation schedule. We have outlined these principles in detail in a letter to the Commissions. To summarize them, ISDA believes that:

- Sufficient time should be granted to market participations to implement the final rules so as to avoid market disruptions;
- Our first implementation priority is providing regulators with enhanced transparency through the trade repositories;
- Requirements should be phased in by type of market participant and asset class;
- Systemically important initiatives should be phased in first;
- We need to allow adequate time for these changes to flow through to customers; and
- Regulators should rationalize how they implement different rules.

* * *

It's clear that we are entering a new era of finance – and of financial regulation – in the US and abroad. ISDA supports public policy and industry efforts to build a more robust, stable financial system in which safe, efficient OTC derivatives markets enable more effective risk, investment and financial management.

As we work to do so, it is vitally important that the competitiveness of the US financial markets stay top of mind. Financial institutions, pension funds, asset managers, corporations, energy and commodity companies and others routinely use OTC derivatives. According to our research, over 90% of the largest US companies use OTC derivatives to manage their business and financial risks.

OTC derivatives play an important role in the American financial systems and the American economy. While we are all supportive of initiatives that decrease systemic risk, policy differences that impose significant costs but offer few, if any, offsetting benefits may lead to increase costs, decreased liquidity, a reduction in growth capital, the erosion of US competitiveness and the loss of jobs in the US financial markets. Although the US remains one of the most dynamic, innovative marketplaces in the world, we note that transaction volume in London already exceeds that in New York. We also note that the five largest US-based dealers reported a notional amount outstanding equal to only 37% of the total notional amount for interest rate, credit, and equity derivatives globally.

The best way to avoid many of the issues that I have discussed, and to protect the competitiveness of US markets, is to work with the EU and other overseas jurisdictions towards a convergence of the rule sets and a convergence of the timelines for implementation, thus reducing the impact of any temporary or permanent regulatory differences between the US and other financial markets and mitigating the damage that these differences will cause.

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STATEMENT FOR THE RECORD
BY
T. TIMOTHY RYAN, JR.
PRESIDENT & CEO
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

Re: International Context of Financial Regulatory Reform

JUNE 16, 2011

Chairman Bachus, Ranking Member Frank, and Members of the Committee, my name is Tim Ryan and I am President & CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] SIFMA appreciates the opportunity to testify at this important hearing on the International Context of Financial Regulatory Reform. In this context, our testimony will specifically discuss the capital regimes proposed by the Basel Committee on Banking Supervision ("Basel") and the Financial Stability Board of the G-20 ("FSB"), the Volcker Rule under Section 619 of the Dodd Frank Act ("Dodd-Frank" or the "Act"), global reforms to the derivatives markets, and the impact of convergence of U.S. GAAP accounting standards with International Financial Reporting Standards ("IFRS").

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in he financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

The passage of Dodd-Frank, together with industry initiatives, other U.S and global regulatory reforms, and actions proposed by Basel and FSB, are important efforts to ensure safety and soundness and to restore confidence in the global financial system in the aftermath of the financial crisis. As important as these various actions have and will be, it is equally important that policy makers, market participants, investors and consumers understand the magnitude and collective impact of these actions and their effect on U.S. markets, the economy and the lives of ordinary Americans. As Federal Reserve Chairman Ben Bernanke recently stated no such effort to consider the collective impact of these actions has taken place.[2]

Furthermore, we believe that U.S. regulators and our G-20 partners continue to be insufficiently coordinated to provide consistent implementation of reforms on a cross-border basis. We echo the comments of Treasury Secretary Geithner last week in calling for better such coordination.[3]

As we move towards the one year anniversary of the passage of Dodd-Frank, we welcome your focus on these issues and their impact on the future health and competitiveness of the U.S. financial services sector and markets and on economic growth.

SIFMA has been, and will continue to be, a constructive voice as these U.S. and global reforms are developed and implemented. Our members understand the value that a well-designed regulatory system can bring to restoring investor confidence and minimizing systemic risk. However, while we are supportive of many of these initiatives, we also believe that the range and extent of them, combined with the significant changes already implemented, could have potentially far reaching consequences for the economy and the long-term viability of U.S. financial markets as a ready source of capital and credit.

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[2] Response of Federal Reserve Chairman Ben Bernanke, International Monetary Conference, June 7, 2011

[3] Remarks of Secretary Timothy Geithner before the International Monetary Conference, June 6, 2011.

Based on this, we ask the Committee to view our testimony within the context of the following broad themes and exert its oversight powers with respect to the following:

1) **Costs to the economy must be taken into account.** The layering and aggregate impact of both U.S. and global regulatory reforms imposes significant costs not just on the industry, issuers, and investors, but on consumers and the U.S. economy. In the wake of the crisis, it may be tempting to adopt *any* reform that seems to promote safety, but that would be extremely unwise if the economic costs outweigh the marginal benefits to increased safety. At present, far too little attention is paid to examining potential costs of particular reforms in terms of reduced credit or financial intermediation. And far too little attention is paid to assessing the actual amount of additional safety that particular proposed reforms will achieve. This balance ***must*** be taken into account -- costs and benefits -- for reform to be effective.

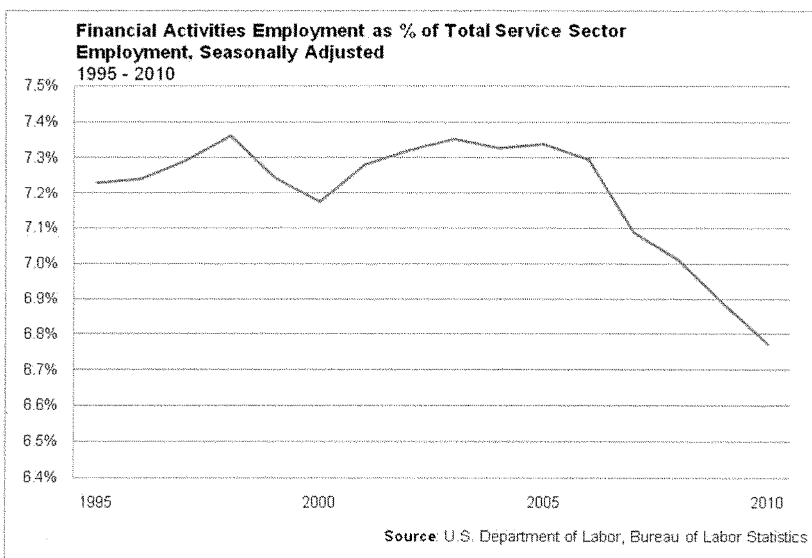
2) **Consistent rules and their consistent implementation across jurisdictions is critical to fairness, U.S. competitiveness, and safety and soundness.** Uniform global rules and their consistent global application with respect to major financial reforms, such as Basel III and FSB capital requirements, changes to the derivatives market, and limits on proprietary trading, are critical if the U.S. is to maintain its position as the deepest, most liquid, and most innovative financial market in the world. This fundamental principle will be undermined if the U.S. unilaterally imposes restrictions on its institutions that do not apply in other major financial markets around the world -- which is already occurring with respect to certain aspects of derivatives reform and the "Volcker Rule" restrictions on proprietary trading. And it is also undermined where supposedly common rules are implemented inconsistently in different countries -- as critics have complained about with respect to Basel capital

rules. Much more needs to be done to ensure the consistent application of ***existing*** rules before significant new rules are adopted, which will only widen competitive disparities.

Accordingly, my testimony will address the following key points: 1) the importance of the healthy and vibrant financial services sector to the U.S. economy; 2) concerns related to the aggregate impact and fragmentation of global regulatory reforms; and 3) the potentially negative impact of certain regulatory reforms.

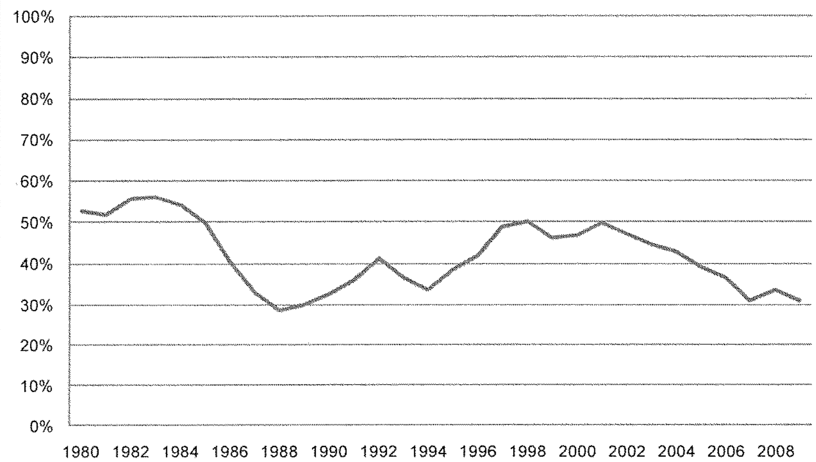
Benefits of the Financial Services Sector

A robust finance industry provides businesses with vehicles to lower the cost of capital, stimulates global investment and trade, and presents investors with a broad array of products and services to increase return and manage risk. Importantly, these financial services and products help facilitate and finance the export of manufactured goods and agricultural products, while helping the U.S. become the world's number one exporter of services, a key contributor in terms of U.S. private sector employment.



The long-term health and vigor of this sector, and its ability to service customer needs, depends on its ability to remain competitive. This is all the more important as the U.S. share of global output and its financial markets has become relatively smaller, and as the U.S. faces increasing competition from both developed and emerging markets, such as China.[4] Highlighting this point is the fact that the U.S. share of global equity market capitalization in 2009 was about 31%, roughly half the share in 1983. In comparison, emerging markets now account for about 28% of global equity market capitalization, over five times their share in 1982.

US Equity Market Capitalization as % of Global Equity Market Capitalization
1980 - 2009



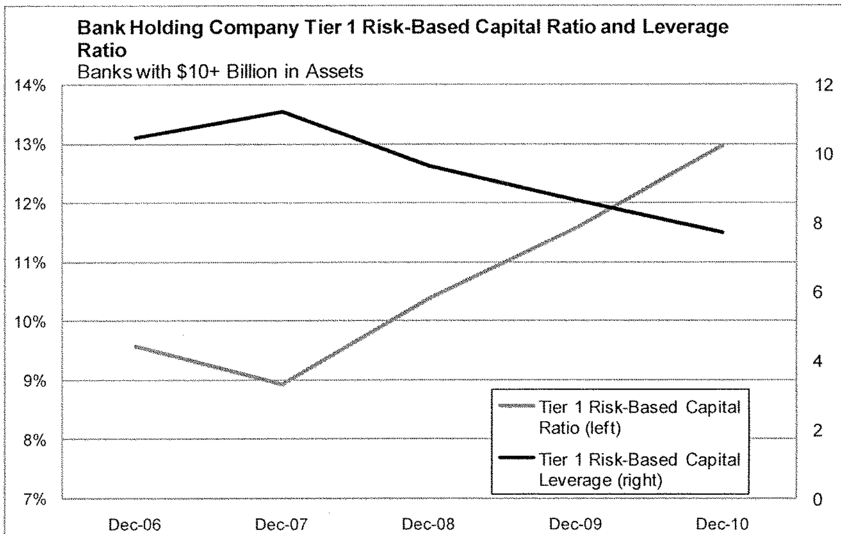
Source: Standard and Poor's

[4] "The 10 companies that went public abroad in 2010 — and 75 from 2000 to 2009 — compares with only two United States companies choosing foreign exchanges from 1991 to 1999." New York Times, June 8, 2011, "Fleeing to Foreign Shores", by Graham Bowley.

As U.S. corporations continue to expand their global capabilities and establish themselves in foreign markets, financial firms must follow them to remain competitive. That is, financial institutions provide the services that facilitate the entry of companies into international markets. They have developed global platforms in order to offer their services on a cross-border basis, or they have established local offices. In this way, financial services firms have set up the infrastructure to help multinationals navigate through the complexities of trade and investment flows that span geographic regions and economies. These are not services that can be replicated by smaller domestic financial firms as some have suggested. Furthermore, because of our deep and liquid markets, and strong investor based economy, foreign financial firms have made significant investments in the U.S., adding capital, liquidity, and employment. An unlevel playing field resulting from the failure to coordinate regulations cross-border in terms of capital requirements and activities restrictions would not only affect U.S. firms but diminish the attractiveness of U.S. markets to foreign financial firms, to the detriment of U.S. markets, issuers and investors.[5]

That is not to say there shouldn't be new enhanced capital requirements and activity rules; to the contrary, institutions operating in the United States, both U.S. and foreign domiciled, hold much greater, and higher quality capital today than before the crisis. Since the end of 2007, U.S. financial firms have raised more than $300 billion of common equity while repaying U.S. taxpayers for their TARP investment early and with a $12 billion profit. The largest U.S. banks have also reduced their average leverage ratio from 16:1 to 11:1 and increased loan loss reserves by almost 200%.[6]

[5] Foreign firms operating in the U.S. employ 250,000 U.S. citizens and permanent residents and are responsible for 25% of commercial and industrial lending in the U.S., according to the Institute of International Bankers.
[6] Remarks of Secretary Timothy Geithner before the International Monetary Conference, June 6, 2011.



Tier 1 Risk-Based Capital Ratio =
Tier 1 Risk-Based Capital / Total Risk-Weighted Assets
Leverage Ratio = 1/Capital Ratio **Source**: Federal Financial Institutions Examination Council

Piling on additional capital requirements and other rules designed to reduce risks in the system, absent a clear understanding of the cumulative effect of such changes, will negatively impact both the ability to fund credit and capital demand in the United States and the recovery of the general economy by raising costs to consumers or reducing credit availability. No regulator has attempted to assess this impact on the economy in a thorough and robust manner.

Fragmentation of Global Regulation

Furthermore, SIFMA believes that fragmented or conflicting regulation will complicate the ability of market intermediaries, investors, and those seeking to raise capital to conduct business efficiently. That is why it is critical that, as U.S. regulatory authorities implement Dodd-Frank, and our G-20 partners implement their reform measures, they adhere to G-20 principles by avoiding inconsistent and divergent regulation that would impose unnecessary burdens on global markets, create barriers to market entry, distort competition, and encourage regulatory arbitrage.

Indeed, U.S. regulations that are being implemented on a unilateral basis are threatening the competitiveness of the U.S. markets. Consequently, we urge the Committee to request that the Financial Stability Oversight Council ("FSOC") meet its Dodd-Frank mandate to monitor domestic and international regulatory proposals that impact U.S. competitiveness.[7] This is essential to ensure that U.S. financial markets, and ultimately the U.S. economy, are not put at a competitive disadvantage in terms of access to credit and capital. While the Dodd-Frank Act created a legal framework for regulatory reform, advances in other jurisdictions are moving at different and uneven paces. It remains vital that we seek a well-balanced and well-coordinated regulatory framework and guard against the potential for the promulgation and implementation of reforms that can result in the type of regulation that the G20 committed to avoid – measures that create barriers to market entry, distort competition, and encourage regulatory arbitrage. Secretary Geithner underscored this point in his remarks on June 6 where he stated:

> We live in a global financial marketplace, with other financial centers competing to attract a greater share of future financial activity and profits. As we strengthen the protections we need in the United States, we have to reduce the chance that risk just moves outside the Untied States. Allowing that would not just weaken the relative strength of U.S. firms and markets, it would also leave the world economy vulnerable to future crisis.[8]

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[7] "...to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress and make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets;" Section 112 (a) (2) (D), Dodd-Frank Wall Street Reform and Consumer Protection Act

[8] Remarks of Secretary Timothy Geithner before the International Monetary Conference, June 6, 2011.

Equally important is to be able to understand the aggregate impact these regulatory and legislative initiatives will have on the economy's ability to grow. While individually each initiative may have merit – and SIFMA's members support many of the reforms – it is also vital to determine whether, taken together, these reforms negatively impact consumers, investors, capital flows, economic growth, or job creation during a period of global economic vulnerability. However, no such determination has been made. As previously noted, in response to a question on the matter, Federal Reserve Chairman Bernanke stated: "Nobody has looked at it in all detail, but we certainly are trying as in each part to develop a system that is coherent and that is consistent with banks performing their vital social function in terms of extending credit."[9]

We believe that the FSOC, as mandated by Congress under the Act, should conduct an analysis of the major policy changes implemented by U.S. regulators since the crisis, including those required by the Act and the proposed global reforms to determine the aggregate impact of these changes on the U.S. economy and U.S. financial markets. We also believe such an analysis should be done with respect to each major financial reform proposal, including increased capital requirements, comprehensive derivatives reform, and the Volcker rule.

Nearly two years ago, G20 Leaders identified this as a potential problem, noting that in light of these far reaching reforms that they must "...work together to assess how our policies fit together, to evaluate whether they are collectively consistent with more sustainable and balanced growth, and to act as necessary to meet our common objectives."[10] This is critically important so as to ensure a durable economic recovery. To date we have seen no analysis from the G20 that looks at the costs and aggregate impact to the global economy of the unprecedented level of reforms. We believe that a sound framework for gauging the cumulative impact of global reform measures on economic growth and job

[9] Federal Reserve Chairman Ben Bernanke, International Monetary Conference, June 7, 2011

[10] G20 Leaders Statement of September 24-25, 2009 related to developing a "Framework for Strong, Sustainable, and Balanced Growth".

creation, and where the right balance lies, is one of the most important tasks ahead.

For example, viewed in the aggregate, it will be important to ensure that Basel III capital and liquidity rules, combined with the proposed FSB capital surcharge on globally systemically important financial institutions ("G-SIFI's") and Dodd-Frank's "enhanced prudential standards" for like institutions deemed systemic in the U.S., do not unduly reduce lending and underwriting capacity in our financial markets, resulting in significantly reduced capital formation and investment. It will be important to assess whether sharply increased capital and liquidity requirements will lead to counterproductive changes to business models and increases to the cost of financial intermediation. Furthermore, U.S. and global regulators must consider the tangible effects of other reform provisions, such as Orderly Liquidation Authority, Living Wills, the Collins Amendment in Dodd-Frank, The Federal Reserve Board's recently proposed capital plans requirement, Basel 2.5, Volcker prohibitions on proprietary trading, pushing out derivatives trading from banks (Section 716), and exchange trading and clearing mandates for OTC derivatives.

These provisions, at least for U.S. and foreign-domiciled firms operating in the U.S., are expressly designed to reduce risk, both to individual firms and to the financial system. As a result, with all due respect, we strongly disagree with Governor Tarullo that such provisions should be viewed as "complementary" to "enhanced prudential standards" or any G-SIFI surcharge.[11] Rather, we concur with the recent comments of Secretary Geithner where he stated that in considering a surcharge, regulators

> "also need to look at the full impact of other reforms in the system that have the effect of reducing both the probability of failure of large institutions ... the new liquidity requirements on these institutions, limits

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[11] For these reasons, the special resolution mechanism of Dodd-Frank and the enhanced capital requirements called for by that same law should be regarded as complementary rather than as substitutes>" Remarks of Federal Reserve Governor Daniel K. Tarullo, Peter G. Peterson Institute for International Economics June 3, 2011.

> on leverage, concentration limits, activity restrictions, the forthcoming margin rules for derivatives, the stronger financial cushions being built in central counterparties, the tougher requirements on tri-party repos and securities lending. In short, capital requirements cannot bear the full burden of protecting the system against risk, and they should be considered in the context of the reinforcement provided by these other reforms."[12]

From a global perspective, we believe that the FSB should undertake a global impact assessment that would model the economic impact of the disparate global reform efforts on global growth and job creation. This should be done both for individual major reform proposals and for the proposals in the aggregate. In addition, the FSB and Basel should institute a rigorous peer review process among global supervisors, not one based simply on surveys, to make certain that reforms are implemented and applied in a consistent manner.

Discussion of Key Regulatory Reform Measures and their Potential Impact on U.S. Markets

While the regulatory reform and repair measures taken to date have put the U.S. and global financial systems on sounder footing, it is also the case that a number of measures, either create, or risk creating, divergences that could raise costs to investors, unnecessarily increase the complexity of compliance, hinder global efforts to cooperate and coordinate regulation, and at their worst provoke retaliatory measures by other jurisdictions, ultimately resulting in a drag on global economic recovery. We note that similar examples can be found in regulatory reform measures in other regions, but for purpose of this testimony, we focus on Dodd-Frank measures.

[12] Secretary Timothy Geithner, International Monetary Conference, June 6, 2011

G-SIFIs Capital Surcharge

SIFMA members fully accept that any institution, regardless of its size, complexity, or interconnectedness should be allowed to fail and that taxpayers should not be called upon to support such institutions to prevent their failure. We believe that significant progress towards this goal has already been made, particularly in light of the new Basel III standards, which substantially enhance both the quality and quantity of capital, Basel 2.5, the Collins Amendment in Dodd-Frank, the Federal Reserve's recent requirement that firms prepare capital and dividend plans, and Title II of Dodd-Frank, which provides for an orderly liquidation of a failing systemic institution operating in the United States and the requirement that such institutions maintain a "living will" to inform regulators how they would wind down such an institution. Furthermore, it is important to note that the Act explicitly prohibits bailouts and open bank assistance and provides for the industry, not taxpayers, to underwrite any loss in resolving a failed systemic institution. In addition, the European Union has proposed its own form of resolution, "Crisis Resolution" and is working towards finalizing the legislation to apply to the 27 member states. This ongoing action, while no doubt difficult given the different business models and regulatory structures in Europe, greatly improves the outlook for a cross-border resolution framework that provides regulators with the tools to mitigate systemic risk and should be expressly taken into account by U.S. and European regulators and the FSB when assessing the need for other reforms, including substantially increased capital requirements. It is simply incorrect not to give weight to the imposition of resolution plans in the U.S. and Europe.

That is why we are extremely concerned that an additional capital charges for G-SIFIs is being discussed by the FSB, and vigorously disagree that one is needed. This "surcharge" would be in addition to recent substantial increases to capital mandated by domestic regulators in the U.S. (via the stress teat and TARP repayment) as well as the increased capital required by Basel III and Basel 2.5.

Likewise, it is entirely unclear how such an international surcharge would dovetail with the Dodd-Frank requirements for "enhanced prudential standards" for large banks.

The U.S. will decide this month whether to agree with other members of the FSB to propose such an international capital surcharge, which some have reported as being as high as 2 to 3 percentage points, on global systemically identified banks, including many U.S. banks and foreign banks operating in the U.S. An agreement by the FSB could "bind" member country regulators to implement this surcharge on institutions operating in their domestic markets. But this is only a minimum. The Federal Reserve could also decide to make such a surcharge even higher on U.S. banks under the enhanced prudential standard requirement of Dodd-Frank.

Again, it is critical that there be a robust and transparent economic analysis of any FSB or Federal Reserve proposal that would impose a substantial capital surcharge – not just by these bodies but by the FSOC as well. This is precisely the kind of systemic issue for which the FSOC was established, and it should conduct this analysis taking into account other substantial reforms put in place from the crisis. We also believe that Congress should have the benefit of considering this analysis before any such reform is agreed to internationally or adopted as law in the U.S. Given the potential negative economic consequences to the U.S. economy, it is entirely appropriate that congress review such data before such a significant action is taken.

A surcharge, and particularly a surcharge of the amount being discussed, is unwarranted given the current level and quality of capitalization in the U.S. and runs the risk of slowing the economic recovery and impairing U.S. competitiveness,. Nor is it clear that such action would materially mitigate systemic risk in U.S. markets, beyond actions already taken.

It is important to understand that under the Basel III accord, in advance of any G-SIFI surcharge, or "enhanced prudential standards" under Dodd-Frank, and subsequent to the Federal Reserve stress tests, banks are required to make significant increases in both the quality and quantity of their capital:

- First, minimum capital levels are raised – the tier one common equity ratio (CET1) is more than tripled to 7%.

- Second, common equity is defined much more strictly:

    - Regulatory capital deductions have to be taken from common equity rather than from Tier 1 or Tier 2 capital as is currently the case; and
    - The deductions from common equity are significantly more stringent.

- Third, as a practical matter, banks will be required to hold capital buffers above the 7% requirement, due to several factors:

    - Operationally, they must ensure that capital levels do not go below the required minimum in order to avoid negative regulatory consequences;

    - Analysts and investors in the marketplace typically expect banks to operate above the regulatory minimum; and

    - Under the Pillar 2 ICAAP process, supervisors will require banks to build in a cushion above the minimum in order to meet capital objectives.

Why do surcharges matter? Any additional capital requirements in excess of those already imposed by Basel III should be carefully considered in the context of the potentially negative economic consequences they could cause in terms of lower credit availability and a higher cost of capital for the financial system as a whole. These consequences include: passing increased costs of capital on to customers via increased lending costs across the economy; driving SIFIs to allocate capital to less capital intensive activities; inhibiting the availability of credit, causing SIFIs to take on more risk to maintain the return on investment necessary to attract capital and driving businesses to the unregulated shadow banking sector. None of these are good outcomes, particularly considering the added costs imposed by many other new requirements, such as compliance costs, fees, risk management staff, and the like. Excessive capital charges make it more expensive for banks to lend money or provide liquidity to U.S. businesses. The result inevitably will be higher cost of credit and less credit and less funding availability.

In addition, investors will only put capital in an institution if they believe they will receive an adequate return on that capital. If capital levels are set too high, the ability of firms to raise additional capital will be inhibited because markets will perceive that the firms can no longer earn an adequate return or, in the alternative, that firms will have to increase risk to maintain the same level of return. For example, if a firm earns 10% on a certain level of capital, doubling the level of capital will result in a 5% return. If the market will not provide the additional capital for a 5% return, the firm must either shrink back into the lower level of capital (by decreasing loans, for example) or increase its risk in an attempt to maintain the higher return. Furthermore, unrealistic capital levels will drive financial business to the shadow banking system, only increasing risk to the system. Indeed, in his remarks the other week, Secretary Geithner made this point when he said "central banks and supervisors need a balance between setting capital requirements high enough to provide strong cushions against loss but not so high to drive the re-emergence of a risky shadow banking system."[13]

This would appear to be particularly the case for some of the larger institutions subject to the highest surcharges and will inevitably further constrain the supply of credit and suppress growth in GDP. The Final Report of the Macroeconomic Group of the FSB and Basel Committee expressly recognized this point last December with respect to "assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements."[14] That is, it acknowledged that the impact of new requirements on GDP would be dependent on the extent to which banks sought to implement new capital requirements ahead of the transition schedule set by supervisors. The shorter the implementation period the more negative the impact on GDP, with such effects accentuated to the degree that banks chose to hold an additional voluntary equity capital buffer above the new standards.

We strongly believe that given the current quantity and quality of capital of institutions operating in the U.S., effectively four times that held by such institutions at the time of the financial crisis, there is no need for immediate action, without adequate time for study, public comment and Congressional review. Given that the U.S. is already implementing massive regulatory reforms and will imposed substantially higher capital requirements with the implementation of Basel III, we respectfully urge U.S. regulators not to rush into a global agreement this summer. Likewise, in adopting "enhanced prudential standards" for larger banks under Dodd-Frank, including capital plans, we do not believe the Federal Reserve should unilaterally impose a surcharge that exceeds the substantially higher capital threshold required for internationally active banks under Basel III.

[13] Secretary Timothy Geithner, International Monetary Conference, June 6, 2011

[14] FSB and BCBS, *Final Report – Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements* – December 2010.

Again, no sufficient economic analysis has been undertaken to consider the impact of this proposal, in tandem with Dodd-Frank and previous regulatory actions. Thus we restate our view that the FSOC should undertake such an analysis and report to Congress before entering into such an agreement. Given the potential negative economic consequences to the U.S. economy, it is entirely appropriate that Congress review such data. There is no downside to U.S. regulators studying the impact of a surcharge and possible alternatives until other countries, which are moving slower than the U.S., implement regulatory reform and resolution requirements. Nor do we believe we should agree to a surcharge falsely premised on all other countries following the U.S. lead.

Dodd-Frank Section 619 - Volcker Rule

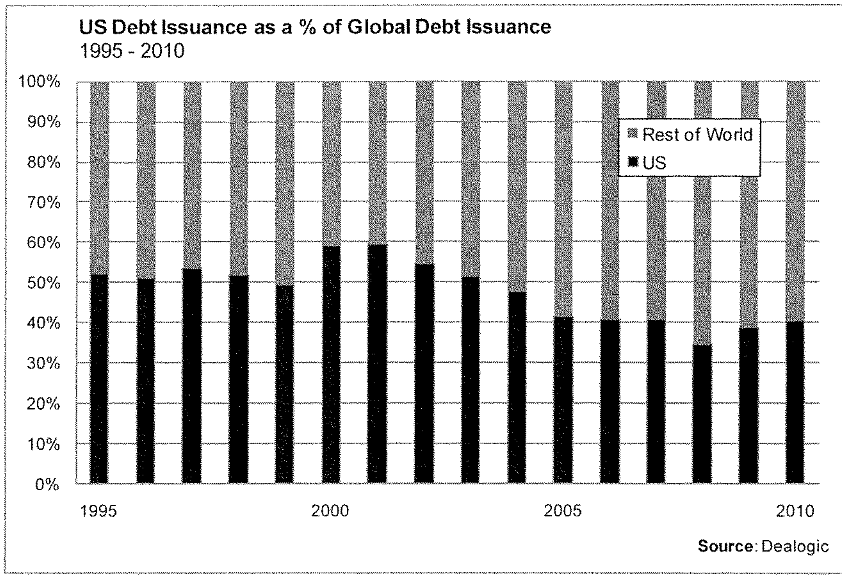
Section 619 of the Dodd-Frank Act, or the Volcker rule, prohibits proprietary trading and sponsorship and investment in hedge funds and private equity funds by U.S. banks and their affiliates and foreign banks and affiliates operating in the U.S. This unilateral U.S. reform measure is unlikely to be replicated in other nations. While such action may lessen potential risk in the U.S. system, importantly, if implemented in an overly restrictive manner, it has the potential to negatively affect the liquidity of U.S. markets by limiting the ability to engage in market making and hedging activities to the detriment of U.S. issuers which could accelerate the decline of U.S. market share for debt and equity offerings. Also, we do not believe that the Volcker Rule was meant to disrupt traditional risk management activities of banks and we believe that these activities should be recognized as outside the scope of the Volcker Rule's prohibitions.

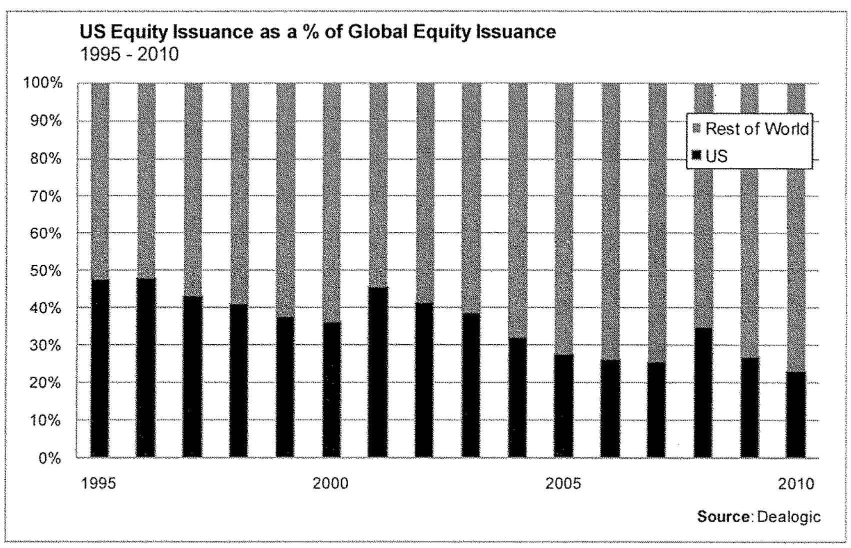
In most securities, derivatives, and commodities markets, banks and their dealer affiliates subject to the Volcker Rule play a critical role as the central providers of liquidity to other market participants. A poorly constructed or excessively restrictive implementation of proprietary trading limitations could hamper that liquidity in a wide range of markets, and consequently impede the ability of businesses to access capital and the ability of households to build wealth.

The risk of unintended consequences for investors and the U.S. economy is significant and should be carefully considered during this rule writing phase of implementation. Congress recognized in the statutory language imposing the Volcker Rule that certain activities, such as market making and hedging, play an important role in capital formation and should not be undermined by overly restrictive rules. Without the liquidity that dealers provide to U.S. capital markets, there could be substantial negative effects, including:

- Higher funding and debt costs for U.S. companies;
- Reduced ability of households to build wealth through participation in liquid, well-functioning securities markets;
- Reduced access to credit for small or growing firms with less established credit ratings and histories;
- Reduced willingness of investors to provide capital to businesses because of greater difficulties in exiting those investments;
- Higher trading costs and consequently lower returns over time for investors, such as pension and mutual funds; and
- Reduced ability for companies to transfer risks to others more willing and able to bear them via derivatives, with a consequent reduction in overall efficiency of the broad economy.

If implemented in a way that is overly restrictive for market making, hedging, the Volcker Rule could harm liquidity in the U.S. market, constrain capital formation, restrict credit availability to the consumer and business, and thus, undermine the nation's fragile recovery. Further, it could hasten further loss of U.S. market share in debt and equity issuance to other nations since issuers and investors demand liquidity as a function and preference of markets in which they issue and list.


US Debt Issuance as a % of Global Debt Issuance
1995 - 2010
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Rest of World
US
1995
2000
2005
2010
Source: Dealogic


US Equity Issuance as a % of Global Equity Issuance
1995 - 2010
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Rest of World
US
1995
2000
2005
2010
Source: Dealogic

Finally, given the potential negative consequences of an overly restrictive approach to this rule, it is critical that the Volcker Rule be implemented in a fashion that is consistent across the various agencies that have been given rule-writing and enforcement authority.

Derivatives Markets

Title VII of Dodd Frank fundamentally transforms the U.S. swap and security-based swap (collectively, "Swap") markets. Of the 106 Dodd Frank rulemaking deadlines due by the third quarter of 2011, the majority relate to over the counter ("OTC") derivatives regulation.

As we approach the July rulemaking deadlines for many of those rules, it has become increasingly clear to market participants and U.S. regulators, as well as legislators, that finalizing these rules will require more time and analysis than Congress originally contemplated. Implementation sequencing and timing are key considerations in the rulemaking process, and we have had extensive discussions with the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission ("SEC," and together "Commissions") on potential frameworks, noting that the Commissions have flexibility to determine effective dates for final rules.[15]

Further, given the SEC's and CFTC's serious consideration of comments and the significant comments from a wide range of markets participants on proposed rules, it seems likely that the Commissions may revise prior proposals. We strongly urge the Commissions to re-propose rules once completed, which will allow an additional comment period after the rule proposals are amended to reflect comments received. We understand that the Commissions may be concerned about additional delay, but re-proposal will only postpone the Title VII rulemaking implementation for a number of months, not years, and the costs of

[15] SIFMA and other Associations Submit Comments to the CFTC and SEC on a Phase-In Schedule for Derivative Requirements of Dodd-Frank Act, May 4, 2011 (www.sifma.org/Issues/item.aspx?id=25260)

any such delay will be far outweighed by the benefits resulting from further industry, market and public input into, and regulatory deliberation with respect to, the rulemaking process.[16]

Most recently, we have commented to both the CFTC and SEC that while most Title VII provisions require rulemaking to become effective, arguably some are scheduled to become effective on July 16 ("self-operative provisions"). In general, intractable compliance, interpretive and operational challenges will arise if such provisions go into effect in July. Compliance with these provisions is complicated in part because certain key terms, "Swap," "Swap dealer" and "major Swap participant," are subject to further definition, and because the self-operative provisions are integrally related to other provisions that require rulemaking. We have requested that self operative provisions for the most part be delayed until final rules are effective.[17] We appreciate the recognition of this situation by the CFTC in its extension granted on Tuesday and acknowledgement by the SEC of the need to take steps in this area. It will be critical that the Commissions actions clearly provide legal certainty until such time as rulemaking is completed and rules are effective.

In addition, given the global nature of this marketplace; it is also important that U.S regulators give careful consideration to the extraterritorial application of their swap dealer regulations. Again, as Treasury Secretary Geithner stated in his June 6 speech, "Without international consensus, the broader cause of central clearing will be undermined. Risk in derivatives will become concentrated in those jurisdictions with the least oversight."[18]

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[16] See SIFMA and Other Associations Submit Comments to the CFTC on the Reopening and Extension of Comment Periods for Rulemakings Implementing Dodd-Frank Act, May 26, 2011 (www.sifma.org/Issues/item.aspx?id=25695) and to the SEC on the Re-proposal of Rules Implementing Title VII of Dodd-Frank Act, May 31, 2011 (www.sifma.org/Issues/item.aspx?id=25741)

[17] See SIFMA and Other Associations Submit Comments to the SEC for Clarification and Relief Under Sections 754 and 739 of the Dodd-Frank Act, June 10, 2011 (www.sifma.org/Issues/item.aspx?id=25938) and SIFMA and Other Associations Submit Comments to the CFTC on Clarification and Relief Under Sections 754 and 739 of the Dodd-Frank Act, June 10, 2011 (www.sifma.org/Issues/item.aspx?id=25937)

[18] Remarks of Secretary Timothy Geithner before the International Monetary Conference, June 6, 2011.

While SIFMA has significant and numerous other concerns with Title VII[19], let me emphasize two important themes: implementation phase-in and extraterritoriality.

Implementation Phase-In

We have discussed with the regulatory community the significant practical hurdles to implementing this new regulatory structure for swaps, including the interdependencies of the key portions of that structure, and we have suggested approaches to a phased-in implementation schedule. Such a phase-in would permit more deliberative consultation and coordination, and also allow for implementation with minimal disruption to the financial institutions, their main street counterparties, and the marketplace. We base our phase-in recommendations on a number of principles, including: implementation of final rules should avoid market disruptions; data reporting to regulators to inform future rulemaking and rules aimed at reducing systemic risk should be prioritized; and implementation should be sequenced so that effectiveness of each rule set is coordinated across interrelated applicable rule sets.

Dealers, major swap participants, asset managers, technology and systems providers, and the Commissions will need to engage in a concerted effort to educate their clients and the market about the changes in business and regulatory practices that the new rules will require. The Commissions should phase in requirements based on the state of readiness of each particular asset class (including, where applicable, by specific products within an asset class) and market participant type.

Application of provisions of Title VII to the diversity of Swaps and market participants will involve the interaction of rules relating to different asset classes and products as well as differences among rules imposed by different U.S.

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[19] See SIFMA comment letters on OTC Derivatives at www.sifma.org/Issues/Regulatory-Reform/OTC-Derivatives/Activity/.

regulators and regulators in different countries. Understanding these interactions and sequencing implementation of the rules accordingly will create a more robust regulatory structure.

Extraterritoriality

The swaps market is truly global: a single swap may be negotiated and executed between counterparties located in two different countries, booked in a third country, and risk-managed in a fourth country, thereby triggering swaps regulation in multiple jurisdictions simultaneously. Many participants use a central booking entity to efficiently manage risks arising from swaps that they execute around the world through their subsidiaries, affiliates and branches.

These global arrangements emerged decades ago from the efforts of counterparties to maximize their credit protection and reduce their risks. The regulation of these swap arrangements is complicated by the nature of swaps, which are characterized by ongoing payments, deliveries or other obligations between the parties throughout their long duration. This may result in regulation of the swaps relationship over the course of many years, rather than primarily at the time of the execution of the transaction as with the purchase or sale of cash instruments.

It is therefore critical that any effective approach to U.S. swaps regulation must accommodate the global risk management and efficient operational structures currently in place. U.S. regulators should carefully draft the Title VII rules to avoid disrupting these international arrangements except where necessary to achieve an explicit legislative purpose. U.S. regulators should also give effect to the principles of international comity by refraining from unnecessarily regulating conduct outside national borders while appropriately allocating supervision of cross-border swaps activities in a way that protects U.S. markets and counterparties and avoids duplicative and inconsistent regulations. We believe that our recommended approach to regulating foreign swap dealers and cross-border swaps activities is consistent with the legal authority provided by Dodd Frank as well as the Commissions' current approach towards extraterritorial application of U.S. regulation, would achieve the statute's objectives, give effect to the principles of comity by appropriately allocating supervisory responsibilities between the U.S. and home country supervisors, and facilitate an efficient, effectively regulated and competitive global swaps market.[20]

It is critical for the competitiveness of the U.S. economy that we get these regulations right – vast sectors of the U.S. economy – including manufacturing, healthcare, and technology – use these products as a tool to manage risks and to compete globally. Final regulations that miss the mark will have a real and negative impact on the economy.

International Accounting Standards

The rapid globalization of the capital markets over the last several decades has accelerated the effort to forge a common set of accounting standards for use by all issuers. Given the importance of accurate and transparent financial reporting to markets, market participants have placed great value upon the attainment of a set of high quality accounting standards.

SIFMA strongly supports convergence towards a single set of high quality accounting standards. The lack of a common set of accounting standards has created barriers for users of financial statements – including creditors, investors and analysts – to compare even firms in the same industry. The issues to be resolved are highly technical, and can have a significant impact on the business of financial services firms.

One area that demonstrates both the material differences between the two sets of standards and the difficulty of convergence is the FASB and the IASB models on offsetting. SIFMA welcomes and is supportive of FASB's work to seek

[20] SIFMA Submits Comments to Multiple Federal Agencies on the Extraterritorial Application of Title VII of the Dodd-Frank Act, February 3, 2011 (http://www.sifma.org/Issues/item.aspx?id=23247).

convergence in this important area; however, we are concerned with FASB's recent exposure draft regarding harmonizing these differences, and do not support the FASB framework in this area as a basis for convergence as we believe it will not result in the highest quality accounting standard.[21] Application of the proposed guidance will require gross presentation of most derivative receivables and payables, most repurchase and reverse repurchase agreements and all receivables and payables from unsettled regular-way trades, which for our member firms will obscure true credit risk positions and liquidity profiles, and provide misleading views of future cash flows given the way in which derivatives settle. This distorted view could impact a reporting entity's capital ratios, funding options, and tax liabilities.

We understand that on June 15 the FASB tentatively agreed to maintain the U.S. GAAP approach to offsetting derivative receivables and payables (on a net basis), while the IASB voted to adopt the gross approach. The differences between the two approaches will be reconciled with disclosures to be agreed upon between the Boards. We believe that the FASB's tentative conclusion will result in the highest quality accounting standard and therefore support the proposed approach to converge balance sheet presentation through disclosure.

In conclusion, we greatly appreciate the Committee's interest in these matters and believe it is entirely appropriate for the Congress to review the actions taken and proposed by U.S. and global regulators as it relates to capital, activities and financial reporting. While we all share the goal of ensuring safety and soundness, and avoiding a future crisis like that experienced in 2008, it is equally important that we considered the economic impact, and potential consequences, of our efforts to ensure the pendulum does not swing to far in the opposite direction at a cost we cannot afford.

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[21] "Proposed Accounting Standards Update: Balance Sheet (Topic 210) Offsetting", April 28, 2011, SIFMA letter to Susan M. Cosper, Technical Director, FASB.

Testimony on "Financial Regulatory Reform: The International Context"

by

Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

Before the United States House Committee on Financial Services

June 16, 2011

Chairman Bachus, Ranking Member Frank, and members of the Committee:

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission ("SEC") regarding the international implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act").

The Dodd-Frank Act establishes a host of new reforms that will have implications for U.S. companies that compete internationally and the U.S. investors who own those companies. My testimony today will outline some of these implications, as well as the SEC's attempts to facilitate coordination and limit regulatory arbitrage, both domestically and internationally. In particular, I will discuss the international implications of the Dodd-Frank Act for regulation of over-the-counter ("OTC") derivatives and foreign investor adviser registration. I also will provide a brief update on the status of international accounting convergence.

OTC Derivatives

The OTC derivatives marketplace has grown dramatically over the past three decades to become enormous and truly international. Since the early 1980s, when the first swap agreements were negotiated, the global notional value of this marketplace has grown to just over $600 trillion.[1] However, OTC derivatives were largely excluded from the financial regulatory framework by the Commodity Futures Modernization Act of 2000.

Title VII of the Dodd-Frank Act would bring this market under the regulatory umbrella and requires that the SEC and Commodity Futures Trading Commission ("CFTC") write rules relating to security-based swaps and swaps that address, among other things, mandatory clearing, the operation of execution facilities and data repositories, capital and margin requirements and business conduct standards for dealers and major participants, and regulatory access to and public transparency for transaction information.

This series of rulemakings is designed to improve transparency and facilitate the centralized clearing of swaps and security-based swaps, helping, among other things, to improve oversight and reduce counterparty risk. It also will increase disclosure regarding swap and security-based swap transactions and help to mitigate conflicts of interest involving swaps and security-based

1 *See* Bank of International Settlements, OTC Derivatives Market Activity in the Second Half of 2010, Monetary and Economic Department (May 2011), available at http://www.bis.org/publ/otc_hy1105.pdf.

swaps. By promoting transparency, efficiency and stability, this framework should help foster a more nimble and competitive market.

Because the OTC derivative marketplace already exists as a functioning, global market with limited oversight or regulation, international coordination is very important to seek to limit creating opportunities for cross-border regulatory arbitrage and competitive disadvantages, and to address unnecessarily duplicative and conflicting regulation, as well as, for achieving the goals of reform: reducing the systemic risks, increasing the transparency and improving the integrity of the OTC derivatives marketplace, while being mindful of the potential effects on efficiency and liquidity.

Pittsburgh G20 Communiqué

While the U.S. has been a leader in this important area, significant international consensus exists around core components of OTC derivatives reform. For example, in September 2009, the G20 Leaders agreed that:

- "[a]ll standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest,"
- "OTC derivatives contracts should be reported to trade repositories," and
- "[n]on-centrally cleared contracts should be subject to higher capital requirements."

The G20 deadline contemplates that every G20 country will have completed the legislation, rulemaking and implementation of these reforms by the 2012 deadline. While progress is being made internationally, other jurisdictions lag behind our efforts here. Apart from the United States, only Japan has enacted OTC derivatives reform legislation since the September 2009 G20 Communiqué, and its legislation only covers clearing and reporting, not mandatory trading. In the European Union, legislation is currently being considered that would establish criteria for the mandatory clearing of eligible OTC derivatives contracts, rules on risk mitigation for OTC derivatives contracts that are not centrally cleared, reporting obligations to, and registration requirements for, trade repositories, and organizational requirements for central counterparties. The proposed legislation is expected to be enacted before year-end 2011, with draft implementing regulations to be proposed to the European Commission by the market regulator by the end of June 2012, at the earliest. With regard to mandatory trading and post-trade reporting, the European Commission published a consultative paper in December 2010 on the issue of moving OTC derivatives trading to exchanges and electronic platforms and establishing post-trade requirements. A legislative proposal in this area has yet to be released.

Although U.S. action on OTC derivatives gives us an opportunity to shape the OTC derivatives regulatory landscape, we also face challenges in negotiating with other regulators, as they have limited scope to commit to regulatory coordination before their own legislative and regulatory frameworks have been established.

Ongoing Regulatory Coordination

Domestically, the SEC is working closely with the CFTC, the Federal Reserve Board, and other federal prudential regulators, as required by the Dodd-Frank Act, to develop a coordinated approach to implementing the statutory provisions of Title VII to the extent practicable, while recognizing relevant differences in products, entities, and markets. Working closely domestically also helps our efforts internationally.

Similarly, the Dodd-Frank Act specifically requires the SEC, the CFTC, and the prudential regulators to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards" with respect to the regulation of OTC derivatives in order to promote consistent global regulation.

Accordingly, the SEC has been extremely active in bilateral and multilateral discussions with regulators at home and abroad. We have been engaged with international securities and market regulators and other bodies, both through informal conversations and more formally through participation in various international task forces and working groups, to discuss issues surrounding the regulation of OTC derivatives, thereby encouraging coordination and limiting opportunities for regulatory arbitrage.

SEC staff has encouraged international securities regulators that are contemplating OTC derivatives market reforms to use the Dodd-Frank Act and its regulations as a model for developing robust and complementary regulatory regimes. The SEC is continuing to actively coordinate with our counterparts in other jurisdictions to foster the development of common frameworks and, in that way, avoid the potential for market participants to engage in regulatory arbitrage. Such efforts include our active involvement in:

- Financial Stability Board Working Group on OTC Derivatives Regulation ("FSB Working Group"): In April 2010, at the initiative of the FSB, a working group led by representatives from the Committee on Payment and Settlement Systems ("CPSS"), the International Organization of Securities Commissions ("IOSCO"), and the European Commission was formed to make recommendations on the implementation of the G20 Leaders' September 2009 commitments. The SEC serves as one of the co-chairs of the FSB Working Group on IOSCO's behalf. The FSB Working Group is comprised of international standard setters and authorities responsible for translating the G20 Leaders' commitments into standards and implementing regulation.

- IOSCO Task Force on OTC Derivatives Regulation ("IOSCO Task Force"): The IOSCO Task Force was formed in October 2010 by the Technical Committee of IOSCO in order to coordinate international securities and futures regulators' efforts to work together in the development of supervisory and oversight structures related to the OTC derivatives markets. The SEC is one of the four co-chairs of the IOSCO Task Force. The IOSCO Task Force seeks to: (1) develop consistent international standards related to OTC derivatives regulation in the areas of clearing, trading, trade data collection and reporting, and the oversight of certain market participants; (2) coordinate other international initiatives relating to OTC derivatives regulation, including addressing certain recommendations made by the FSB Working Group; and (3) serve as a centralized group within IOSCO through which IOSCO members can consult and coordinate generally on issues relating to OTC derivatives regulation.

- CPSS/IOSCO: The CPSS/IOSCO fora (which cover various topics, including principles for financial market infrastructures (e.g., clearinghouses), are joint endeavors through which CPSS, as an organization for central bankers, and IOSCO, as an international policy forum for securities regulators, work together to address issues of concern to both prudential and market regulatory authorities.

Regulatory Divergence and Competitiveness

The SEC also is charged with protecting U.S. investors and reducing systemic risk in the security-based swaps markets, and in doing so we consider the potential impact on the global competitiveness of U.S. companies. U.S. markets have been global leaders in part because of a legal framework that promotes firms and markets that are a benchmark for strength, resilience and transparency.

To this end, we have been carefully considering the potential consequences of certain provisions of Title VII and our proposed rulemaking for domestic and foreign market participants – in particular the impact on the ability of U.S. market participants to compete effectively with foreign market participants that may not be subject to the Dodd-Frank Act. Our goal is to establish a framework that meets the requirements and objectives established by the Congress, while fostering, to the maximum extent possible, a fair and level playing field for all market participants.

One area where these issues arise acutely is in the differing margin standards for U.S. and foreign market participants, where U.S. regulators seek strong standards to maximize safety and soundness, but U.S. firms are concerned that these rules could place their overseas operations at a competitive disadvantage to foreign-owned firms that meet different standards. To address these and other issues, U.S. regulators are working closely with foreign regulators to establish similar standards that will reduce risk more broadly and address competitiveness concerns.

Process

Rather than addressing the international implications of Title VII of the Dodd-Frank Act piecemeal, we are considering addressing the relevant international issues holistically in a single proposal. Such a release would give investors, market participants, foreign regulators, and other interested parties an opportunity to consider our proposed approach to the registration and regulation of foreign entities engaged in cross-border transactions involving the U.S. as an integrated whole. This approach should generate thoughtful and constructive comments for us to consider regarding the application of Title VII to cross-border transactions.

In the meantime, in considering international jurisdictional and harmonization issues in our implementation framework, we continue to welcome input from interested parties, and we look forward to continued discussions about the most effective means of providing necessary regulation without being unduly burdensome to market participants or their competitiveness in the global markets.

Implementation Challenges Generally

Part of balancing regulatory concerns with competitiveness concerns also involves establishing an implementation process for derivatives regulation that permits market participants sufficient time to establish systems and procedures in order to comply with new regulatory requirements without imposing undue implementation burdens and yet does not unnecessarily delay bringing this market under the regulatory umbrella. This is particularly a challenge when imposing a comprehensive regulatory regime on existing markets, particularly ones that until now have been largely unregulated.

We recognize that there are costs and benefits associated with compliance, and we have been keeping these costs and benefits in mind as we have moved forward in proposing rules implementing Title VII. We have requested extensive comment on the costs and benefits associated with the SEC's proposed rulemakings, and have been engaged in many discussions with market participants, as well as domestic and foreign regulators, regarding such costs and benefits.

To this end, we have been working with our fellow regulators and with market participants to craft rules and establish expeditious implementation timeframes that are reasonable for the various rulemakings, and are reviewing what steps market participants will need to take in order to comply with our proposed rules. These discussions are vital to establishing an implementation timeline that is workable. We also recognize the importance of obtaining input on an implementation timeline for Title VII.

After proposing all of the key rules under Title VII, we intend to consider seeking public comment on a detailed implementation plan that will permit a roll-out of the new securities-based swap requirements in an efficient manner, while minimizing unnecessary disruption and costs to the markets. Let me assure you that the implementation plan is not a mechanism for delay. Instead is should help facilitate the important and necessary reform of the OTC derivatives market.

Steps to Address Effective Date of Title VII

We also have announced that we intend to take a series of actions in the coming weeks to clarify the requirements that will apply to security-based swap transactions as of July 16 – the one-year effective date of Title VII of the Dodd-Frank Act – and provide appropriate temporary relief. Specifically, we intend to:

- provide guidance regarding which provisions in Title VII governing security-based swaps become operable as of the effective date and provide temporary relief from several of these provisions;

- provide guidance regarding – and where appropriate, temporary relief from – the various pre-Dodd-Frank provisions that would otherwise apply to security-based swaps on July 16;

- take other actions to address the effective date, including extending certain existing temporary rules and relief to continue to facilitate the clearing of certain credit default swaps by clearing agencies functioning as central counterparties.

We also have proposed rules that would exempt transactions by clearing agencies in security-based swaps that they issue from all provisions of the Securities Act, other than the Section 17(a) anti-fraud provisions, as well as exempt these security-based swaps from Exchange Act registration requirements and from the provisions of the Trust Indenture Act, provided certain conditions are met.

Volcker Rule

Section 619 of the Dodd-Frank Act, often known as the Volcker Rule, may also have international implications. Under the Volcker Rule, banks and bank holding companies and their affiliates as well as the U.S. operations of foreign banks and foreign bank holding companies and their affiliates, including their affiliated broker-dealers (collectively defined as "banking entities" in the Dodd-Frank Act), are generally prohibited from engaging in proprietary trading or sponsoring or investing in a hedge fund or private equity fund. The Volcker Rule includes certain exceptions for activities such as market-making-related activities, risk-mitigating hedging, underwriting, and trading on behalf of customers. Otherwise-permitted activities are impermissible if they involve material conflicts of interest, high-risk assets or trading strategies, or threats to the safety and soundness of the banking entity or U.S. financial stability.

In January, as required by the Dodd-Frank Act, the Financial Stability Oversight Council ("FSOC") issued a study on the Volcker Rule pursuant to requirements under the Dodd-Frank Act. The study was published on January 18, 2011. The FSOC study recommended a supervisory framework for implementing the prohibition on proprietary trading consisting of a programmatic compliance regime (e.g., policies and procedures, internal controls, recordkeeping and reporting, etc.), metrics, supervisory review and oversight, and enforcement procedures for violations. For the restrictions on proprietary trading, the study recognizes the close relationship between impermissible proprietary trading and other permitted activities (for example, whether the position was taken in anticipation of customer demand or for speculative purposes). The recommended supervisory framework seeks to leverage industry compliance efforts involving data review and metrics analysis with examination and testing by the SEC and other financial regulatory agencies to enforce compliance.

Where a banking entity is permitted to invest in a hedge fund or private equity fund to facilitate customer-related business under the Volcker Rule, the study provided that agencies should consider requirements for banking entities to disclose the nature and amount of any such investment. The FSOC study also sets forth various methods that agencies may use to define "customers" for purposes of the "organize/offer" exception, factors to consider in determining the scope of funds that will be included in the definition of "hedge fund" and "private equity fund," and considerations regarding the calculation of a de minimis investment, among other things.

The SEC is required to consider the FSOC's study and coordinate and consult with the federal banking agencies and the CFTC in implementing the Volcker Rule with respect to any entity for which the SEC is the primary financial regulatory agency. The SEC is the primary regulator for registered broker-dealers, registered investment advisers, registered security-based swap dealers, and major security-based swap participants that are affiliates of insured depository institutions.

We are still considering rulemaking regarding the Volcker Rule, and we have been in extensive discussions with other regulators about how to address the various issues raised by the Volcker Rule. We will be seeking extensive comment on the issues of global competitiveness to the extent we can address them in any proposed rulemaking regarding the Volcker Rule.

Global Accounting Standards

Accounting and financial reporting standards are essential to efficient allocation of capital by investors everywhere in the world. Although the Dodd-Frank Act does not specifically address the issue, the SEC is continuing its work on this long standing and important issue. Our primary consideration is the best interests of U.S. investors.

The SEC has long promoted a single set of high-quality globally accepted accounting standards. This position advances the dual goals of improving financial reporting within the United States and reducing country-by-country disparity in financial reporting. As evidenced by the recent economic crisis, the activities and interests of investors, companies, and markets are increasingly global.

In pursuit of this goal, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") have been prioritizing projects most in need of improved global standards, including revenue recognition, leases, financial instruments, and insurance. Their efforts have been marked by rigorous outreach and field-testing. These tasks are important elements of due process and critical to the quality of any globally-accepted accounting standards.

As the Boards move into the phase of final deliberations on some of the highest priority projects, we are encouraging them not only to consider the results of the outreach and field-testing, but to evaluate carefully the feedback and extensive comments received on the proposals as well.

Last year, the SEC published a statement providing an update regarding our consideration of whether and how to incorporate IFRS into the financial reporting system for U.S. issuers, including the SEC's continued support for the convergence of U.S. Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS"). We will continue to consider the ongoing work of the FASB and the IASB to develop and improve financial accounting standards, including its implications with respect to the SEC's ongoing consideration of the potential incorporation of IFRS for U.S. issuers.

In response to the broad public feedback the Commission received on earlier efforts in this area, the SEC determined that a comprehensive analysis was necessary to lay out transparently the work that must be done to support consideration of incorporating IFRS, including the scope, timeframe, and methodology for any such transition. We asked our Office of the Chief Accountant, with consultation from other SEC Divisions and Offices, to carry out the work plan.

Specifically, the principal areas of the work plan include:

- the sufficiency of IFRS' development and application for the U.S. domestic reporting system;
- the independence of IFRS standard-setting process for the benefit of investors;
- investor understanding and education regarding IFRS;
- examination of the U.S. regulatory environment that would be affected by a change in accounting standards;
- the impact on issuers, both large and small; and
- human capital readiness.

The first two areas consider characteristics of IFRS and its standard setting that would be the most relevant to a future determination by the Commission regarding whether to incorporate IFRS into the financial reporting system for U.S. issuers. The remaining four areas relate to transitional considerations that will enable the staff to better evaluate the scope of, timing of, and approach to changes that would be necessary to effectively incorporate IFRS into the financial reporting system for U.S. issuers, should the commission determine in the future to do so.

The staff is executing the work plan in an open and deliberative manner. Last October, the staff published a progress report that discussed each section of the work plan and provided an update of the staff's outreach, research and preliminary observations. Last month, the staff published a paper to provide additional detail and request comment on one potential method of incorporation.

In various forums, the Commission and its staff previously have described and sought public comments on several other possible approaches for progressing toward a single set of high-quality, globally accepted accounting standards. Those approaches include: full adoption of IFRS on a specified date, without any endorsement mechanism; full adoption of IFRS following staged transition over several years, similar to the approach described in the Commission's Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers; and an option for U.S. issuers to apply IFRS, as described in the Commission's Concept Release and the Proposed Roadmap. In addition, in response to the requests for comment on these alternative approaches, some commenters have suggested that the U.S. retain U.S. GAAP with continued convergence efforts, with or without a specific mechanism in place to promote alignment with IFRS. A public roundtable is scheduled for early next month to focus on topics such as investor understanding of IFRS, the impact on smaller public companies, and the regulatory implications of incorporating IFRS.

In addition to acknowledging the clear benefits of a single set of high quality, global accounting standards, we also acknowledge the magnitude of the task that will be involved, and the transition time and costs that would be necessary to incorporate IFRS for U.S. issuers. Accordingly, we are carefully considering the potential incorporation of IFRS for U.S. issuers.

In addition, the SEC has affirmed its belief that, looking forward, the FASB will continue to play a substantive role in achieving the promise of high-quality global accounting standards, and that role will remain critical.

Other Issues

Indemnification Requirement

The Dodd-Frank Act includes a provision requiring domestic and foreign authorities, in certain circumstances, to provide written agreements to indemnify SEC and CFTC-registered trade repositories (i.e., swap and security-based swap data repositories), as well as the SEC and CFTC, for certain litigation expenses as a condition of obtaining data directly from the trade repository regarding swaps and security-based swaps. In addition, the trade repository must notify the SEC or CFTC upon receipt of an information request from a domestic or foreign authority.

Concerns have been raised about the potential effect of the indemnification and notice provisions on the ability of foreign regulators to obtain access to data regarding transactions, positions and market participants active in the derivatives markets. Regulators also must have the ability to verify that trade repositories are complying with their statutory and regulatory obligations. We understand that in response to the indemnification requirement, European regulators are considering including in their final legislation a reciprocal provision that would prohibit a non-EU trade repository from operating in the EU unless the repository's home country regulator has agreed to indemnify the repository and EU authorities for any litigation expenses related to the information provided by the repository to the home country regulator. Like most regulators, the SEC is not in a position to enter into an open-ended indemnification agreement.

Given our need for access to data held in trade repositories registered with a foreign authority and in response to European concerns about their regulators' access to data held in SEC and CFTC-registered trade repositories, Chairman Gensler and I recently provided EU Commissioner Michel Barnier of the European Commission a letter that analyzes the scope of the Dodd-Frank Act's indemnification provision. The European Commission is expected to finalize its data access provisions later this year.

Foreign Investment Adviser Registration and Reporting.

Title IV of the Dodd-Frank Act repeals an exemption from registration for private investment advisers, which means that many hedge fund and private equity fund advisers will be required to register with the Commission. However, the Act also adds certain exemptions from registration for foreign private advisers, venture capital fund advisers and private fund advisers with less than $150 million in assets under management in the United States.

Next week, the Commission will consider final rules that, among other things, would do the following: (1) clarify the meaning of certain terms included in the foreign private adviser exemption; (2) define "venture capital fund"; (3) implement the exemption for private fund advisers with less than $150 million in assets under management; (4) establish tailored reporting requirements for advisers relying on the venture capital and private fund adviser exemptions; and (5) extend the deadline for previously exempt advisers to come into compliance to the first quarter of 2012. In implementing the new registration requirements and exemptions for foreign advisers provided under the Act, the Commission has sought to protect U.S. investors and the functioning of U.S. markets while minimizing potential conflicts with foreign regulation. These rules are intended to provide certainty to foreign advisers who are eager to determine their registration and compliance requirements under U.S. law.

Staff members also continue to work on analyzing and addressing comments in response to the joint proposal of the Commission and the CFTC for private fund reporting.[2] In developing this proposal, the staffs of the Commissions drew heavily on the experience and input of foreign regulators which had conducted or were developing reporting standards for hedge funds. Commission staff are continuing to coordinate with the European Securities and Markets Authority (ESMA), the U.K. Financial Services Authority (FSA) and the International Organization of Securities Commissions (IOSCO) to seek comparability of data and the consistency of reporting requirements. Staff also continue to consult with staff of the other FSOC member agencies.

Conclusion

In conclusion, the Dodd-Frank Act requires the SEC, among other regulators, to conduct a substantial number of rulemakings and studies that, directly or indirectly, may have international implications for U.S. companies and investors seeking to access foreign financial markets. As we proceed with implementation, we look forward to continuing to work closely with Congress, our fellow regulators, and members of the financial and investing public.

Thank you for inviting me to share with you our progress on and plans for implementation. I am happy to respond to your questions.

2 *See* Release No. IA-3145, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF* (January 26, 2011), available at http://www.sec.gov/rules/proposed/2011/ia-3145.pdf.

Testimony of

Hal S. Scott

Director of the Committee on Capital Markets Regulation;
Nomura Professor and Director of the Program on International Financial Systems
at Harvard Law School

Before the

Committee on Financial Services
United States House of Representatives

June 16, 2011

Written Testimony of Hal S. Scott

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* * *

Thank you, Chairman Bachus, Ranking Member Frank, and members of the Committee for permitting me to testify before you today on the impact of financial regulation on U.S. competitiveness. I am testifying in my own capacity and do not purport to represent the views of any organizations with which I am affiliated, although much of my testimony is based on the past work of the Committee on Capital Markets Regulation (CCMR). Indeed, the Committee was formed in 2005 to deal with the foreign competitive threat to our public equity capital markets and in 2006 issued a report, with the encouragement of then-Secretary of the Treasury Henry Paulson, detailing the seriousness of the threat and suggesting how to deal with it.[2] Since that time, we have tracked, on a quarterly basis, thirteen measures of the competitiveness of the U.S. public equity market.[3] In general, we continue to have a substantial competitive problem.

During the financial crisis, restoring the stability of our markets has rightly taken priority over issues of competitiveness. But competitive issues have naturally reemerged as we have considered our regulatory and policy response to the crisis. CCMR's May 2009 report on the

[1] Biography with disclosures on compensated activities available at http://www.law.harvard.edu/faculty/hscott.
[2] COMM. ON CAPITAL MKTS. REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKET REGULATION (Nov. 30, 2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.
[3] Comm. on Capital Mkts. Reg., Competitive Measures, http://www.capmktsreg.org/competitiveness/index.html.

global financial crisis,[4] as well as the Treasury's June report on financial regulatory reform,[5] stressed the importance of international coordination in formulating a response to the crisis. Such cooperation is necessary to avoid regulatory arbitrage and competitive problems, two sides of the same phenomenon. Unfortunately, but understandably, these competitive concerns became less important in the intense domestic political environment that dominated the congressional debates that culminated in the Dodd-Frank Act. Nonetheless, that Act largely left regulators with sufficient discretion to permit them to minimize competitive damage to the U.S. But this requires that regulations be designed in coordination with our major competitors, coordination that has not sufficiently occurred up to now.

I will focus my remarks on five areas of regulation under Dodd-Frank that can affect competition: the Volcker Rule; regulations governing derivatives; capital requirements; the designation and regulation of systemically important financial institutions; and resolution of insolvent financial firms.

I. The Volcker Rule

The so-called Volcker Rule bans proprietary trading in banking organizations (not just in the banks themselves), and limits their sponsorship of private equity and hedge funds to 3% of any fund and 3% of their capital.[6] This proposal was not in the Treasury 2009 recommendations, nor was it in the Wall Street Reform and Consumer Protection Act,[7] the bill that passed the

[4] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 203 (May 2009), http://www.capmktsreg.org/research.html.
[5] DEP'T OF TREASURY, A NEW FOUNDATION REBUILDING FINANCIAL SUPERVISION AND REGULATION (June 17, 2009), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=2cbde5d4-68ea-4c48-8121-9cc4fa1f2901.
[6] Dodd-Frank Wall Street Reform and Consumer Protection Act § 619, Pub. L. No. 111-203, 124 Stat. 1376 (hereinafter Dodd-Frank Act).
[7] Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

House on December 11, 2009. It was endorsed by the White House in early 2010 and was included in the Restoring American Financial Stability Act of 2010[8] that was passed by the U.S. Senate. It survived in conference. Despite Paul Volcker's hope that his rules would be accepted internationally, no other country has moved in this direction. Most recently, the U.K. Independent Commission on Banking rejected this approach.[9] Instead, it outlined a plan for separating within a banking firm (internal ring-fencing) retail banking activities, supported by insured deposits, from wholesale and investment banking activities. The retail bank would have higher equity capital requirements.

As I have previously testified, the Volcker Rule was ill-advised because proprietary trading and private equity and hedge fund investing was not responsible for the financial crisis, and indeed was a source of profitability to banks during the crisis.[10] The losses to banks resulted from bad housing loans and investments in pools of those loans, traditional banking activities. I also observed that such a rule would put our banks at a competitive disadvantage, a major reason in fact why President Clinton and his then-Secretary of the Treasury Larry Summers pushed through Glass-Steagall reform, in the Gramm Leach Bliley Act, about 10 years earlier.[11]

The effect of the ban is not limited to our shores. The statute restricts not just a U.S. banking organization's activities in the U.S., but also its activities abroad. The ban does not, nor could it practically, affect a foreign bank's proprietary trading or private equity or hedge fund investing outside the U.S. Indeed, proprietary trading by foreign banks might even occur in the U.S. if implementing regulations were to allow a foreign bank to trade for its own account in

[8] Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010).
[9] INDEP. COMM'N ON BANKING, INTERIM REPORT CONSULTING ON REFORM OPTIONS (Apr. 2011), http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf.
[10] *Implications of the 'Volcker Rules' for Financial Stability: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. (Feb. 4, 2010) (testimony of Hal S. Scott) (hereinafter *2010 Testimony*).
[11] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

U.S. securities on a U.S. exchange with a U.S. counterparty through a U.S. broker, as was recently recommended by the Institute of International Bankers.[12]

Unfortunately the regulatory agencies are not sufficiently focused on issues of competitiveness with respect to the Volcker Rule. FSOC is specifically tasked with making recommendations that "enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets."[13] Yet in the study it was required to conduct on the Volcker Rule, it mentioned competitiveness in only one sentence: "[S]ome commenters voiced strong concern that a restrictive definition of market making might damage U.S. markets and place U.S. banking entities and their customers at a competitive disadvantage internationally."[14] The study did not elaborate on this concern.

In anticipation of the implementation of the Volcker Rule, many financial institutions, including Morgan Stanley, Goldman Sachs, and Bank of America, have already made significant business decisions regarding their proprietary trading desks and hedge/private equity fund investments.[15] Several firms have sold or wound down their proprietary trading desks. Some have sold their interest in private equity and hedge funds, and others have initiated the process. Goldman Sachs has been forced to dismantle much of its proprietary trading operation, which analysts estimate will erase about $3.7 billion in revenue and $1.5 billion in profit annually—

[12] Letter from Inst. of Int'l Bankers to Bd. of Governors of the Fed. Reserve Sys., Dep't of the Treasury, Office of the Comptroller of the Currency, Commodity Futures Trading Commission, Fed. Deposit Insurance Corp., and Securities and Exchange Comm'n 3–8 (May 10, 2011).
[13] Dodd-Frank Act § 112(a)(2)(D).
[14] FIN. STABILITY OVERSIGHT COUNCIL, STUDY AND RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS 11 (Jan. 2011) (hereinafter FSOC Study), http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.
[15] *Id.* at 2. While the study suggests that banks are presently shutting down dedicated proprietary trading desks, hedge funds, and private equity funds "that were a source of losses during the crisis," it is not clear, however, that banking entities have shut down only money-losing operations.

over 50% of revenues and 15% of earnings per share.[16] The same is true for Morgan Stanley, which is expected to take a 13% earnings per share hit.[17] Citigroup will have to divest its interest in various hedge funds, such as its Mortgage/Credit Opportunity Fund, which climbed 16% in the first four months of 2011, almost doubling its pace last year.[18] About 90% of the $395 million invested in the fund is the bank's own capital. None of these changes have been made by foreign competitors.

The Volcker Rule is coupled in Dodd-Frank with a concentration limit, which prohibits a financial company from merging with or acquiring another company if the combined company's consolidated liabilities would exceed 10% of the aggregate consolidated liabilities of all financial companies.[19] This will further hurt the competitiveness of U.S. financial institutions compared to companies in countries that do not limit size. As it stands now, the U.S. does not even have the largest banks in the world. Not a single U.S. bank is one of the top 5 biggest banks globally, and there are only 3 U.S. banks in the top 20.[20]

The costs of the Volcker rule and concentration limits are not just diminished economic activity, but also the compliance costs and uncertainty of complying with the ban. The assurance that with proprietary trading, "you know it when you see it," is not good enough. Banking organizations need to know, particularly in the litigious U.S. environment, where the line is between legal and illegal activity. However, the line between permissible market making and

[16] Lauren T. LaCapra, *Goldman Sachs 'Totally Freaked Out' About Volcker Rule, Lobbying Hard*, REUTERS (May 4, 2011), http://www.reuters.com/article/2011/05/04/goldman-volcker-idUSN0418474320110504.
[17] *Id.*
[18] "The fund, run by Rajesh Kumar, 41, has posted profits every year since it began in 2008... Kumar's hedge fund is part of Citi Capital Advisors, which oversees about $16 billion in so-called alternative funds, including private equity and venture capital funds..." Donal Griffin, *Citigroup's Hedge-Fund Returns Jump as Volcker Rule Looms*, BLOOMBERG, May 18, 2011, http://www.bloomberg.com/news/2011-05-18/citigroup-hedge-fund-returns-jump-as-ban-on-prop-trading-looms.html; *see also* Donal Griffin, *Citigroup Said to Shut $400 Million Proprietary Fund as Ahmed Has New Role*, BLOOMBERG, June 2, 2011, http://www.bloomberg.com/news/2011-06-02/citigroup-said-to-shut-proprietary-fund-as-manager-has-new-role.html.
[19] *See* Dodd-Frank Act § 622.
[20] *See* World's 50 Biggest Banks 2010, GLOBAL FIN., Sept. 13, 2010, http://www.gfmag.com/tools/best-banks/10619-worlds-50-biggest-banks.html.

possibly impermissible proprietary trading is difficult to draw. Further, the regulatory process for making rules is problematic. Several regulatory agencies, namely the Fed, SEC, CFTC, and banking regulators, are responsible for writing rules implementing the statute, but unlike other sections of the Dodd-Frank Act, which require joint rulemaking, the Volcker Rule, under §619, requires only "coordinated rulemaking," with the Secretary of the Treasury, as Chairman of FSOC, having unclear powers to actually achieve coordination.

As CCMR explained in its comment letter to FSOC's call for input into its study on the Volcker Rule, too broad a rule could have serious negative effects, but a narrow one could help to alleviate the impact.[21] Large banks frequently engage in hedging, market making, and other permissible activities that are not banned by the statute but may run afoul of an overly broad rule. For example, different legal entities within a bank frequently sell different types of products. Yet a version of a rule that requires permissible hedging to be done in a single entity could ban as proprietary trading the practice of one entity of a banking organization buying an asset even though its affiliate was simultaneously hedging through the sale of the same asset. It is also unclear how the ban on sponsorship of hedge and private equity funds affects a bank that acts as a "directed trustee" for an ERISA pension plan. Similarly, it is unclear how the 3% *de minimus* exception applies to ownership of a fund of funds. And above all, a workable definition of proprietary trading must be written in a way that will not cover activities that are driven by or taken in response to customer needs, requests, or orders.[22] These details must be worked out in the final rules, preferably in a way that minimizes harm to the competitiveness of U.S. banks.

[21] *See* Comm. on Capital Mkts. Reg., comment to Timothy Geithner, Chairman of the Financial Stability Oversight Council, *Regarding Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds*, 75 Fed. Reg. 61,758 (filed Nov. 5, 2010), http://www.capmktsreg.org/pdfs/2010.11.05_Volcker_Rule_letter.pdf.
[22] *See id.* at 2.

There is time to get this right. It is almost certain that the Volcker Rule will not take effect until July 2012.[23]

II. Derivatives Regulations

The E.U. and the U.S., as well as other countries, are now in the process of writing rules that will dramatically reshape the worldwide derivatives markets.[24] During this process it is important for national regulators to work together in order to minimize the differences between their rules. Coordination is important not only to avoid disrupting cross-border transactions, but also to avoid creating the opportunity for regulatory arbitrage and leaving the U.S. at a competitive disadvantage.

Notably, both the U.S. and E.U. regimes, as currently proposed, will only permit their home-country institutions to participate in a foreign clearinghouse if the regulation of a foreign clearinghouse is equivalent to that of the regulation of clearinghouses in the home country.[25] These equivalence determinations, which will be made by U.S. regulators and the European Securities and Markets Authority (ESMA), may be difficult if the two regimes differ about important aspects of regulation and oversight. While both sides generally favor central clearing of standardized and liquid derivative contracts, a measure which I strongly support, there are differences on important specifics.

The CFTC has proposed to set capital requirements for membership in a clearinghouse at $50 million (compared to the current requirement of the CME Clearing and ICE Trust of

[23] The Volcker Rule is set to take effect on the earlier of: (A) 12 months after the final rules are issued, or (B) 2 years after the enactment of the Dodd-Frank Act, *i.e.* July 2012. *See* Dodd-Frank Act § 619.
[24] For the E.U. effort, *see Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories*, COM (2010) 484 final (Sept. 15, 2010) (hereinafter E.U. Proposal).
[25] *See* Dodd-Frank Act § 738(a); E.U. Proposal, Article 23.

respectively $1 and $5 billion),[26] while the E.U. may set a higher threshold or may not impose one at all. Will the E.U. regulators permit E.U. firms to use clearinghouses in the U.S. that set lower limits and thus arguably are more risky? This is not to say the CFTC should necessarily raise its capital requirements, but it must at least ensure that U.S. clearinghouses will be structured in a way that will make them as safe and as resilient as E.U. clearinghouses to member failures. In addition, the CFTC has proposed limiting ownership of clearinghouses by swap dealers, bank holding companies with consolidated assets of $50 billion or more, and systemically important nonbank financial institutions, to a combined 40%.[27] Will the CFTC thus permit U.S. firms to use E.U. clearinghouses that are completely owned or controlled by dealers? Similarly, U.S. clearinghouses have access to the Fed's discount window in unusual and exigent circumstances. Will the Fed permit U.S. banks to use E.U. clearinghouses that do not have access to the ECB discount window? If either side prohibits its domestic institutions from using foreign clearinghouses, the markets will be disrupted. If, on the other hand, they do not intervene, dealers may seek to do business in the E.U.'s more dealer-friendly environment.

There are other problems. U.S. regulators do not exempt foreign sovereigns from the obligation to post collateral for uncleared swaps.[28] That very well may cause foreign countries to stop trading with U.S. banks. In addition, the E.U. proposal has a more generous end user exception. In the U.S., the end user exception only applies to hedging activities, but in the E.U.

[26] *See* Risk Management Requirements for Derivatives Clearing Organizations § 39.12, 76 Fed. Reg. 3,698, 3,719 (proposed Jan. 20, 2011) ($50 million requirement); Katy Burne, *U.K.'s FSA Warns US Against Lowering Barriers to Swap Clearing*, FOX BUSINESS, Mar. 25, 2011, http://www.foxbusiness.com/industries/2011/03/25/uks-fsa-warns-lowering-barriers-swap-clearing/.
[27] *See* Dodd-Frank Act § 726(a); *see also* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest § 39.25, 75 Fed. Reg. 63,732, 63,750 (proposed Oct. 18, 2010) (imposing limits on ownership).
[28] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants § 23.150, 76 Fed. Reg. 23,732, 23,743 (proposed Apr. 28, 2011); *see also* Margin and Capital Requirements for Covered Swap Entities § __.2(h)(6), 76 Fed. Reg. 27,564, 27,587 (proposed May 11, 2011).

the exception applies to any activity up to a certain threshold.[29] This may send U.S. commercial firms abroad to trade with non-U.S. banks. The differences go on and on. The U.S. has more detailed requirements for trade repositories, including provisions for disclosing information to both U.S. and foreign regulators;[30] the E.U. lacks these detailed rules or disclosure provisions.[31] Importantly, the U.S. and E.U may establish different margin requirements for cleared swaps, as well.

Requirements for trading (as opposed to clearing) standard and liquid contracts are also generally the same in the U.S. and E.U., but again significant divergence occurs in the details. Thus, the U.S. envisions Swap Execution Facilities (SEFs); the E.U. equivalents are Organised Trading Facilities (OTFs). Although the U.S. has proposed to allow voice-based ordering systems when communicating with an operator of a SEF, the proposal would not consider one-to-one voice services, in which a dealer calls buyers directly, to be a valid SEF.[32] The E.U. proposal is written more broadly and may allow one-to-one voice services between dealers to qualify as an OTF.[33]

[29] The thresholds have yet to be determined.
[30] *See* Dodd-Frank Act § 728.
[31] *See* E.U. Proposal, Article 64.
[32] *See* Core Principles and Other Requirements for Swap Execution Facilities § 37.9(c), 76 Fed. Reg. 1214, 1240–41 (proposed Jan. 7, 2011).
[33] *See* EUROPEAN COMM'N DIRECTORATE GENERAL INTERNAL MARKET AND SERVICES, PUBLIC CONSULTATION: REVIEW OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE § 2.2 (Dec. 8, 2010), http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf; *see also* Jeremy Grant, *Reform in Europe: Governments Wary About Boosting Monopolies*, FIN. TIMES, May 31, 2011, http://www.ft.com/intl/cms/s/0/c0fca2b4-8a56-11e0-beff-00144feab49a.html.

Accounting issues also affect the markets, and the U.S. accounting rules for derivatives diverge from European standards in important areas, including hedging and netting.[34] This is not to say they are always to our disadvantage. Under U.S. GAAP, but not the International Financial Reporting Standards (IFRS), banks can net offsetting derivatives positions they have with the same counterparties. This is actually a competitive advantage; the International Accounting Standards Board called this issue "the single largest quantitative difference in amounts presented in statements of financial position prepared in accordance with IFRSs and those prepared in accordance with U.S. GAAP."[35]

Yet another big issue looms, and that is timing. The bulk of the U.S. regulators' rules on derivatives are due next month, and although it is now clear that this deadline will be missed in many instances, the regulators may finish issuing most of the final rules before the end of the year. By contrast, the E.U. has yet to unveil even basic proposals on important issues such as capital and margin requirements. It will likely be late 2012 or 2013 before the E.U. completes its rules. If trading in the U.S. is more expensive, even for a year, participants may shift trading abroad in order to incur lower costs, and once trading has moved abroad it will be difficult to get back. It is thus clear that the U.S. and the E.U. should collaborate not just on substantive issues, but timing, as well. Michel Barnier, the European Commissioner for Internal Market and Services, reportedly told Secretary of the Treasury Timothy Geithner earlier this month that

[34] *See* INT'L ACCOUNTING STANDARDS BD., HEDGE ACCOUNTING ED/2010/13 (Dec. 2010) (hedging), http://www.ifrs.org/NR/rdonlyres/05439229-8491-4A70-BF4A-714FEA872CAD/0/EDFIHedgeAcctDec10.pdf; INT'L ACCOUNTING STANDARDS BD., OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES ED/2011/1 (Jan. 2011) (netting), http://www.ifrs.org/NR/rdonlyres/7E046B06-30CC-4E83-9317-35AB081F44AA/0/EDOffsettingFinancialAssetsjanuary2011.pdf.

[35] INT'L ACCOUNTING STANDARDS BD., OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES ED/2011/1, at 4.

Europe plans to leave no divergence or opportunities for regulatory arbitrage between the U.S. and E.U. rules.[36] We should hope this is true not only for substance, but also timing.

Secretary Geithner has recognized the competitive threat to the U.S. from having more stringent derivatives regulation.[37] But it's no solution to say, as he has, that foreign regulation should follow ours. As some foreign regulators noted in response to the Secretary, our track record in the past on effective regulation is not that strong.[38] Further, the U.S. cannot force other regulatory jurisdictions to follow the U.S. approach. These jurisdictions could well ask why we are not following their approaches. The solution is better coordination, and that takes time, much more time than the regulatory schedule that Dodd-Frank envisions.

III. Capital Requirements

Changes to capital requirements for banks are among the most significant changes to the regulation of the banking industry. The recently proposed third version of the Basel Capital Accord, known as Basel III, involves tremendous potential costs and may have uneven competitive effects.

A. Summary of Basel III and Possible Responses

Basel III, when fully implemented by 2019, will require banks to hold 4.5% of common equity and 6% of Tier I capital (up from 4%) of risk-weighted assets (RWAs). Basel III also introduces additional capital buffers, a mandatory capital conservation buffer of 2.5% and a

[36] Deborah Solomon, *Regulators Wrangle on Rules: Geithner and EU Counterpart Diverge on Bank Capital, Compensation Caps*, WALL ST. J., June 3, 2011, http://online.wsj.com/article/SB10001424052702304563104576361803281173520.html.
[37] Damian Paletta, *Geithner Wants Global Rules on Derivatives*, WALL ST. J., June 7, 2011, http://online.wsj.com/article/SB10001424052702304432304576369413015984874.html.
[38] *See id.*; *see also* Tom Braithwaite and Nikki Tait, *Geithner Warns On Light-touch Oversight*, FIN. TIMES, June 6, 2011, http://www.ft.com/intl/cms/s/0/255e97ac-9048-11e0-85a0-00144feab49a.html?ftcamp=rss#axzz1OtJsuHQbg.

discretionary countercyclical buffer, which allows national regulators to require up to another 2.5% of capital during periods of high credit growth. In addition, Basel III introduces a minimum 3% leverage ratio and two required liquidity ratios. The Liquidity Coverage Ratio requires a bank to hold sufficient high-quality liquid assets to cover its total net cash flows over 30 days; the Net Stable Funding Ratio requires the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress.

Banks can comply with these new requirements in a number of ways. For example, a bank could:

1. increase retained earnings by reducing dividends;
2. issue new capital instruments;
3. increase lending spreads;
4. reduce assets (*e.g.*, by lending less); or
5. shift assets to areas requiring less capital but not less risk or return (regulatory arbitrage).

As a result, it is impossible to predict precisely how the banking industry will change as a result of the new requirements. It is also difficult to predict the economic effects of the changes. Just last week Chairman Bernanke, in response to a question about the economic impact of the multitude of new rules, including capital requirements, said, "Has anybody done a comprehensive analysis of the impact on credit? I can't pretend that anybody really has. You know, it's just too complicated. We don't really have the quantitative tools to do that."[39] Several organizations have tried, however.

B. Studies to Quantify Costs

The Basel Committee, along with the Financial Stability Board, established the Macroeconomic Assessment Group (MAG) to examine the global impact of increased capital requirements.[40] The MAG's report incorporates the results of dozens of studies from regulators, central banks, and other organizations. It found that the impact on global GDP of a 1 percentage point increase in common equity—a standard measure in these studies—would have a peak effect after 35 quarters, at which point it would have lowered GDP by 17 basis points (0.17%) below what it would otherwise be, and would then partially recover to 0.10% below baseline after 40 quarters.[41] The study assumes credit spreads will widen and lending will be reduced. It did not consider the countercyclical buffer or liquidity ratio—which will add further significant costs—and it also assumed that national regulators will pursue aggressive monetary policies in order to limit negative effects. It also assumed, controversially, that banks will enjoy lower costs of capital as a result of being more stable. In a separate report, the Basel Committee identified the economic benefits of increased capital requirements, namely reducing the costs associated with banking crises by reducing the frequency of crises and the costs from each crisis.[42] The study, however, provided little convincing evidence that increased capital requirements would

[39] Ben Bernanke, Chairman, Fed. Reserve Sys. Bd. of Governors, Address at the Int'l Monetary Conference: Remarks on the Economic Outlook (June 7, 2011) (remarks edited for clarity), http://www.federalreserve.gov/newsevents/speech/bernanke20080603a.htm.
[40] MACROECONOMIC ASSESSMENT GROUP, FINAL REPORT: ASSESSING THE MACROECONOMIC IMPACT OF THE TRANSITION TO STRONGER CAPITAL AND LIQUIDITY REQUIREMENTS (Dec. 2010), http://www.bis.org/publ/othp12.pdf.
[41] *Id.* at 8.
[42] BASEL COMM.ON BANKING SUPERVISION, AN ASSESSMENT OF THE LONG-TERM EXCONOMIC IMPACT OF STRONGER CAPITAL AND LIQUIDITY REQUIREMENTS 8–19 (Aug. 2010), http://www.bis.org/publ/bcbs173.pdf.

prevent losses in a run-like situation in which banks are forced to sell assets at reduced, "fire sale" prices.

The Institute of International Finance (IIF) conducted a study, completed in June 2010 and then updated in October 2010,[43] that accounts for a fuller measure of the requirements of Basel III than do the MAG and other studies, which primarily focus on the impact of an increase in common equity. Specifically, the IIF study included consideration of the liquidity requirements (but not the leverage ratio), the countercyclical capital buffer, which it assumed to be 1%, and additional national regulations. It also assumed a much more aggressive implementation timeline—that nearly all requirements would be implemented by 2012. This assumption may be justified to the extent that banking organizations will seek to quickly implement any new requirements even if they are not technically binding for several years. Under these assumptions, the IIF projects that the capital requirements will reduce the real GDP of the U.S., Euro Area, and Japan by about 3.1% below what it otherwise would be, and that there would be 4.6 million fewer jobs by 2015.[44] The IIF study did not attempt to quantify the benefits of increasing capital requirements, and its October update criticized the attempts, including Basel's, to do so. Notably, it pointed out that many crises originate outside the banking system, and although bank regulation may help to reduce the costs of a crisis, it cannot reduce the frequency of crises that originate outside the system.[45]

[43] INST. OF INT'L FIN., THE NET CUMULATIVE ECONOMIC IMPACT OF BANKING SECTOR REGULATION: SOME NEW PERSPECTIVES (Oct. 2010), http://www.iif.com/download.php?id=/0cTxourA+A=; *IIF Follows Up Its Predictions of Basel III Output Loss*, THE FIN. REG. FORUM (Oct. 15, 2010), http://www.financialregulationforum.com/wpmember/iif-follows-up-its-predictions-of-basel-iii-output-loss-5083; *see* INST. OF INT'L FIN., INTERIM REPORT ON THE CUMULATIVE IMPACT ON THE GLOBAL ECONOMY OF PROPOSED CHANGES IN THE BANKING REGULATORY FRAMEWORK (June 2010), http://www.ebf-fbe.eu/uploads/10-Interim%20NCI_June2010_Web.pdf.

[44] INST. OF INT'L FIN., *supra* note 43, at 9, 49 (June 2010).

[45] INST. OF INT'L FIN., *supra* note 43, at 13–17 (Oct. 2010).

The IMF conducted a study that assumed an increase in the required common equity ratio of two percentage points, and a 25% increase in bank liquidity requirements, phased in over a period of between 2 and 6 years.[46] It outlined the effects of three different strategies by banks: cutting dividends and increasing lending spreads, which resulted in a peak decline in GDP of about 0.3% to 0.5%, or cumulative loss in output of about 1 percentage point; maintaining dividends and increasing lending spreads, which resulted in a peak decline in GDP of 0.5%; and adjusting bank assets, which resulted in a peak decline of GDP of about 0.9%. The study also considered an increase in liquidity requirements, which it predicts could have a cumulative output loss of nearly 1% in GDP.

The OECD also conducted a study on the impact of Basel III.[47] It made several different assumptions. First, it assumed that banks will maintain capital buffers that were already in place in 2006, that were above the required minimums, but not the higher buffers that were put in place in 2009. Second, it assumed that banks would maintain their current dividend policy and instead increase lending spreads. Third, it assumed there would be no active monetary policy response. Fourth, it assumed the new requirements would be implemented over a period of 5 years. Its simulations found that each percentage point increase in bank capital ratios will "reduce the level of GDP in the three main OECD economics on average by -0.23%."[48] This decrease in GDP is fueled by a 14.4 basis point increase on bank lending spreads.[49]

Still another recent study was coauthored by staff from the Federal Reserve Bank of New York, Bank of Italy, BIS, European Central Bank, European Commission, and IMF. It found that

[46] SCOTT ROGER & JAN VLCEK, INT'L MONETARY FUND, MACROECONOMIC COSTS OF HIGHER BANK CAPITAL AND LIQUIDITY REQUIREMENTS (May 2011), http://www.imf.org/external/pubs/ft/wp/2011/wp11103.pdf.
[47] Patrick Slovik & Boris Cournède, *Macroeconomic Impact of Basel III* (Org. for Econ. Cooperation and Dev., Econ. Dep't Working Paper No. 844, 2011), http://dx.doi.org/10.1787/5kghwnhkkjs8-en.
[48] *Id.* at 10.
[49] *Id.* at 7–8.

"[e]ach percentage point increase in the capital ratio causes a median 0.09 percent decline in the level of GDP over what it would be with the increase. The impact of the new liquidity regulation is of a similar order of magnitude, at 0.08 percent."[50] The study did not estimate the benefits, nor did it quantify the effects of capital buffers.

In sum, the studies estimate the impact on global GDP of a 1 percentage point increase in bank common equity to have a peak negative effect of up to 1.1% of GDP, or up to $748 billion by 2019. The cumulative effects of the various provisions in Basel III could lead to a decline in U.S. GDP alone of up to $951 billion over the period 2011 to 2015 according to IIF. But as Chairman Bernanke admits, we really do not know the impact; it might be much greater.

C. Differential Impact

These studies are difficult to compare because they each make different assumptions, but it is clear that raising capital requirements will dampen global output and have a significant effect on the banking system. A crucial question is whether the decline in GDP will be higher in some countries than others and whether some countries' banks will be more affected than others. This depends in part on whether the Basel rules will be implemented uniformly in each country. It is far from clear that they will be. Last month it was revealed that the E.U. may delay a decision on whether to adopt Basel III's leverage and liquidity rules,[51] although Michel Barnier, European Commissioner for Internal Market and Services, has since denied that the E.U. will do

[50] PAOLO ANGELINI ET AL., BANK OF INT'L SETTLEMENTS, BASEL III: LONG-TERM IMPACT ON ECONOMIC PERFORMANCE AND FLUCTUATIONS vii (Feb. 2011), http://www.bis.org/publ/work338.pdf.

[51] *See* Anthony Aarons & Peter Chapman, eds., *EU May Delay Decision on Basel Leverage, Liquidity Rules*, BLOOMBERG BUSINESSWEEK, May 24, 2011, http://news.businessweek.com/article.asp?documentKey=1376-LLNN571A74E901-5FJ92HU5HBP3MTG3GKO23GR61F; *see also* Nikki Tait et al., *Barnier Hits Back at Basel III Criticism*, FIN. TIMES, May 26, 2011, http://www.ft.com/intl/cms/s/0/b5a5f94a-87d3-11e0-a6de-00144feabdc0.html.

so. The truth remains to be seen.[52] Further, even if countries have the same nominal rules, adopted at the same time, they might enforce them differently. For example, for the largest international banks, Basel permits the use of internal ratings through credit models. Will such models be subject to the same scrutiny in all countries? On the other hand, some countries question whether the U.S. will implement Basel III on schedule, considering we never fully implemented Basel II and that the Dodd-Frank Act's ban on references to credit ratings will make it difficult to implement the resecuritization risk-weightings adopted in Basel III.[53]

Even if Basel III is implemented uniformly, its actual effect may not be uniform. For example, the OECD study found that bank lending spreads in the U.S. are more sensitive to changes in capital ratios than, for example, Japan, "mainly due to a higher return on equity and a higher share of risk-weighted assets in bank balance sheets" in the U.S.[54] Basel III itself also permits individual national regulators to require additional buffers, which will further distort the effects across countries. More generally, the same capital requirements can have dramatically different effects depending on the accounting or tax rules of particular countries.[55] For example, if the E.U. adopts a less stringent fair value accounting rule, at least for regulatory purposes, than does the U.S., the impact of the same capital requirements will be less in the E.U. than the U.S.[56]

[52] Michael Barnier, *Basel III Will Bolster Banks*, WALL ST. J., June 2, 2011, http://online.wsj.com/article/SB10001424052702303745304576358911333711564.html.
[53] Dodd-Frank Act § 939A.
[54] SLOVIK & COURNÈDE, *supra* note 47, at 7–8.
[55] *See* Hal S. Scott & Shinsaku Iwahara, *In Search of A Level Playing Field: The Implementation of the Basle Capital Accord in Japan and the United States* (Group of Thirty Occasional Paper 46, 1994).
[56] Although the IFRS and FASB have issued common requirements with only minor variations, the E.U. has yet to endorse the new rule. *See* PricewaterhouseCoopers, International Standards Updates (May 18, 2011), https://pwcinform.pwc.com/inform2/show?action=informContent&id=1144191305091868.

IV. Systemically Important Financial Institutions

Regulators and legislators in the U.S. and abroad have begun the process of designating, in advance, certain firms as "systemically important financial institutions," or SIFIs, believing that the failure of these institutions could significantly damage the financial system and the real economy. These systemically important firms will be subject to enhanced government scrutiny and additional substantive regulation, particularly in the form of more capital.

In the U.S., under Dodd-Frank, banking organizations with total consolidated assets of $50 billion or greater are supervised by the Federal Reserve. In addition, FSOC is charged with designating non-bank financial institutions that should also be supervised by the Fed. The statutory criteria are:

(A) the extent of the leverage of the company;

(B) the extent and nature of the off-balance-sheet exposures of the company;

(C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;

(D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;

(E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

(F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;

(G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;

(H) the degree to which the company is already regulated by one or more primary financial regulatory agencies;

(I) the amount and nature of the financial assets of the company;

(J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and

(K) any other risk-related factors that the Council deems appropriate.[57]

FSOC is presently considering the criteria and methods it will use for designating nonbanks as SIFIs, but so far it has not formulated any criteria.[58]

Foreign regulators are also engaged in a similar exercise. Last November the G-20 endorsed a framework developed by the Financial Stability Board (FSB), in coordination with the IMF, that recommends enhanced supervision and regulation of SIFIs, as well as the development of new resolution procedures.[59] Later this year the FSB is expected to release more details on this plan.

SIFIs will undoubtedly face higher costs as result of being designated. They will very likely face additional reporting and compliance obligations, as well as additional capital charges in the form of a "SIFI surcharge." For example, the FSB highlighted "supplementary requirements" for SIFIs, which "could consist of a capital or liquidity surcharge linked to the

[57] Dodd-Frank Act § 113.
[58] *See* Advance Notice of Proposed Rulemaking, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653 (proposed Oct. 6, 2010); *see also* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4,555 (proposed Jan. 26, 2011).
[59] FIN. STABILITY BD., INTENSITY AND EFFECTIVENESS OF SIFI SUPERVISION: RECOMMENDATION FOR ENHANCED SUPERVISION (Nov. 2, 2010), http://www.financialstabilityboard.org/publications/r_101101.pdf.

systemic importance of the institution,"[60] and the U.K. Independent Commission on Banking has said that 3% is the "minimum credible" SIFI surcharge.[61] Switzerland has also proposed to require its two big banks to have a 19% capital ratio, of which more than half must be held in common equity.[62] These proposals have been gaining momentum, and earlier this month Fed Governor Daniel Tarullo stated that the Federal Reserve is considering using a methodology that could result in a U.S. SIFI surcharge of up to 7%.[63] The IIF has conducted a study about the costs of SIFI surcharges, and estimates that a 3% surcharge would reduce GDP by about 0.20% over the first two years of implementation.[64] Yet that cost is not evenly distributed across countries; IIF found that Japan could expect only a 0.05% reduction, while the U.K. could expect a 0.27% reduction.[65] The U.S. was about average.

While Governor Tarullo rightly prefers that any requirements for additional capital for SIFIs be done internationally, this is unlikely to occur on a uniform basis because countries will differ on the designation and regulatory requirements for SIFIs. If some countries impose higher SIFI surcharges than others, then banks from countries with relatively low SIFI surcharges will be at an advantage. Further, countries may differ in their approach to designating SIFIs, so that similar institutions, in competition with each other, might or might not be subject to any SIFI

[60] FIN. STABILITY BD., REDUCING THE MORAL HAZARD POSED BY SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS: INTERIM REPORT TO G20 LEADERS 5 (June 18, 2010), http://www.financialstabilityboard.org/publications/r_100627b.pdf.
[61] INDEP. COMM'N ON BANKING, *supra* note 9, at 70–71.
[62] *See* THOMAS J. JORDAN, INT'L CENTER FOR MONETARY AND BANKING STUDIES, APPROACHING THE FINISH LINE: THE TOO BIG TO FAIL PROJECT IN SWITZERLAND 4n.3 (May 17, 2011), http://www.snb.ch/en/mmr/speeches/id/ref_20110517_tjn/source/ref_20110517_tjn.en.pdf; Patrick Jenkins & Haig Simonian, *Swiss Urge Capital Boost For Banks*, FIN. TIMES, Oct. 4, 2010, http://www.ft.com/intl/cms/s/0/4a24a1c8-cf26-11df-9be2-00144feab49a.html#axzz1OtJsuHQb.
[63] Daniel K. Tarullo, Governor, Fed. Reserve Sys. Bd. of Governors, Speech at the Peter G. Peterson Institute for International Economics: Regulating Systemically Important Financial Firms (June 3, 2011), http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm.
[64] *See* INST. OF INT'L FIN., SIFI SURCHARGES: FUNDAMENTAL ISSUES AND EMPIRICAL ESTIMATES 16–17 (Apr. 20, 2011).
[65] *Id.*

surcharges. In addition, as CCMR described in its comment letter about the SIFI designation, the SIFI designation could increase moral hazard and artificially lower the cost of funds for some institutions since the market may believe the designation implies a bailout.[66] Thus, SIFIs in countries with low surcharges might have a significant advantage over competitors in countries with fewer SIFIs with low surcharges or over competitors in countries with many SIFIs with high surcharges.

V. Resolution of Financial Firms

Clear competitive advantages can be derived from the approach different countries take to resolving their insolvent financial institutions. Until the lost decade in the 1990s, Japan explicitly guaranteed that its banks would not fail, which significantly reduced the cost of capital of Japanese banks. Indeed, such guarantees made it difficult, if not impossible, for Basel I to even the playing field between Japanese and other banks by imposing common capital requirements—Japanese banks enjoyed a cheaper cost of holding the same amount of capital as their U.S. counterparts.[67] The E.U. has clearly understood this problem by trying to limit the "subsidies" that countries can effectively provide to their banks by various forms of bailout, although the boundaries of this prohibition against state aid have been at issue during the financial crisis.[68]

[66] *See* Comm. on Capital Mkts. Regulation, Comment to Fin. Stability Oversight Council's Advance Notice of Proposed Rulemaking, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* 2, 75 Fed. Reg. 61,653 (filed Nov. 5, 2010), http://www.capmktsreg.org/pdfs/2010.11.05_FSOC_Systemic_Importance_comment_letter.pdf.
[67] *See* Scott & Iwahara, *supra* note 55.
[68] *See* CTR. FOR EUR. POL'Y STUDIES, BANK STATE AID IN THE FINANCIAL CRISIS: FRAGMENTATION OR LEVEL PLAYING FIELD (Oct. 2010), http://aei.pitt.edu/15133/1/Task_Force_Report_on_Bank_State_Aid.pdf; *see also* Consolidated Version of the Treaty on the Functioning of the European Union art. 107, Sept. 5, 2008, 2008 O.J. (C 115) 47, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:0047:0199:EN:PDF.

The U.S., in the wake of the financial crisis, has taken a strong anti-bailout position. The ability of the Federal Reserve to provide emergency liquidity to the financial system and the ability of the FDIC or the Treasury to guarantee liabilities of banks and other financial institutions has been significantly curtailed by the Dodd-Frank Act. The Fed now needs the written approval of the Secretary of the Treasury to create the kinds of liquidity facilities that it did in the crisis, and it subject to more stringent collateral requirements.[69] While the FDIC can continue to provide public assistance to failed banks under the Federal Deposit Insurance Act,[70] and now to systemically important nonbank financial companies under the Orderly Liquidation Authority provisions of the Dodd-Frank Act,[71] Chairman Bair has publicly indicated her reluctance to do so, constrained in part by the political consensus against such bailouts.[72] Other countries may continue to have a more generous attitude toward bailouts than the United States, which could put our financial institutions at a competitive disadvantage. These different approaches to resolution once again indicate the need for international coordination to avoid distortion of competition.

Another serious resolution issue that must be resolved on a global basis is the resolution of financial companies that have significant cross-border operations. As the financial crisis demonstrated, the resolution of a failed financial institution can affect all of the countries in which it operates. For example, Europe was dramatically impacted during the crisis by the failure of Icelandic banks with large branch operations in the United Kingdom and the Netherlands, as well as the failure of Fortis, which had major operations in Belgium and the Netherlands. And

[69] Dodd-Frank Act § 1101(a)(6)(B)(iv).
[70] 12 U.S.C. §§ 1811 *et seq.*
[71] *See* Dodd-Frank Act Title II.
[72] *See, e.g.*, Sheila C. Bair, Chairman, FDIC, Remarks Before the 47th Annual Conference on Bank Structure and Competition Sponsored by the Federal Reserve Bank of Chicago: We Must Resolve to End Too Big To Fail (May 5, 2001), http://www.fdic.gov/news/news/speeches/chairman/spmay0511.html.

the United States and many other countries, but principally the United Kingdom, had to deal with the consequences of the Lehman Brothers failure. Lehman had 433 subsidiaries in 20 countries.[73]

Without coordination, the resolution system of any country is only capable of dealing with entities that operate in that jurisdiction. Each country may have an incentive to "ring fence" the assets of local operations of banks for the benefit of local creditors, whether these operations are in the form of branches or subsidiaries.[74] For example, if a U.S. banking organization has a subsidiary bank in Country X and the banking organization as a whole looks to be in danger, Country X might ring fence the subsidiary bank's assets to satisfy the claims of local creditors, whether or not insured. The strength of local protection through ring-fencing could itself have a competitive effect as creditors will be more willing to have claims against local entities that may benefit by strong ring fencing (and in extreme cases even a bailout). Local ring fencing may not be in the overall interest of maximizing value in a failed financial company since it will impede reorganizations on a company-wide basis.

With the support of the G-20, the International Monetary Fund (IMF) and Bank for International Settlements (BIS) have issued reports with recommendations for more effective cross-border resolution.[75] The FSB has also addressed some of these issues, with a more comprehensive report coming in 2012.[76] There are some extreme options for dealing with this issue including an international treaty allocating responsibility among countries for cross-border

[73] *See* George G. Kaufman, *Living Wills: Putting the Caboose before the Engine and Designing a Better Engine* 2 (Working Paper Series, May 3, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1599787.
[74] *See* BANK FOR INT'L SETTLEMENTS, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 16 (Mar. 2010), http://www.bis.org/publ/bcbs169.pdf.
[75] *Id.*; INT'L MONETARY FUND, RESOLUTION OF CROSS-BORDER BANKS—A PROPOSED FRAMEWORK FOR ENHANCED COORDINATION (June 11, 2010), http://www.imf.org/external/np/pp/eng/2010/061110.pdf.
[76] *See* FIN. STABILITY BD., REDUCING THE MORAL HAZARD POSED BY SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS: FSB RECOMMENDATIONS AND TIME LINES 6, http://www.financialstabilityboard.org/publications/r_101111a.pdf.

resolutions or even creating a new international authority, or a requirement that financial companies operate in all countries through subsidiaries (rather than branches) to facilitate host-country control.[77] The former is impractical and the latter would be inefficient—without branches firms would have to capitalize all operations in each country through subsidiaries. The subsidiarization approach would also run afoul of the E.U. single passport system in which E.U. banks are free to operate throughout the E.U.

There is a middle ground, however, that involves the harmonization and mutual recognition of resolution systems across borders. These proposals recommend establishing and agreeing to a framework under which countries would cooperate, under certain conditions, with other countries that meet defined standards. The IMF framework has four elements:

1. each country would amend its laws to require its authorities to coordinate resolution efforts with foreign counterparts;
2. the coordination framework would only apply to countries that have in place "core-coordination standards," so countries would not be obligated to coordinate with other countries that have not agreed to the common coordination system;
3. principles to guide sharing of the burden for possible public funding of failing institutions must be developed; and
4. each country that subscribes to this framework would agree to procedures designed to enable cross-resolution resolution during a crisis to occur as quickly as possible.[78]

[77] *See, e.g.*, INT'L MONETARY FUND, *supra* note 75, at 3.
[78] *Id.* at 4–5.

The BIS recommendations are similar, but also emphasize the intentional reduction of complexity of financial institutions' structures, cross-border information sharing, and contingency plans for institutions.[79] However, it is far from clear how realistic even these more modest proposals are.

In summary, the financial reform process has the potential to create large competitive disadvantages for U.S. financial institutions. The only way forward to minimize these distortions is for U.S. regulators to be conscious of this potential in designing their own regulations and for there to more international coordination. Both may take some more time than our current regulatory timetable for implementation allows. I am fully aware that some may seek to delay the implementation of Dodd-Frank in hopes that it may be repealed. This is not my objective—many of its provisions are sorely needed. However, we need to be careful about how we implement our reforms in a global financial system where the competitiveness of our institutions can be significantly affected by what we do.

It is clear that in most of the areas covered by my testimony, it is not too late to help to preserve our competitiveness.

1. For the Volcker rule, regulators should take a narrow approach to defining proprietary trading.
2. For the derivatives rules, we should put aside for now the initiatives we are taking that are in conflict with the E.U. These areas can be defined in concert with the E.U. We can implement the non-conflicting initiatives on an appropriate timetable (the CFTC has called for comments on proper sequencing). We may have to make some compromises, as will the E.U.

[79] BANK FOR INT'L SETTLEMENTS, *supra* note 74, at 1–3.

3. For capital requirements, this is an international initiative but one with differential impact in different countries. We should use the long full phase-in time provided by Basel to reexamine how these rules can be implemented in a fashion to minimize the differential impact.
4. Designating firms as systemically important should be done on a global basis, and only if there is an agreement among countries about which firms should be designated; our national process should be tightly coordinated with the work of the Financial Stability Board. There should also be a common international approach to minimum SIFI surcharges.
5. Resolution of failed financial firms remains an important and difficult issue with competitive implications. We should continue to work with the FSB to achieve as internationally coordinated an approach as possible.

Thank you and I look forward to your questions.

Testimony of Damon A. Silvers

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American Federation of Labor and Congress of Industrial Organizations

To The Committee on Financial Services

U.S. House of Representatives on

"Financial Regulatory Reform: The International Context"

June 16, 2011

Good afternoon Chairman Bachus and Ranking Member Frank. Thank you for the opportunity to testify today. Thank you for the opportunity to testify today. My name is Damon Silvers and I am the Policy Director and Special Counsel for the AFL-CIO. I am testifying today on behalf of Americans for Financial Reform as well as for the AFL-CIO.[1] Americans for Financial Reform is an unprecedented coalition of over 250 national, state and local groups which have come together to reform the financial system. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, religious and business groups as well as Nobel Prize-winning economists. The organizations of the AFR represent well over 50 million Americans.

This hearing addresses the international aspects of a question which has been at the heart of recent American history—how should we regulate the U.S. financial system? Congress' approach to this question has been cyclical. The cycle begins with an unbounded faith in the ability of markets and institutions to regulate themselves, which is followed by shock at the level of economic destruction that comes in the wake of that delusion. There then comes a brief moment of reform, to be followed as soon as the pain of financial scandal and economic collapse dulls a bit, by the warm embrace of the deregulatory faith once again. Here this afternoon, one can almost feel the slow return of the worldview of 2006, or was it 1999, or 1995? Of course, with each cycle, the level of economic ruin inflicted on our country rises—from the S&L crisis to the Enron-Worldcom-dotcom crisis, to the continuing economic crisis set off by the collapse of the credit-fed housing bubble in 2007.

Rather than once again succumbing to this ruinous cycle, Congress should begin by asking, what regulatory approach results in a stable financial system that makes productive capital allocation decisions and contributes to, rather than damages our nation's real economy? Part of the answer to that question must be the establishment of an international regulatory floor, a set of minimum financial regulatory standards.

[1] The AFL-CIO is the country's largest labor federation and represents 12.2 million union members. Union-sponsored pension and employee benefit places hold more than $480 billion in assets. Union members also participate directly in the capital markets as individual investors and as participants in pension plans sponsored by corporate or public-sector employers.

There will always be countries in this world that do not live up to those standards. They will undercut those standards in an effort to attract financial activity. These countries are the Icelands of the future. In fairness, it is hard not to conclude that in a global context the United States was such a country over the last twenty years—that we dangerously weakened our financial regulatory system, with the aim of, among other things, attracting and retaining financial activity within our borders. The result was the United States became a source of instability in the global financial system, and we damaged our competitive position vis-a-vis other countries that pursued other economic strategies.

Capital adequacy and transparency are at the heart of any system of financial regulation. During the last twenty years, our system of financial regulation developed a number of gaping holes that allowed market participants to operate without adequate capital and to do so opaquely. And, as we discovered in 2008, these same loopholes allowed institutions that were too big and too interconnected to fail to develop outside of the regulatory safeguards, like deposit insurance, that were supposed to protect against systemic failure.

The Dodd-Frank Act began to address these problems in a fairly comprehensive manner. But the Dodd-Frank Act was not the only effort in this area. Governments around the world have taken action to address similar problems in their national regulatory structures, and there has been a concerted, though limited effort through international institutions like the G-20, the Basel Committee on Banking Supervision and the Financial Stability Board to create the beginnings of a global regulatory floor for finance. The process of global regulatory coordination was initiated at a meeting of the leaders of the G-20 nations in November 2008.[2] The G-20 released a declaration in conjunction with that meeting that described the root causes of the crisis:

> During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.[3]

The November 2008 G-20 Declaration also laid out common principles of regulatory reform that the participating countries agreed to pursue including increased transparency of complex financial products, aligning incentives at financial institutions to avoid excessive risk-taking, and

[2] G-20 Communique, Declaration: Summit on Financial Markets and the World Economy (Nov. 15, 2008) *available at* http://www.g20.org/Documents/g20_summit_declaration.pdf.
[3] G-20 Communique, Declaration: Summit on Financial Markets and the World Economy (Nov. 15, 2008) *available at* http://www.g20.org/Documents/g20_summit_declaration.pdf.

ensuring that all financial products and institutions are subject to regulatory oversight.[4] The job of setting international standards for bank capital has been led by the Basel Committee on Banking Supervision, which released the text of the Basel III rules in December 2010.[5] The G-20 has tasked the Financial Stability Board with coordinating international implementation of financial regulatory reform.[6]

Each national effort at strengthening financial regulation has its strong points and its weak points. Most observers agree that the United States, for example, has moved more aggressively on derivatives regulation than Europe, but has been less aggressive with private pools of capital like hedge funds and private equity. [7,8] In particular, European regulators have faulted the weakness of our executive pay approach to regulating executive pay in financial firms. Michel Barnier, the European Commissioner for Internal Market and Services, said earlier this month at a speech at the Brookings Institution:

> Banks of every size must allowed to fail but without bringing the world financial system with them. Bankers, shareholders and creditors must understand that they will carry the cost of a failure and only this can generate greater responsibility. One small final point where I also hope to see change on your side in the United States is compensation for bankers. We in Europe are the only ones if I'm correctly informed that have put binding rules on bonuses in place. I hope the situation will change to stop encouraging excessive risk taking. Let us be aware, ladies and gentlemen, that certain compensations and certain bonuses are simply beyond our citizens' comprehension and mine too. [9]

Finally, international efforts like Basel III inevitably are weaker than the more effective national efforts—that is their nature as international efforts.[10]

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[4] G-20 Communique, Declaration: Summit on Financial Markets and the World Economy (Nov. 15, 2008) *available at* http://www.g20.org/Documents/g20_summit_declaration.pdf.

[5] A compilation of documents that form 'Basel III' is available at http://www.bis.org/list/basel3/index.htm.

[6] The FSB produces periodic reports on international progress toward implementation of the G-20 financial reform objectives. These reports are available online at http://www.financialstabilityboard.org/.

[7] Geithner again pushes alignment with US, Financial Times (June 1, 2011) *available at* http://www.ft.com/intl/cms/s/0/1341508c-91f1-11e0-b8c1-00144feab49a.html#axzz1PHMcMZRa; Geithner triggers backlash on regulation, Financial Times (June 7,2011) *available at* http://www.ft.com/intl/cms/s/0/38e6dd84-911f-11e0-9668-00144feab49a.html#axzz1PHMcMZRa.

[8] European Parliament, Committee on Economic and Monetary Affairs, Press Release: Parliament sees its priorities through on hedge funds directive (Oct. 26, 2010); Ben Moshinsky, EU Reaches Compromise on Regulations for Hedge Funds, Bloomberg (Oct. 26, 2010).

[9] Speech by EU Commissioner Michel Barnier at the Brookings Institution, Washington, D.C., The Shape of EU Financial Regulation and its Impact on the United States and Europe (June 3, 2011) *transcript and audio available at* http://www.brookings.edu/events/2011/0603_eu_regulation.aspx.

[10] Letter from Stanford Prof. Anat Admati, et. al., Healthy banking system is the goal, not profitable banks, Financial Times (Nov. 9, 2010) *available at* http://www.gsb.stanford.edu/news/research/admatiFTletter11.09.10.pdf; Simon Johnson, Capital Failure, NY Times Economix Blow (Nov. 11, 2010) *available at* http://economix.blogs.nytimes.com/2010/11/11/capital-failure/;

Today you have heard from the representatives of the financial firms. They say that Dodd-Frank is too tough, and will cause financial activity to move away from the United States. At the same time, European banks have threatened to leave to move business to the U.S. and other jurisdictions because they viewed their home countries' proposed regulatory reforms as too tough.[11] In the labor movement we call this whipsawing. If we allow international financial firms to whipsaw the United States, we will find ourselves once again without an adequate financial regulatory structure, and our financial system will once again be a threat both to our real economy and to the larger global economy.

Let me address briefly the major arguments that you have heard today from the representatives of the businesses that the American public so recently rescued from imminent bankruptcy, and who now, amid 9% unemployment and after 7 million foreclosures, after record bonuses and amid rising CEO pay, think that they are the people whom Congress needs to help.

With respect to derivatives, the Dodd-Frank Act required generally that derivatives market participants, other than commercial end users, post collateral to support their positions through a clearinghouse. It also required that transactions are conducted through a trading platform, such as an exchange or swap execution facility, that provides some pricing transparency for most derivatives. This approach closes the loophole that unregulated derivatives created in the system for regulating insurance, securities, and commodities.

The prior witnesses assert that by requiring that capital be posted and that there be disclosure, we will drive derivatives trading away from U.S. institutions. This type of argument has been used to oppose every effort to regulate finance for the last century. It sounds plausible, but it is historically wrong. As a general matter, capital markets activity flows to well-regulated markets, where market participants have confidence in their counterparties and can benefit from transparent pricing. This dynamic was how the U.S. securities markets grew in the postwar era under a strict disclosure regime.[12]

But even if that were not the basic dynamic of capital markets, there are some kinds of business we do not want. We do not want the next AIG—the next seller of bond insurance without any capital to back it—to be a U.S. based firm, destabilizing the U.S. economy and looking to the

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[11] Haig Simonian, UBS warns against excessive capital rules, Financial Times (Apr. 28, 2011) *available at* http://www.ft.com/intl/cms/s/0/587c7cb2-717b-11e0-9b7a-00144feabdc0.html#axzz1PHMcMZRa; UBS's investment bank, Financial Times (May 26, 2011) *available at* http://www.ft.com/intl/cms/s/3/3d37e384-87aa-11e0-af98-00144feabdc0.html#axzz1PHMcMZRa; Patrick Jenkins, Sharlene Goff and Megan Murphy, Finance: Flight delayed, Financial Times (Apr. 14, 2011) *available at* http://www.ft.com/intl/cms/s/0/d85fbb0c-66cb-11e0-8d88-00144feab49a,dwp_uuid=24382cba-6c8e-11de-a6e6-00144feabdc0.html#axzz1PHMcMZRa; Megan Murphy and Alastair Marsh, Grim City warns of exodus, Financial Times (Dec. 10, 2009) *available at* http://www.ft.com/intl/cms/s/0/bd36405c-e52c-11de-9a25-00144feab49a.html.

[12] Luigi Zingales, The Future of Securities Regulation (January 29, 2009). Chicago Booth School of Business Research Paper No. 08-27 *available at* http://ssrn.com/abstract=1319648; Zohar Goshen and Gideon Parchomovsky, The Essential Role of Securities Regulation. Duke Law Journal, Vol. 55, p. 711, 2006; Columbia Law and Economics Working Paper No. 259 *available at* http://ssrn.com/abstract=600709 or doi:10.2139/ssrn.600709.

American public to bail it out when it inevitably fails. We do not want the U.S. to retain a dominant position in derivatives by guaranteeing the derivatives dealers' monopolistic profits at the expense of our real economy.[13]

The second argument made today relates to the regulation of financial institution activities. The Dodd-Frank Act made only modest steps in the direction of regulating substantive business activities, most prominently a weakened version of former Federal Reserve Chairman Paul Volcker's proposal that bank holding companies not be allowed to engage in securities trading for their own account. The criticism leveled today is that these modest limitations will impair the competitiveness of U.S. financial institutions—apparently by lowering their rate of return to be more like the rate of return of a lending institution and less like the rate of return of a hedge fund, while non-U.S. institutions are supposedly free to generate hedge-fund like returns. Set aside for a moment the fact that the Volcker proposal was surfaced by the Group of Thirty, senior former central bankers and bank regulators from around the world, and that the Swiss and British governments seem to be moving toward more robust separation of riskier activity from core commercial bank activity.

It is a general principle of investing that strategies that seek higher returns expose the firm to greater risk. The Volcker rule represents an effort to insist that banks and bank holding companies, with their access to central bank liquidity and insured deposits, must be at the low end of the risk-return continuum. In other words, the Volcker rule is a way of trying to ensure that the goal of both Democrats and Republicans in pursuing financial regulatory reform – No More Bailouts – is achieved. Other countries may have other ways of insisting on that principle, but surely no one really thinks that insured depositary institutions and their holding companies should be at the high end of the risk return tradeoff. Other than of course the executives of those firms who benefit from the heads I win, tails you lose nature of allowing publically insured firms to place bets in the securities markets.

The third argument in play today relates to capital requirements, and whether it is a good idea for the United States to have tougher capital requirements than the international minimums created by the Basel III process. The Basel III process envisions basically a risk based capital requirement system, back stopped by an absolute leverage limit of 33-1. This means about 97 dollars in borrowed money for every 100 dollars in assets the bank owns. . Interestingly, this is just about the leverage ratio that the Securities and Exchange Commission allowed major broker dealers to go to in an act that has been widely cited as contributing to the eventual collapse of

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[13] Louise Story, A Secretive Banking Elite Rules Trading in Derivatives, NY Times (Dec. 11, 2010) *available at* http://www.nytimes.com/2010/12/12/business/12advantage.html?s=&_r=1&adxnnl=1&adxnnlx=1308150358-T7S19xeNJw8hDoXMOXFysA.

three of those firms, and the decision of the other two to seek shelter as bank holding companies.[14]

Governor Tarullo has stated recently his support for additional capital requirements for systemically significant institutions, paralleling provisions in Dodd-Frank.[15] However, the strong elements of the Basel III system of capital requirements will not be effective for a number of years, and it is unclear how to compare the risk-based capital requirements of Basel III with those requirements in the United States.

Here Congress should ask, do we want the United States to have a robust system of capital requirements for our banks, or do we want to be no better than the global minimum standard? Or to put it another way, do we want to repeat our role as the source of global financial contagion that we played in 2008? We can seek to attract high-risk banking activity as a nation with weak banking regulation, but in doing so we will certainly expose the American public to the certainty of future bailouts. In the end a well capitalized banking system is critical to a sustainable competitive advantage in banking, and to a banking system that is capable of serving its core function of providing commercial credit to real economy firms.

For two generations the combination of deposit insurance, capital regulations, and the separation of commercial banking from riskier financial activities produced a stable U.S. financial system. After the damage we did to our financial regulatory system over the last two decades, merely meeting international minimum standards will not be enough to ensure our financial system does not destabilize our economy.

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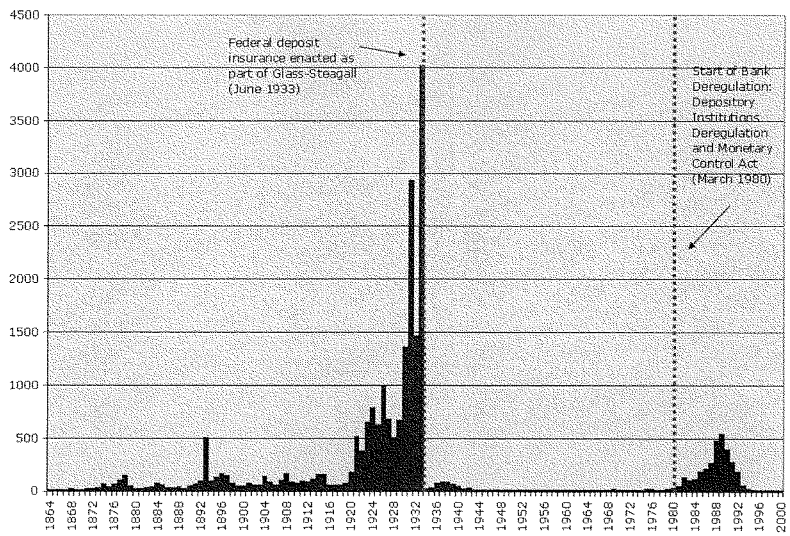
[14] Roddy Boyd, The last days of Bear Stearns, CNN Money (Mar. 31, 2008) *available at* http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/; The end of Wall Street, CNN Money (Sept. 21, 2008) *available at* http://money.cnn.com/2008/09/15/news/companies/lehman_endofwallstreet_tully.fortune/index.htm;

[15] Speech by Federal Reserve Board Governor Daniel K. Tarullo at the Peter G. Peterson Institute for International Economics, Washington, D.C., Regulating Systemically Important Financial Firms (June 3, 2011) *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm.

A Unique Period of Calm Amid the Storm: Bank Failures (Suspensions), 1864–2000



Source: David Moss, "An Ounce of Prevention: The Power of Sound Risk Management in Stabilizing the American Financial System," 2009.

Virtually every member of this Committee has expressed the desire to end the phenomenon of "Too Big to Fail" banking. The Dodd-Frank Act gave banking regulators the responsibility (with discretion) to address both the "too big" aspect of the problem, and the "can't fail" aspect. Today, firms enjoy a financial advantage for increased size and, at least until the bets go bad, tolerance for risk. Title II, Sec. 165 mandates that regulators change the existing incentives so that there is, for the first time, a regulatory cost that discourages being "Too Big to Fail". For many pro-reform experts, this section's promise made the claim that Dodd-Frank could end "Too Big to Fail" credible. Larger, riskier, more interconnected firms will rightly face higher prudential standards than their smaller, less-likely-to-fail competitors. We believe size-based capital requirements should be done through a sliding scale, not a binary system. But a binary system is an improvement on the Basel III approach. If designed well, these standards will change the incentives so that our largest banks (which are bigger than they were before the crisis) will change their business model to become leaner, more manageable, and more sustainable institutions. Higher capital charges are a key part of changing those incentives. Put simply, calls to keep these firms' capital requirements to the Basel III floor are pleas to maintain "Too Big to Fail".

Finally, Dodd-Frank addresses the "can't fail" part of the problem by extending the successful FDIC bank resolution authority to the bank holding companies and bailed-out shadow banks that held taxpayers hostage in 2008. Nevertheless, today we hear that we cannot implement the resolution authority process envisioned in Dodd-Frank until we have a comprehensive international resolution authority. This argument is clearly setting the stage for sick banks of the future to demand a TARP like bailout, where their bondholders are made whole and their stockholders preserved, rather than the tough approach embodied in Dodd-Frank, that requires executives be replaced and stockholders wiped out. This argument is a red herring. Conflicts among international insolvency regimes come into play only if a global financial institution actually becomes insolvent and all of its obligations are in question.

The resolution process in Dodd-Frank envisions that systemically significant bank holding companies are wound down, but are never allowed to be technically insolvent. The breakup and wind-down of the failed parent occurs entirely within U.S. law. Their foreign subsidiaries are never insolvent, and do not need to be resolved. Of course, more of an international framework for addressing conflicts in bankruptcy of international firms is a good idea, but it is not a prerequisite for implementing Dodd-Frank's resolution process for systemically significant firms.

To conclude, a global financial regulatory floor should be a central policy objective of the United States. Since 2008, real progress has been made in the direction of having such a global minimum standard. Great credit for these achievements goes to the witnesses in the first panel, particularly to Governor Tarullo and his colleagues at the Federal Reserve Board for their work on Basel III. But a minimum standard is just that, a minimum. The measure of U.S. financial regulatory policy should not be whether we managed to meet the global minimum. The measure of our financial regulatory system should be whether it ensures that the financial system is a contributor to sustained, balanced growth in our real economy—does our financial system help create jobs, or does it destroy them. Deregulatory whipsawing of the kind recommended today by my fellow witnesses may temporarily increase some bank profits. But the price will be another cycle of economic crisis and job loss. Surely we can do better than that.

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Statement by

Daniel K. Tarullo

Member

Board of Governors of the Federal Reserve System

Before the

Committee on Financial Services

U.S. House of Representatives

Washington, D.C.

June 16, 2011

Chairman Bachus, Ranking Member Frank, and other members of the Committee, thank you for your invitation to testify today about capital and liquidity standards and their relationship to international competitiveness.

I will start by explaining how new international standards on regulatory capital and liquidity will foster global financial stability. Next, I will discuss several areas in which international work to enhance the resiliency of the financial system continues. Then I will turn to the agenda for implementation of these standards across national jurisdictions, as well as reforms in other areas such as derivatives markets and resolution regimes. In particular, I will address the need to expand the implementation agenda beyond assuring that the international standards are incorporated into national legislation and regulations. This is especially the case where the opaqueness of financial firms hinders observation of compliance with applicable standards, such as with minimum capital and liquidity requirements. Here it will be essential for international bodies of regulators to adopt effective oversight and monitoring mechanisms, in order to achieve the financial stability benefits that the minimum standards promise, to prevent the emergence of significant competitive disadvantages for internationally active firms, and promote international cooperation in addressing the technical and policy questions that will arise.

Capital and Liquidity Standards

The recent financial crisis exposed significant weaknesses in the regulatory capital requirements for large banking institutions in many parts of the world, including the United States. The amount of capital held by many banking institutions proved to be inadequate given the risks that had built up in the financial system. In some cases, especially for holdings of asset-backed securities in the trading books of the largest banks, it was evident that capital requirements were set far too low.

In addition, it became apparent that some of the instruments that qualified for regulatory capital purposes as tier 1 capital, which was the core measure of capital adequacy, were not truly loss absorbing, at least not in a way that permitted a financial firm to remain a viable financial intermediary. During the crisis, market assessments of the strength of financial firms focused on common equity, the most loss-absorbent form of capital. Many market participants questioned whether levels of common equity at the largest institutions would be sufficient to withstand potential losses. In conducting stress tests under the Supervisory Capital Assessment Program in the winter and early spring of 2009, we focused predominantly on common equity ratios. It was the disclosure of these ratios, along with our insistence that firms raise additional common equity to meet these ratios, that helped reassure financial markets of the continued viability of the nation's nineteen largest bank holding companies.

The uncertainty about institutions' financial strength had also contributed to severe liquidity problems at the height of the crisis. Investors and other counterparties were unwilling to extend credit of any sort in the absence of reliable information on the firms' true capital positions. Institutions that substantially relied on short-term funding were unable to roll over this funding. Moreover, exacerbating this liquidity squeeze, many of the largest institutions were unable to unwind positions that they had assumed could be liquidated even in stressed markets.

The crisis thus revealed capital and liquidity shortfalls and confirmed that weaknesses in one group of internationally active firms could quickly be transmitted globally. In response, national prudential regulators represented on the Basel Committee on Banking Supervision have developed new standards to enhance the stability of the global financial system. In July 2009, the Basel Committee adopted more stringent regulatory capital standards for trading activities and securitization exposures. Subsequently, in December 2010, the Basel Committee published its Basel III framework.

Basel III represents a major step forward for capital standards. Basel III not only promotes a higher *quantity* of capital by raising the minimum level of capital required at banking organizations. It also addresses the *quality* of capital by introducing for the first time a specific common equity capital requirement, thereby helping to ensure that a bank's capital structure is composed of truly loss-absorbing forms of capital. In addition, Basel III enlarges the range of risks accounted for in the regulatory capital requirements and improves their measurement, particularly for the counterparty credit risk associated with over-the-counter (OTC) derivatives. The Basel agreement also adds for the first time an international leverage ratio as a complement to the long-standing Basel risk-based capital ratios.

Basel III likewise includes two sets of international standards for liquidity, the first efforts to develop quantitative standards for liquidity management. One standard, the Liquidity Coverage Ratio (LCR), is designed to ensure firms' ability to withstand short-term liquidity shocks through adequate holdings of highly liquid assets. The other, the Net Stable Funding Ratio (NSFR), is intended to avoid significant maturity mismatches over longer-term horizons. These new standards are an important part of the global effort to enhance the financial system's ability to withstand stresses comparable to those faced during the recent financial crisis.

Areas for Continued International Work

The risk-based capital requirements finalized in Basel III, and applicable to all internationally active banks, will be central to an effective framework for financial stability. There is an additional capital standard – along with the liquidity standards just mentioned – where the considerable work done to date still needs to be completed in the Basel Committee.

Global initiatives have also been started in two other areas covered by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), derivatives regulation, and resolution regimes, but a good deal remains to be done before we have agreement on appropriate international measures to promote global financial stability and to assure congruence between U.S. practices and those of other major financial centers.

An important capital policy initiative that has yet to be completed pertains to additional capital requirements for systemically important financial institutions (SIFIs). Section 165 of the Dodd-Frank Act directs the Federal Reserve to impose enhanced prudential standards, including capital requirements, on bank holding companies with consolidated assets of $50 billion or more. These requirements must be more stringent than those for firms that do not pose a similar risk to U.S. financial stability, and must increase in stringency based on the systemic footprint of the firm.

Last year, we proposed development of a comparable enhanced international capital requirement for SIFIs. Such a requirement would promote international financial stability while avoiding significant competitive disadvantage for any country's firms. Work on the subject of SIFI capital surcharges in the Basel Committee started a bit slowly, but it has picked up considerably in recent months. Although there is not yet consensus, we are hopeful that in the next several months the Committee will agree upon a proposal and can seek public comment. This international process would roughly coincide with the domestic notice and comment process for rules proposed by the Federal Reserve covering enhanced prudential standards for SIFIs. The parallelism of the international and domestic processes should facilitate the goal of congruence between U.S. and international standards.

While the Basel III capital standards take effect during a transition period beginning in 2013, implementation of the two sets of liquidity standards will not begin until 2015 for the LCR and 2018 for the NSFR. The central bank governors and heads of supervision recognized that there may be a number of unintended consequences arising from the specifics of the LCR. For this reason, the Federal Reserve, supported by our counterparts from a number of other central banks, suggested a multi-year observation period before the LCR takes effect. During this period, the U.S. agencies and a Basel Committee working group will collect data, solicit comments from banks, analyze the effects of the new liquidity measures on financial markets and the broader economy, and determine whether the standards need to be amended to avoid adverse unintended consequences. With respect to the NSFR, while the Basel Committee countries are committed to having this standard in place in 2018, considerable technical work is still needed to refine this measure in the coming years.

In addition to these ongoing efforts regarding capital and liquidity, I would like to emphasize the importance of international cooperation on reforms to the derivatives market. In the United States, the market regulators and banking agencies are implementing the requirements of the Dodd-Frank Act to strengthen the infrastructure and regulation of the OTC derivatives market. This task includes enhancing the role of central counterparties, which can be an important tool for managing counterparty credit risk in the derivatives market, and introducing new margin requirements for certain derivatives activities that are not cleared with a central counterparty.

Even as these initiatives are underway in the United States, it is important that progress on reforming the OTC derivatives market continue at the international level. In 2009, the Group of Twenty (G-20) leaders set out commitments related to reform of the OTC derivatives markets that, when implemented by national authorities, will form a broadly consistent international regulatory approach.[1] As work on the G-20 commitments is being pursued in a number of international groups, continued attention will be required to ensure that the convergence process continues in a timely fashion. In addition, there is need for agreement on a topic not covered by the G-20 declaration – that of global minimum margin requirements for derivatives not cleared through a central counterparty. Such an agreement would increase the stability of the financial system by reducing the likelihood of a race to the bottom in jurisdictions that do not implement equivalent standards.

A final issue that must remain on the international reform agenda is the development in major financial centers of effective resolution regimes for SIFIs. The Dodd-Frank Act gave the Federal Deposit Insurance Corporation (FDIC) authority to resolve failing financial firms where necessary to mitigate serious effects on financial stability. The efficacy of this mechanism and market discipline more generally will both be increased if other significant jurisdictions have parallel authority, with similar expectations for how SIFIs operating in multiple jurisdictions will be resolved. Work has been underway for some time at the Basel Committee and the Financial Stability Board to identify key attributes of effective regimes that will facilitate resolution of SIFIs while preserving critical market functions. In cooperation with our colleagues at the FDIC, we have encouraged these efforts, as well as an exploration of possible channels for avoiding impediments to successful resolution of firms with substantial operations in multiple jurisdictions.

[1] See G-20 (2009), "Leaders' Statement: The Pittsburgh Summit," September.

Implementation of International Standards

The financial stability benefits of the Basel III reforms will be realized only if they are implemented rigorously and consistently across jurisdictions. In this regard, it is important to note that incorporating internationally acceptable standards into national legislation or regulations is only the first step in effective implementation. A second, critical step is ensuring that these standards are, in practice, rigorously enforced by national supervisors and observed by firms across all the Basel Committee countries.

In the United States, the Federal Reserve, FDIC, and Office of the Comptroller of the Currency (collectively, the banking agencies) are working to update and enhance risk-based capital standards, and introduce liquidity standards through a series of rulemakings. These rulemakings will be used to align U.S. capital and liquidity regulations with Basel III. In accordance with the internationally agreed-upon implementation timeframes, the banking agencies plan to issue a notice of proposed rulemaking in 2011 and a final rule in 2012 that would implement the Basel III reforms. We expect that other jurisdictions will be adopting regulations or, where necessary, legislation in a similar timeframe. The Basel Committee will review progress and identify any potential inconsistencies with the terms of Basel III.

Monitoring the incorporation of Basel agreements into national law is a fairly straightforward exercise, though no less important for that. It is also a familiar exercise in the Basel Committee. In this regard, the international leverage ratio the Basel Committee has adopted and is currently monitoring serves as an important backstop to risk-based ratios that rely extensively on banks' models. It is notable that analysts that follow significant global financial institutions use a leverage ratio to gain insights into the credibility of banks' average risk-weighted assets. The Federal Reserve Board is fully committed to ensuring a robust leverage ratio remains in place for internationally active institutions.

Despite extensive sharing of information on supervisory practices, the Basel Committee has, over the years, found it difficult to achieve what I have characterized as the second critical step in the implementation of international capital accords – that is, rigorous and consistent application of those rules by supervisors and firms across countries, as reflected in reported capital levels and amounts of risk-weighted assets of individual banks. An international process for monitoring implementation on a bank-by-bank basis has become increasingly necessary as capital standards have relied to a greater extent on internal market-risk or credit-risk models, the parameters and operation of which are not transparent. This tendency has combined with the relatively opaque nature of bank balance sheets to complicate external efforts to assess how banks are meeting their capital requirements.

One area that has deservedly received attention of late is the potential for differences in the calculation of risk-weighted assets across banks, both currently and prospectively under the Basel III standards. In particular, market participants have focused on differences in measured risk exposure. Analysts have pointed out that large U.S. banks generally have markedly higher average risk weights, ratios of risk-weighted assets to total assets, and ratios of common equity to total assets, adjusted for differences in accounting, than some of their foreign competitors. These large disparities cannot be easily explained away through differences in risk profiles, which are largely similar within the business lines of competing banks.

Indeed, with regard to capital for trading activities, where a commonly disclosed measure of risk is one-day value-at-risk (VaR),[2] U.S. trading banks appear to hold multiples of the capital

[2] A value-at-risk approach measures the potential gain or loss in a position, portfolio, or organization that is associated with a price movement of a given probability over a specified time period.

non-U.S. trading banks hold per unit of VaR. Precisely because of the opacity of bank balance sheets and their internal risk models, we do not yet fully understand the reasons for these disparities. Some observers have suggested that U.S. stringency in application of the rules and standards may be a factor. Gaining insight into these differences and taking action to more closely align capital requirements for similar risk exposures across countries will take concerted work within the Basel Committee.

The Basel Committee leadership has acknowledged that failing to implement Basel III in a globally consistent manner could lead to a competitive race to the bottom and increase risks to the global financial system.[3] The Committee must take action to avoid this outcome, specifically through the Committee's Standards Implementation Group (SIG). The SIG is initiating this year a peer review process, through which teams of experts will assess the extent to which countries have implemented Basel Committee standards. While these reviews will focus initially on standards other than capital, such as stress testing, the process should nevertheless provide insight into how approaches and outcomes related to the implementation of Basel III can be meaningfully monitored and compared.

The SIG has already begun sharing information on the status of Basel III implementation by member countries and is in the early stages of planning comparative work on risk-weighted assets across jurisdictions and banks to promote consistent implementation.

As the Basel Committee moves into this next phase, we will urge the Committee to take a comprehensive approach to monitoring processes that includes three elements. First, the Committee should begin work as soon as possible to develop mechanisms to implement effective

[3] See, for example, Nout Wellink (2011), "Basel III: A Roadmap to Better Banking Regulation and Supervision," remarks delivered at the FSI High-Level Meeting on the New Framework to Strengthen Financial Stability and Regulatory Priorities, St. Petersburg, Russia, May; and Stefan Walter (2011), "Basel III: Stronger Banks and a More Resilient Financial System," remarks delivered at the Financial Stability Institute Conference on Basel III, Basel, April.

cross-country monitoring. Second, this process should go beyond traditional stocktaking exercises to include a careful assessment of the methodologies national regulators use to determine the appropriateness and acceptability of bank practices. Third – and here is where the real work will lie – the Committee must develop a mechanism to validate the actual risk-weighted assets calculated by individual banks under international capital standards.

There are several possibilities for conducting this work. One that has been discussed in the Basel Committee would be to use tools such as benchmarks and test portfolios, in order to provide an accurate, quantifiable comparison of standards implementation across jurisdictions. Another, more far-reaching option would be to use validation teams working under the auspices of the Basel Committee itself to verify the methodologies used at individual banks to ensure their compliance with international standards. They could use expertise gained through horizontal reviews of institutions to make assessments of individual banks in different jurisdictions. A less far-reaching variant of this option would entail national supervisors collaboratively participating in examinations of specific institutions.

As a result of these monitoring and validation processes, outliers (i.e., banks whose risk weights for comparable assets differ materially from those of other banks) could be identified so that national supervisors might perform more in-depth analyses of their banks' processes and outcomes. This would lead to a greater understanding of the disparity in results for certain institutions or jurisdictions based on their assumptions, data, or risk profiles. There can be legitimate reasons that banks may have different risk estimates for similar portfolios. Where disparities are identified, however, national supervisors of outlier banks should be called upon to explain the results to their fellow supervisors, as well as steps they are taking to address situations in which differences may arise from systematic underestimation of risk or manipulation of capital ratios to achieve desired outcomes.

Any of these options would require the Basel Committee, international supervisors, and banking organizations to work together to address confidentiality concerns, as well as other jurisdictional issues. Some options will surely prove more feasible than others. While we do not prejudge which will prove to be most effective, we do maintain that something of this sort is necessary in order to assure that the benefits for financial stability promised by international capital standards are in fact being realized, as well as to prevent some banks from enjoying competitive advantage through lax application of these standards. At the same time, any of these options will give banking supervisors from the countries represented on the Basel Committee an opportunity to work together to address the many issues of implementation, interpretation, and evasion that will surely arise under Basel III.

Thank you for your attention. I would be pleased to answer any questions you might have.

For Release Upon Delivery
10:00 a.m., June 16, 2011

TESTIMONY OF

JOHN WALSH
ACTING COMPTROLLER OF THE CURRENCY

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

June 16, 2011

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Chairman Bachus, Ranking Member Frank, and Members of the Committee, I appreciate the opportunity to appear before the Financial Services Committee to discuss the work that the OCC is doing to implement new bank regulations in the U.S. and to harmonize those rules with those of other countries to avoid a regulatory race to the bottom. The Committee's letter of invitation has indicated your particular interest in the new capital and liquidity standards being developed by the Basel Committee on Banking Supervision. Accordingly, my testimony focuses on the efforts underway to revise bank capital and liquidity requirements, including the implementation of capital-related provisions of the Dodd-Frank Act and the new international capital and liquidity standards commonly referred to as Basel III.

Implementation of key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and the new Basel capital and liquidity requirements is particularly challenging because of the number of related provisions that must be considered together. Regulators are trying to understand not just how individual provisions will impact the international competitiveness of U.S. firms, but how the interaction of all of the various requirements of the Dodd-Frank Act and Basel III will impact U.S. firms.

In assessing the impact of the capital and liquidity requirements in Basel III and the Dodd-Frank Act, there is little reason to be concerned about an international "race to the bottom." In every major jurisdiction around the globe, regulatory requirements imposed on the financial sector are becoming more stringent. This raises two issues. First, if capital and liquidity standards are set too high, we may unnecessarily restrict financial intermediation and economic performance. Second, if some countries do not adopt the same high standards and enforce them with the same rigor, we could wind up with an unlevel playing field that gives an advantage to firms in countries with less stringent standards.

While the failure of others to act in a comparable fashion is no reason to relax our prudential standards in the U.S., it is important to analyze the individual and cumulative impact of the changes under consideration to be certain we are making sensible decisions about how far we should go domestically. Our goal must be to address the problems that led to the financial crisis without undermining the ability of our banking institutions to support a strong national economy, or placing U.S. institutions at an unfair competitive disadvantage relative to foreign competitors.

II. Changes to Domestic and International Capital and Liquidity Standards

A. Background and Overview

The new Basel III agreement, which was published at the end of 2010, is the latest version of internationally agreed standards adopted by the Basel Committee on Banking Supervision (Basel Committee).[1] Like the Dodd-Frank Act, it is designed to promote a more resilient banking sector. However, Basel III is more narrowly focused than the Dodd-Frank Act in that it is limited to strengthening global capital and liquidity requirements for internationally active banks. Basel III requires increases in both the amount and the quality of regulatory capital relative to banks' risks, including a greater reliance on common equity. As currently formulated, Basel III also will require banks to

[1] The term "Basel III," as it is used here, refers to the set of capital and liquidity standards published by the Basel Committee in December 2010, as well as those published in July 2009. A compilation of the documents that form Basel III is available at www.bis.org/list/basel3/index.htm.

hold substantially more liquidity in the form of short-term, low-risk assets and to increase their reliance on more stable long-term debt and core deposits.

Basel III introduces other significant enhancements designed to ensure that all material risks confronting financial companies – especially risks held in trading portfolios and the risks posed by complex structured-finance transactions – are appropriately reflected in regulatory capital requirements. In this respect, Basel III builds upon and further strengthens the more risk-sensitive capital regime established by the Basel II capital framework. Basel III also increases the focus on consideration of systemic risk issues in bank supervision practices and capital rules.

In developing a consistent set of standards for internationally active banks, the Basel Committee aims to enhance the safety and soundness of the global banking system and, secondarily, to facilitate a level playing field on an international basis. This is important because the largest banks in the U.S. and abroad compete with one another for business worldwide. Consistent international implementation of common standards discourages regulatory arbitrage across national boundaries.

Basel III represents the third generation of standards, building upon the Basel II framework that was designed to replace the original and much simpler Basel I standards. While there are elements of Basel III that each Basel Committee member would like to see changed, the revisions represent a significant accomplishment in that 27 countries reached a general agreement on highly technical policy issues and detailed regulatory standards.

Still, even with this agreement, details of implementation can vary from country to country. For U.S. institutions, the overlay of the Dodd-Frank Act requirements – and the existing Prompt Corrective Action (PCA) regime – adds substantial complexity in implementing the internationally agreed-upon standards.

The Dodd-Frank Act contains several provisions that affect both U.S. regulatory capital and liquidity standards. For example, the Dodd-Frank Act requires the Federal Reserve to develop more stringent prudential standards, including capital and liquidity requirements, for larger, more systemically important bank holding companies, which are generally defined as those with more than $50 billion in assets. In contrast, the Basel II advanced approaches regulations are required to be used only by banks with $250 billion or more in total assets or $10 billion or more in total foreign exposures. In addition, international agreement is still being sought to impose a surcharge above the Basel III levels for the very largest and most sophisticated global financial institutions.

Implementing all of these new standards in the U.S. poses a number of challenges. The banking regulators are currently working to determine how best to interweave the new Basel III minimum capital requirements and capital buffers, the Dodd-Frank Act capital surcharge for large U.S. institutions, and the Basel III capital surcharge for the largest global institutions into the statutory PCA framework, which requires the regulators to define separate capital levels for well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized institutions. Under the PCA framework, banks face consequences and restrictions of increasing severity as their capital levels fall, which is similar to the operation of the "capital conservation buffer" under Basel III.

The Dodd-Frank Act also addresses capital regulations by limiting the degree to which certain hybrid instruments can be included in regulatory capital. In addition, the law provides that the largest internationally active U.S. banks subject to the advanced approaches in the Basel II risk-based capital rules may not hold comparatively less capital than is required of U.S. banks generally under Basel I. The Dodd-Frank Act also establishes specific requirements relating to the leverage ratio.

Other provisions of the Dodd-Frank Act restrict reliance on credit ratings by federal agencies as a determinant of credit quality. Specifically, section 939A of the Dodd-Frank Act requires each federal agency to review their regulations and "remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations." This requirement necessitates changes to a number of the existing risk-based capital regulations and affects implementation of several of the Basel III capital and liquidity provisions, which rely on credit ratings to set specific regulatory requirements. As a result, U.S. banks' capital rules will necessarily diverge from the international standards.

B. Regulatory Capital Requirements

Basel III emphasizes the quality of capital by seeking a more stringent definition of what banks should be permitted to count as regulatory capital. The financial crisis clearly demonstrated that common equity is superior to other capital instruments in its ability to absorb losses on a going-concern basis. Innovative instruments, such as "hybrid" capital instruments that have characteristics of both debt and equity, which had become an ever-larger proportion of the capital base for banks of all sizes, were found lacking. While many of these instruments permit banks to defer or cancel dividends, which helps preserve liquidity and capital in times of stress, during the financial crisis many banks did not exercise this option out of fear that such actions would reinforce market perceptions of the bank's weakened financial condition. Many non-U.S. banks even exercised call options to redeem hybrid instruments for fear that failure to do so would send strong market signals about the deteriorating condition of the bank.

Basel III addresses these problems by defining regulatory capital more narrowly and placing greater reliance on common equity. Under Basel III, banks will be required to hold a minimum amount of common equity based on their level of risk. This common equity ratio cannot be met through the issuance of other forms of capital, even relatively high-quality capital such as non-cumulative perpetual preferred stock. Basel III also tightens the definitions of other forms of regulatory capital – Tier 1 and Tier 2 – to exclude some of the innovative hybrid capital instruments, and it places strict limits on the amounts of mortgage servicing assets and deferred tax assets that may be recognized for regulatory capital purposes.

Another key element of the Basel III package is a substantial increase in minimum risk-based capital ratios – requiring banks to hold more capital for every dollar of risk exposure. The Basel III reforms set higher capital requirements that essentially will move the Tier 1 common ratio from a minimum of roughly 2 percent under current rules to 4.5 percent. They also set a 2.5 percent conservation buffer of capital above the 4.5 percent minimum requirement, bringing the total requirement to 7 percent. This capital buffer is intended to ensure that banks are well-positioned to withstand economic downturns or stresses that are unique to their portfolio. For example, a bank that had capital equal to, or in excess of, 7 percent of risk-weighted assets during strong economic times might dip into its buffer during a period of economic stress, while still maintaining capital levels that should not lead to concerns about its viability. Though the capital buffer could be used during a period of stress, there also would be a constraint associated with that use. One of the consequences of dipping into the buffer would be progressively more stringent capital distribution restrictions as the bank's capital levels erode and approach the minimum thresholds.

This formulaic response to falling capital levels will create the appropriate incentive for banks to maintain a healthy buffer during benign economic times, and also limit the ability of banks to dissipate capital when their capital ratio is deteriorating. This works much like the restrictions in the current PCA framework, but the agencies still must consider whether, and/or how, to combine the two. For example, in light of the Basel Committee's stated intention that banks be able to draw on the conservation buffer in times of stress, the banking regulators must determine whether or not to define the PCA "well capitalized" category in a way that allows a bank to be considered "well capitalized" even if its capital levels fall below the buffer but remain above the minimum requirements.

All together then, the minimum requirement for Tier 1 common capital will rise to 7 percent by the end of the decade. The recent crisis demonstrated that market analysts were particularly focused on common equity ratios, and banks that had higher and stronger ratios tended to avoid the intense market speculation and fears that plagued some of those with weaker ratios. Some of the banking organizations that struggled the most during the turmoil had capital levels below the 4.5 percent minimum standard.

The Basel III changes, discussed previously, tighten the definition of what can count as capital. As discussed in greater detail below, they will also require more capital for certain risks than the current standards, and they substantially increase the allowable minimum capital ratios that banks must maintain. All of this is to say that the 7 percent requirement represents a significant strengthening of our capital standards.

Large U.S. banks have already raised large amounts of capital since the peak of the crisis and are very highly capitalized by traditional measures. We expect that these increases in actual capital levels, combined with an extended phase-in period for the higher capital standards of Basel III, should allow banks to transition to the higher capital requirements in a reasonable manner without causing undue stress on the current economic recovery. However, we are concerned with how much more we can and should turn up the dial on our banks without having negative effects on lending. Our concerns on this front are most evident in the context of the surcharges being contemplated for systemically important firms, which are discussed in more detail below.

Another key element of the Basel III reforms is the introduction of an international leverage ratio. The financial crisis witnessed the build-up of excessive on- and off-balance sheet leverage in the banking system. To address these problems, the international leverage ratio requirement will serve as a backstop to the risk-based measures. Though similar in many respects to the existing U.S. leverage ratio calculation, the international leverage ratio also will capture off-balance sheet exposures that, during the crisis, led to a build-up of leverage, which eventually came cascading onto some banks' balance sheets.

The Basel III reforms also greatly improve the assignment of capital to the exposures that proved most problematic during the crisis. Certain securitization positions, such as CDO-squared instruments and CDOs of MBS, will see greatly increased capital requirements under the Basel III revisions. Similarly, the capital requirements for trading activities will be increased substantially. In addition, the calibration of the bank-generated measure of potential counterparty credit exposures from derivative transactions has been significantly enlarged. Capital requirements also are being increased more generally for bank exposures to other large financial firms to address concerns with interconnectedness and possible contagion effects. Taken together, these changes will result in significant increases in the capital requirements for those risks and sources of losses that were most prominent during the crisis.

We support the Basel III capital requirements, which we believe will materially enhance the resiliency of the banking sector, as well as the broader financial system. It is crucial to recognize, however, that the Basel framework requires these standards to be applied to *internationally active banks*. This scope of application is critical to the issue of how many banks should be subject to the requirements for systemically important financial institutions, and how much of a capital surcharge should be applied. It is also crucial to how we approach application of the new Basel III standards to the several thousand other banks and thrifts that are not internationally active. For those institutions, application of the Basel III standards is at the discretion of U.S. bank regulators.

What does the experience of U.S. banks during the crisis suggest about which of the Basel III changes should be applied generally to U.S. banks? Regarding the definition of capital, if we believe a capital instrument is not loss absorbing, it should not be recognized for regulatory purposes regardless of whether a bank is internationally active or not. Thus, a greater regulatory focus on common equity should make sense for all banks.

Less obvious is whether it makes sense to impose the same minimum capital ratio that applies to large internationally active banks on the majority of U.S. banks that are not internationally active and have relatively simple balance sheets and risk profiles. A final decision on this issue has yet to be reached as the federal banking regulators are continuing to consider and weigh the merits of a wide application of all the changes contemplated under Basel III.

Capital Surcharge for Systemically Important Financial Institutions

At the international level, the Basel Committee and the Financial Stability Board (FSB) are not yet finished setting capital requirements. These groups have on-going projects to define global systemically important banks (G-SIBs), and global systemically important financial institutions (G-SIFIs), respectively, and to assess how much additional "loss absorbing capacity" these institutions need to maintain. Notably, the Basel Committee is continuing to debate decisions on identifying which institutions should be designated G-SIBs and the potential application of a capital surcharge to those firms. It also continues to assess the role that contingent capital might play in such a surcharge. This work is expected to be completed by the end of 2011.

We support the application of a surcharge of common equity for the very largest globally significant banks, but we believe the amount of the surcharge should recognize that it is adding to a base – Basel III – that is already designed to address risks presented by these very same large, internationally active banking institutions. In fact, the design of the components of Basel III was based exclusively on analyses of the capital requirements for our largest and most complex institutions, and based on lessons learned from the recent, severe financial crisis. Based on our analysis of the capital levels needed to protect the largest institutions from failure under stressed conditions, the OCC believes a moderate surcharge may be appropriate to protect the financial system against the failure of systemic banks.

A further important consideration for determining the appropriate capital surcharge for a category of large and potentially systemically significant institutions is the regulatory environment in which they operate. In many other countries, large internationally active banking institutions are extremely large relative to the domestic economy, as measured by GDP, and the risk to the national economy of problems at those institutions is much more fundamental. The largest banks in the UK, for example, have assets roughly equal to the UK GDP, and assets of the largest Swiss banks substantially exceed that country's GDP. Such countries may prudently add an additional buffer on top of international standards to mitigate the high risk posed to their domestic economy by banks of this scale. In contrast, the U.S. is unique in the international community in applying caps on deposit concentrations in the U.S. banking industry and now, under the Dodd-Frank Act, imposing special concentration limits on large financial firms. No U.S. bank exceeds these caps, and even our largest institutions are only a fraction of U.S. GDP.

All Basel capital levels are minima, including the surcharges for the largest banks. Since individual countries have freedom to set higher capital levels appropriate to their individual circumstances, we should consider whether a surcharge intended for general application should be importantly influenced by conditions in countries with unique financial characteristics. As we weigh these considerations in determining appropriate capital surcharges for systemically important institutions, we must also take into account that higher capital requirements are not without costs. Attempting to wring risk out of the banking system through the device of high capital requirements must be weighed against the costs of less intermediation and potentially lower economic growth. Finding that tipping point involves as much judgment as calculation, and the right outcome is probably not a simple average of national preferences resulting in an international one-size-fits-all answer.

A particular concern in light of recent experience in the U.S. is the risk that excessive capital requirements will cause lending and investing to move from the regulated banking sector into other less regulated sectors, which could serve to reduce the effectiveness of the enhanced bank capital standards. The largest of these less-regulated "shadow banking" entities are expected to be subject to the enhanced supervision and oversight that the Dodd-Frank Act envisions, but there remains a substantial concern that a new batch of "shadow banking" firms will emerge to fill any void left by depository institutions. While moving certain risks out of deposit-taking institutions may be a desirable result, these less regulated sectors do not face comprehensive capital requirements, enhanced liquidity and disclosure standards, or the same level of regulatory scrutiny that will apply to banks, and there is the danger that risks could be more easily hidden in these pockets of the financial system. And it's not obvious that a shift of financial activity into the shadow banking system protects the financial safety net; we saw the apparent extension of that safety net into that space during the recent financial crisis. Among the lessons we must learn from the financial crisis is that we cannot tolerate the re-emergence of a risky parallel or "shadow" banking system.

Section 171 of the Dodd-Frank Act – Risk-Based Capital Floor

An example of legislation unique to the U.S. that will result in more stringent standards for U.S. firms and an uneven playing field is section 171 of the Dodd-Frank Act (the "Collins Amendment"). The Collins Amendment establishes a floor on the capital requirements for U.S. banks based on current Basel I-based capital standards. In practical terms, this will limit the incentives for large internationally active U.S. banks to undertake the complex and costly task of implementing the Basel II framework, since the simpler Basel I framework will still govern.

Notably, the primary reason the Basel Committee decided to replace the Basel I framework – the framework that was in place during the financial crisis in the U.S. – was its lack of risk sensitivity. By removing incentives for reducing risk, the OCC is concerned that the implementation of section 171 may lead to perverse incentives for U.S. banks. If an institution can take on additional risk without triggering an additional capital charge under the Basel I standards, it may be tempted to do so if Basel I is the bank's operative constraint. For example, lending to a large, highly diversified multinational corporation or a small startup with an unproven business strategy would have the same charge under Basel I, and banks would have an incentive to take on the riskier loan to generate higher returns. Similarly, the bank may have less incentive to look favorably on safer loans, due to the lack of any reduction in required capital.

Section 939A of the Dodd-Frank Act – External Credit Ratings

The OCC recognizes that issues surrounding credit ratings were a significant factor in market overconfidence that contributed to subsequent losses in the markets for various structured and complex products, including mortgage-backed securities, in 2008 to 2009. The Dodd-Frank Act includes a number of important remedial measures to address this problem, including structural changes at the rating agencies, greater SEC oversight of the ratings process, and loan-level disclosures to investors in asset-backed securities. As I have stated in previous testimony, in the context of enhanced regulation provided by the Dodd-Frank Act, the absolute prohibition against any references to ratings under section 939A goes further than is reasonably necessary.

Because no other jurisdiction is subject to a similar limitation, section 939A is impeding our efforts to achieve international consistency in the implementation of Basel III. The Basel III framework, together with the Basel II framework on which it is built, makes use of external ratings in several areas including securitizations, assessment of counterparty credit risk, and trading book positions. Because of section 939A, the banking regulators' proposal to amend the risk-based capital rules for market risk, published on January 11, 2011, did not include these ratings-based provisions that would have significantly increased the amount of capital required to be held against traded assets. More broadly, the federal banking regulators' inability to implement this important provision of the international standards may hamper our credibility in future negotiations for global standards.

Potential for Inconsistent Implementation of Basel III

In addition to the provisions of the Dodd-Frank Act that will result in different application of certain aspects of the revised Basel framework, a level playing field for U.S. banks may be difficult to achieve if Basel III is unevenly implemented across jurisdictions, despite the very detailed prescriptions it contains.

For example, the Basel II qualification requirements have been implemented with varying degrees of rigor in different countries. While many international regulators permitted large banks in their jurisdictions to move to the Basel II framework several years ago, U.S. supervisors have enforced very stringent standards on U.S. banks in order for them to qualify to use Basel II. No U.S. bank has qualified yet. The more conservative approach taken by U.S. supervisors relative to our non-U.S. counterparts is evident in many aspects of the Basel II implementation process, and experience has shown that even small differences in implementation can still lead to measurable differences in capital requirements.

Of course we should not lower our standards domestically for these reasons, but these points illustrate that international consistency will be very challenging to achieve in practice. In fact, some differences are so fundamental that it may simply not be possible to achieve the goal of a level playing field.

C. Liquidity Requirements

The recent financial crisis highlighted the importance of effective liquidity management to the proper functioning of financial markets and the banking sector. In fact, during the early phase of the financial crisis, many banks – despite adequate capital levels – still experienced difficulties because of inadequate liquidity.

In 2010 the federal banking regulators, in conjunction with the Conference of State Bank Supervisors, issued a policy statement on expectations for sound funding and liquidity risk management practices. This policy statement summarized the principles of sound liquidity risk management issued previously and, where appropriate, supplemented them with Basel's 2008 "Principles for Sound Liquidity Risk Management and Supervision."

With Basel III, the Basel Committee raised the bar by introducing explicit minimum liquidity standards. These standards are designed to achieve two separate but complementary objectives. The first is to promote short-term resilience by ensuring that a bank has sufficient high quality liquid resources to offset cash outflows under acute short-term stresses. The Basel Committee developed the Liquidity Coverage Ratio, with a one-month time horizon, to achieve this objective. The second objective is to promote longer-term resilience by creating additional incentives for a bank to fund its on-going activities with stable sources of funding. The Net Stable Funding Ratio has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities. Its goal is to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items.

Although the goal of setting common minimum liquidity standards is laudable – sound liquidity management is fundamental to the safety and soundness of all banks – the proposed new standards and required ratios have so far produced counterintuitive results in testing and clearly need to be recalibrated. For this reason, the Basel Committee has elected to phase in these standards over time to allow for further calibration and more robust testing. The OCC supports the cautious and deliberative approach that the Basel Committee is taking in implementing these important standards. It is fair to say that the tougher standards have already had a favorable impact on liquidity management practices at most banks as liquidity across most all measures within the banking system is at historically high levels.

We are concerned, however, that overly conservative stress calibrations could lead to changes in funds management practices that are detrimental to sound banking practices and that unduly restrict banks' balance sheet capacity for lending activities. To address some of these concerns, there is a joint interagency effort underway to assess the economic impact of Basel liquidity requirements on the industry's capacity to lend. The validity of various assumptions about deposit arrangements between banks, relationships with government sponsored entities, and the offering of liquidity and credit facilities are examples of some of the critical factors that are being assessed. We support this analysis which is timely and prudent in light of concerns regarding potentially adverse impacts on a relatively weak economic recovery.

Again, we are also mindful of the interaction among various provisions of the Dodd-Frank Act. For example, we have to ensure that enhanced capital and liquidity requirements do not interact in such a way that banks are incented to invest solely in low-risk, highly liquid, sovereign debt instruments at the expense of making other loans to businesses and consumers that support economic growth. Likewise, the margin requirements associated with the newly proposed derivatives regulations, established under Title VIII of the Dodd-Frank Act, have the potential to effectively decrease liquidity at the same time we are considering a new regime designed to increase the liquidity requirements imposed on our banks.

III. Conclusion

In the post-crisis environment, as the financial system works toward full recovery, there are strong reasons for the largest financial firms to hold additional capital and enhanced liquidity. We fully support raising the bar for these firms.

In addition to heightened capital and liquidity requirements, Congress and the banking regulators have responded to the financial crisis by introducing other equally significant reforms, including frequent mandatory stress tests, enhanced resolution authority, limits on leverage, concentration limits, margin requirements on derivatives, and restrictions on high-risk activities (including restrictions on proprietary trading, such as making investments in hedge funds).

While we are working to more fully assess the potential impact of the new capital and liquidity standards, it is difficult to gauge how all of the Dodd-Frank Act and Basel III reforms, acting in concert, will affect the financial system. As we consider further increases to minimum capital and liquidity requirements, we need to consider all of the various reforms being introduced to increase the ability of the financial system to absorb losses and to reduce the probability and potential impact of the failure of large institutions. Failure to consider and balance the combined impact of all of the changes will have real consequences to the extent that constraints on liquidity translate into constraints on bank lending and the availability of credit within the economy.

Testimony of Barry Zubrow
Chief Risk Officer, JPMorgan Chase & Co.
Hearing before the House Financial Services Committee
June 16, 2011

Chairman Bachus, Ranking Member Frank, Members of the Committee, thank you for the opportunity to testify before you today on the international context for regulatory reform. My name is Barry Zubrow, and I have been the Chief Risk Officer of JPMorgan Chase since 2007.

Introduction

Let me begin by describing the current competitive landscape. It is not one of American dominance, as some may believe, but rather considerable competitive challenges. None of the world's five largest banks is a U.S. bank. U.S. banks represent 24 percent of the market share of the 50 largest global banks, down from over 50 percent only eight years ago; Chinese banks now hold 22 percent. These trends are likely to continue as emerging markets continue to expand.

History teaches that a vibrant economy requires a vibrant financial sector. There is simply no way to sustain economic growth without a strong financial sector providing loans, debt and equity financing, and risk management services to growing companies, and useful and innovative services to consumers. For over a century, the U.S. economy has benefited from having the most sophisticated and innovative finance system in the world.

The growth of the largest U.S. banks, like JPMorgan Chase, has mirrored the growth in U.S. corporations and the globalization of business and financial markets. A corporate treasurer for a Fortune 500 U.S. company relies on global banks like JPMorgan Chase to raise billions of dollars of debt or equity on short notice, and to raise that debt and equity in whatever capital market and currency in the world is currently offering the most advantageous terms; to offer a wide range of derivatives products to manage the company's currency, interest rate and other risks; to manage the company's pension plan; and to the extent that company intends to expand into an emerging market, to be there waiting, ready to provide treasury and custody services, trade finance and a host of other services. By the same token, a foreign company looking to establish operations (and jobs) in the United States will retain JPMorgan Chase to fund and manage that expansion. And it is worth noting that Chase also is the largest Small Business Administration lender in the United States.

Those of us who regularly meet with corporate managers take this connection for granted, but I fear that this connection is not widely appreciated. If large U.S. banks are hobbled by uneconomic capital levels or risk restrictions, a U.S. company is not going to turn to smaller U.S. banks to underwrite a €1 billion debt offering paired with a euro/dollar swap, or to lend it $200 million, or to provide custody services for a new overseas subsidiary; rather, it is going to turn to our foreign bank competitors.

Certainly, the financial crisis exposed serious flaws in the U.S. regulatory system, particularly the dangers of unchecked leverage and regulatory arbitrage. Most of the reforms imposed in the wake of the recent financial crisis – by market participants, accounting authorities, supervisors, regulators and the Congress – will improve the soundness of our system while allowing U.S. firms to remain competitive. Most importantly, leverage has been reduced by applying bank holding company capital standards broadly across firms, and originators of mortgage and other products now cannot escape regulation by changing their legal structure or charter. We at JPMorgan Chase and others in the financial services industry have been supportive of these measures. Indeed, we worry that the lack of controversy around these important measures has left them underappreciated.

That said, the regulatory pendulum clearly has now begun to swing to a point that risks hobbling our financial system and our economic growth. We believe that U.S. policymakers should focus on:

- how much the regulations they have proposed *collectively* reduce risk taking by financial firms;
- how this collective impact is likely to result in reduced U.S. economic and job growth, because funding business growth requires someone to take a financial risk;
- how many of these regulations are being rejected or deferred by other countries, providing their banks at least a temporary competitive advantage in the marketplace, and in many cases a permanent one.

I will focus today on the two most stark cases – a capital surcharge on U.S. banks and extraterritorial application of margin requirements – where regulation currently risks doing more harm than good, and putting U.S. firms at a distinct and unnecessary competitive disadvantage globally. Regulators have different levers to reduce the risk of a bank's failure, particularly a large bank's failure: high capital to protect against unexpected losses; liquidity to allow continued operation under stress; regulation to discourage risk taking; supervision to discourage risk taking; recovery and resolution regimes that allow banks to fail without causing systemic crises or imposing costs on taxpayers. U.S. regulators have dramatically increased scrutiny on all these fronts, but now are considering a capital surcharge above Basel III levels that does not adequately account for the changes that have been made, and proposed margin requirements for derivatives transactions that risk doing extraordinary and unnecessary damage to the ability of U.S. firms to serve their clients.

Before turning to those two issues, I will review the current state of regulation, and its competitive impact on U.S. banks.

The Regulatory Landscape Post Dodd-Frank Act

It is critical not to underestimate the collective impact of Dodd-Frank and numerous other regulatory and supervisory initiatives designed to reduce risk at U.S. financial firms, and ensure that failed firms can be resolved without creating systemic risk or imposing loss on taxpayers.

Diminishing the Risk of Financial Institutions

Numerous regulatory initiatives are making U.S. financial institutions less risky, both by limiting the risk of the activities they undertake, and by dramatically increasing the amount of capital and liquidity firms must hold.

A Quick Inventory of Risk Reduction

Let me briefly highlight the host of recent initiatives designed to reduce risks taking by U.S. financial firms.

- All large U.S. financial institutions are now subject to Federal Reserve supervision and capital requirements.
- Off-balance-sheet activity has been reduced dramatically by heightened risk management practices, a FASB requirement that such structured products be consolidated on the firm's balance sheet, and dramatically higher capital and liquidity requirements for such obligations. Dodd-Frank's credit risk retention requirements for asset-backed securitizations are designed to improve the quality of the underwriting of the assets underlying such securities, and the SEC's Regulation AB overhaul will require a new and robust disclosure regime (including loan-level data) at issuance and on an ongoing basis.
- All large participants in derivatives markets – be they dealers or participants – are subject to supervision, reporting and margin requirements.
- Most derivatives trades will be centrally cleared, eliminating counterparty risk with other firms, and some will be exchange traded. The systemic impact of the failure of a derivatives dealer will thereby be reduced, provided that clearing houses are properly capitalized and managed.
- Originators of mortgages and other consumer products are now all subject to the same rules, and to federal supervision.
- Banks are prohibited from engaging in proprietary trading.

Thus, as a result of these post- financial crisis changes, Lehman Brothers would have been subject to the same Federal Reserve capital and prudential supervision as JPMorgan Chase, including extremely high capital charges for collateralized debt obligations (CDOs) and other exotic securities. AIG would have been required to register as a major swap participant, report on its positions, and subject itself to federal supervision. Countrywide and Washington Mutual would have been subject to the same mortgage underwriting standards as national banks, and would have been either significantly limited in making subprime loans or required to retain the risk of those mortgages. And the Financial Stability Oversight Council (FSOC) and the Office of Financial Research would have been gathering data on concentration risk and counterparty exposure, and empowered to act on their findings. These are very important changes.

Capital

Nowhere has change been more profound than with respect to capital. In addition to expanding the application of such requirements to all large financial institutions, U.S. regulators have agreed with other supervisors, through the Basel Committee on Banking Supervision's Basel III process, to a dramatic increase in regulatory capital requirements. I wish to be clear that JPMorgan Chase strongly supports the Basel III capital requirements, and believes that they will bring additional stability to the financial system without causing adverse consequences that outweigh these benefits. As I will discuss in a moment, it is a potential surcharge on Globally Systemically Important Financial Institutions (G-SIFIs) that is a bridge too far, and creates costs that risk exceeding the diminishing benefits of higher capital requirements above Basel III minimums.

As a frame of reference for how stringent capital standards are at this point, our analysis shows that at the Basel III 7 percent minimum, the nine likely U.S. G-SIFI banks, in aggregate, could absorb an instantaneous loss equal to two years of their average losses during the financial crisis – $203 billion – and *still* maintain a 5 percent Tier 1 Common capital ratio.[1] (The two-year time frame and 5 percent ratio were the standards required by the Federal Reserve under CCAR. The average two years of losses include losses both for the nine banks and the institutions they acquired during the crisis.)

As another frame of reference for current capital levels, consider that JPMorgan Chase entered the financial crisis with a ratio of tier 1 common equity to risk-weighted assets of 7 percent under the applicable capital rules (Basel I). (In other words, we held $7 in common stock or instruments of similar quality for every $100 of loans or other assets we had at risk.) Starting at that level, we were able to weather the financial crisis, *and* to acquire both Bear Stearns and Washington Mutual, and the chairman of Congress's Financial Crisis Inquiry Commission has stated that JPMorgan Chase would have survived the crisis without assistance. So, if the question is, "How much capital is necessary to weather the worst financial crisis in U.S. history?" the answer should be "about what JPMorgan Chase held."

With this in mind, note that the Basel III rules effectively would require JPMorgan Chase to hold approximately ***45 percent*** *more capital than it did during the crisis.* This is because the new 7 percent tier 1 common equity minimum standard under Basel III corresponds to more than 10 percent under its Basel I predecessor requirement in effect in 2007, particularly for banks having meaningful counterparty exposures and that are engaged in trading activity. This includes, through an interim measure called Basel II.5 that focuses on market risk – a 100 percent capital charge against high-risk securitization structures, including certain high risk CDOs, which contributed to losses in the recent crisis. It also includes a narrowing of the definition of what instruments count as capital, which we strongly support.

Liquidity

In addition to dramatically increasing capital requirements, Basel III also establishes an entirely new regime for liquidity requirements. There is no doubt that this was an important and

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[1] These nine are C, JPM, BAC, WFC, GS, MS, BK, STT and USB. Acquired companies whose losses are included are Bear Stearns, Wachovia, Countrywide and Washington Mutual.

necessary step, and will reduce systemic risk and increase safety and soundness once implemented. We do have serious concerns about some aspects of the liquidity coverage ratio and other initiatives, but these are beyond the scope of my testimony today.

Supervision

While regulatory changes are the part of oversight that the public sees, supervision by examiners occurs under the waterline but is every bit as significant. It is worth remembering that one reason national banks generally avoided subprime lending – and one reason unregulated entities were able to occupy that field – was pressure from the OCC to exit this business.

At any given time, we at JPMorgan Chase have 75-135 on-site, full-time examiners from the OCC, Federal Reserve and FDIC; the U.K. FSA and other regulators have still more examiners overseeing our overseas operations. We underwent 218 examinations in 2010, and will see more this year. It is difficult to overstate the increase in supervisory oversight for large financial firms.

Ensuring Resolution and Thereby Ending Too Big to Fail

Just as the examples above demonstrate that critical steps have been taken to reduce the likelihood of a large bank failure, other measures have been taken in the United States to lessen the impact on the financial system should a failure occur.

- The largest firms must draft recovery and resolution plans (also known as a "living will"), detailing the actions it would take to survive a crisis and its plan for liquidation, sale or recapitalization in an insolvency scenario. Supervisors oversee this process.

- Under Dodd-Frank, each large firm also must submit a recovery and resolution plan under the Bankruptcy Code.

- Under Dodd-Frank, in the event resolution under the Bankruptcy Code proves unworkable, the FDIC can be granted authority to resolve a financial services holding company in much the same way it has resolved banks.

- In the event it becomes receiver for a financial company, the FDIC is permitted to provide liquidity support to enable an orderly liquidation or recapitalization, with any losses borne by surviving companies.

The United States is ahead of the rest of the world: the FDIC's new authorities are already in place, while most countries have no plans for orderly resolution, and some have effectively acknowledged that their banks would be bailed out at taxpayer expense should a crisis occur. The United States is doing the hard work to make orderly resolution of large financial institutions a viable option, and JPMorgan Chase and other banks are devoting extraordinary resources to this unheralded project.

The European Union is debating a legal framework for resolution that is similar in approach to the U.K. Banking Act of 2009 and, if adopted and implemented, would be a useful step forward. Even then, however, such plans would be unproven and run against recent history. In contrast, the United States during the financial crisis allowed one of its largest depository institutions, Washington Mutual, and largest broker dealers, Lehman, to fail, with Washington Mutual being resolved through the FDIC process that has now been extended to non-banks. Hundreds of smaller banks have been closed by the FDIC. U.S. policymakers need to understand how unique this history is: most nations around the world have never allowed a bank of any size to fail in modern times.

This point is important because a country expecting to bail out its largest banks in the event of crisis might rationally insist on higher capital levels *ex ante* than one committed to orderly resolution at no expense to the taxpayer. The same might be true for a country still establishing its resolution framework or unsure of its practicality. U.S. banks should not suffer the worst of both worlds: preparing at extraordinary expense and dislocation for an orderly resolution, and suffering a capital charged premised on all recovery and resolution planning having been for nothing.

Further Insulation for Taxpayers

Aside from decreasing the risk of trouble at large financial institutions, Dodd-Frank also reduces the risk that a large institution's failure would impose costs on taxpayers. Under Dodd-Frank, if the FDIC suffers losses on liquidity support to a large financial institution in the course of resolution, other large firms must pay for those losses. It is worth noting that the Deposit Insurance Fund (DIF) and its predecessor, the Bank Insurance Fund, have never imposed a loss on taxpayers. JPMorgan Chase alone has paid approximately $3.5 billion in special assessments and prefunding of future assessments in order to recapitalize the DIF. Under the FDIC's new assessment scheme, JPMorgan Chase pays approximately $1.3 billion in deposit insurance premiums that cannot be justified based on the risks we pose to the deposit insurance fund, and are effectively used to pay for small bank failures.

The Limits of Regulation

All of these new requirements will substantially increase the safety and soundness of large U.S. financial institutions and decrease the risk of their causing systemic risk or economic harm. That said, no amount of regulation, or even overregulation, can guarantee that there will never be another financial crisis. So long as a financial system requires one group of people to lend money to another group of people for short periods of time – and any useful financial system must – there will always be the possibility of panic, and there will always be the need for the government as lender of last resort to provide liquidity to solvent institutions suffering a short-term liquidity crisis. This is why the Federal Reserve's discount window has existed since 1913. As well capitalized as JPMorgan Chase was during the financial crisis, we benefited from the liquidity programs provided by the Federal Reserve when short-term funding became unavailable to any firm at any price, regardless of credit quality.

Thus, at some point regulatory changes reach the limits of their utility, and the costs they collectively impose in terms of economic activity and growth and competitive harm outweigh diminishing marginal benefits. We have reached that point in U.S. regulatory reform.

The Shape of the Regulatory Playing Field Thus Far

As we near the one-year anniversary of the Dodd-Frank Act, European Union and individual countries in the EU are considering over a hundred different legislative initiatives, including a European Commission proposed European Market Infrastructure Regulation (EMIR) and a revision to the Markets in Financial Instruments Directive (MiFID). At this point, the European proposals are very complex and different from the U.S. approach in many areas, and their final form is very difficult to predict. We know enough, however, to be concerned that the regulatory landscape that emerges from the European political process may differ from that in the United States. Put another way, U.S. policymakers should not assume that a level playing-field will emerge from whatever European or Asian regulatory initiatives eventually take shape. The new regulatory environment has the potential to hasten rather than reverse the long-term competitive decline of the U.S. financial services sector, vis-à-vis our international competitors. For example:

- The Volcker rule has been rejected by every country to have considered it, and is not the law in any other country in the world in any form.

- U.S. banks are subject to among the highest level of supervisory scrutiny in the world, particularly when one recognizes that we are subject to supervision by multiple regulators (for example, Federal Reserve, OCC, FDIC, CFPB, SEC, CFTC, FTC, and state attorneys general and securities regulators) whereas most foreign financial institutions have only one or two.

- At this point, U.S. regulators have proposed draconian margin requirements, and proposed to apply them to U.S. firms operating abroad, which would effectively end their overseas business. We are hopeful that these proposals will be rationalized, but at this stage, the U.S. approach is an outlier compared to the rest of the world.

- Similarly, the European Commission appears to have decided to permit derivative trades within a banking group without the posting of margin, which we believe is appropriate, but only for transactions within a Member State of the European Union. Asian regulators have no plans for similar restrictions. The corresponding U.S. provisions require affiliates to post margin to one another, and would needlessly put U.S. financial services companies at a significant disadvantage.

- U.S. regulators subject U.S. institutions to stress tests of their capital that are, by all accounts, the most stringent of any country in the world.

- While U.S. securitization markets remain moribund and risk concentrates in Fannie Mae and Freddie Mac, European banks continue to fund their mortgage market through a multi-trillion dollar covered bond program that proved resilient through the crisis. (Fortunately, this

Committee has passed at a subcommittee level a bipartisan bill sponsored by Representatives Garrett and Maloney that would remove legal obstacles to establishing a similar market here in the United States.)

- With respect to capital, it is fair to note that European supervisors implemented Basel II in 2008, whereas U.S. regulators are still in the process of implementation. We believe, however, that the delay by U.S. regulators reflects a desire to ensure that the models necessary to implement it – the same models that will be necessary for Basel III – fully reflect risk. As I discuss below, there is evidence that implementation around the world has not always been consistent. In any event, the stress testing under Federal Reserve's recent Supervisory Capital Assessment Program (SCAP) and Comprehensive Capital Analysis and Review (CCAR), which required banks to demonstrate how they will meet Basel III standards, clearly represents an extraordinarily rigorous capital standard, and can fairly be seen as having leapfrogged Basel II to impose the toughest current capital standard in the world.

- As a general matter, Asian regulators appear to be waiting to see the judgments of both the United States and Europe before deciding whether and how to increase regulation.

Given this background, I would now like to discuss two areas that pose the greatest danger to U.S. competitiveness, and U.S. economic and job growth.

The Proposed Imposition of a Capital Surcharge on Large Financial Institutions

Let me first turn to proposals for imposing a capital "surcharge" on certain large banks – so-called global systemically important financial institutions, or G-SIFIs – including our own. For comparison, please note that the Basel III capital requirements were the product of a process that was transparent, thoughtful, deliberate and professional. A series of proposals were made public, their quantitative impact studied, and the proposals refined; this was done by experts in their fields. By contrast, the process for producing the G-SIFI surcharge does not at this point appear to share these attributes. The Dodd-Frank Act directed U.S. regulators to impose a capital charge on large banks, but only after notice and comment rulemaking, which has not occurred. Furthermore, there is no indication that Congress expected such a charge to be as large as some suggest some supervisors are considering, in the range of 100-300 basis points on top of Basel III minimums.

Too Much

Leaving aside procedural issues, there are several reasons to question the substance of such a charge:

- As described above, the 7 percent minimum already set by Basel III would effectively require JPMorgan Chase to hold 45 percent more capital than it took to weather the crisis. In the context of all the other changes being made, it is difficult to understand how one could justify a surcharge for U.S. banks in addition to this Basel III requirement.

- The results of the stress tests included in the Federal Reserve's recent CCAR process demonstrated that leading U.S. banks are appropriately capitalized under highly adverse stress scenarios. The results of the CCAR are particularly significant given their methodology, which included a replay of the financial crisis and recession over a two-year stress period.

- Basel III minimums were designed to apply only to large, internationally active banks, including G-SIFIs. And, as I have noted, the market risk charges of Basel II.5 – an increase in capital requirements of approximately 400 percent for many positions – apply primarily to large, internationally active trading banks – that is, G-SIFIs.

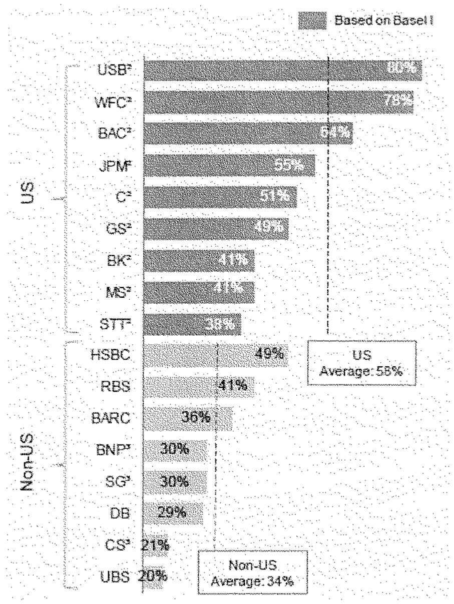
- Requiring capital at a level significantly above Basel III requirements will diminish investor appetite for large bank equity, which will require large banks to abandon more capital-intensive businesses, increase prices to earn a sufficient return on equity, or push banks to reduce the size of their balance sheets. Any of these options will have impacts on the U.S. economy.

  Commentators have argued that the delay of any surcharge until 2019 will mitigate adverse affects. We believe the truth is exactly the opposite. The market and banks will immediately gravitate to the new standards, at exactly the same time the financial system is adjusting to all the other regulatory impacts, further exacerbating pressure on the fragile economic recovery. Over the past few weeks, we have observed significant volatility on rumors of relatively larger or smaller surcharges.

Too Inconsistent

While current capital rules are consistent as written, there are strong reasons to believe that U.S. regulators are applying them far more strictly than other supervisors. The risk weighting of an asset has a direct effect on its capital requirement: an asset with a 100 percent risk weight requires twice as much capital as a less risky asset with a 50 percent risk weight. Whereas measuring a bank's qualifying capital is an objective and relatively simply process, determining the appropriate risk weight for a given asset is a complicated and increasingly subjective process, heavily reliant on modeling. One can gain a sense for how conservatively or liberally a bank is applying its models by comparing its risk-weighted assets to its total assets, as reported in financial statements (which is an objective number). Doing so, we observe large differences between U.S. and foreign firms.

4Q10 RWA % of Total Assets adj. for netting[1]



[1] Non-US banks total assets adjusted (when applicable) for disclosed derivative and repurchase agreement netting for purposes of comparability with US banks, which are subject to FIN 39 & FIN 41 US GAAP requirements.
[2] Based on Basel I 4Q10 disclosed data. Under Dodd-Frank US banks must continue to calculate Basel I and Basel III capital ratios and then use whichever of the two ratios requires a higher level of capital.
[3] Netting adjustments not disclosed

Of course, it is theoretically possible that U.S. firms simply hold more risky assets than their foreign competitors. But this seems unlikely given that we compete in the same markets and tend to hold similar assets, and in some cases opposite sides of the same trade. The more plausible explanation is that our competitors apply a more favorable risk weighting. This means, though, that the effective capital rate for a large U.S. bank already is considerably higher than its foreign competitors.

The Basel Committee has recognized the need for peer review to ensure that its standards are implemented consistently, and U.S. regulators have stressed the importance of including risk-weighted asset calculations in any such review. It is premature, however, to impose a surcharge on U.S. banks that could substantially exacerbate an existing competitive disparity; U.S. regulators should withhold judgment on any surcharge until they are convinced that the playing field is level.

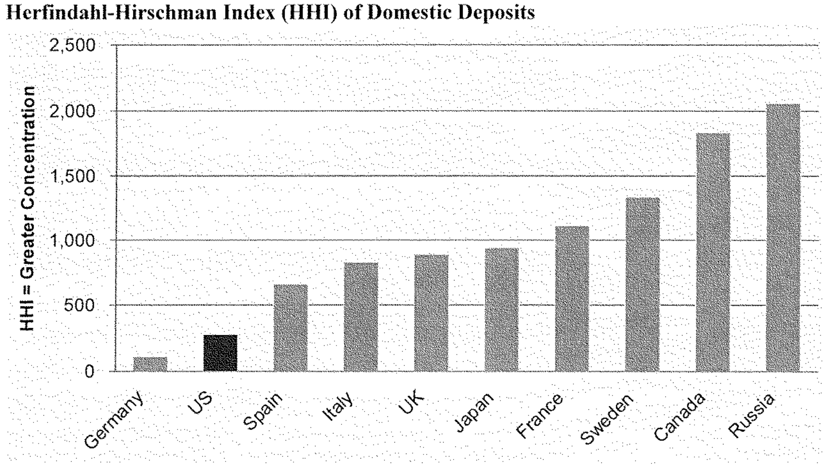
Too Different

Even leaving aside implementation of Basel III, it is striking how differently the United States has responded to the financial crisis from almost all other major countries. As I have outlined, every other country has rejected the Volcker rule; almost every country has failed to adopt plans for orderly resolution of SIFIs; no country has yet to propose margin requirements, and none is likely to adopt a scheme like the one here. No other country has both the present intent and long history of surviving banks covering the losses of failed banks; many have neither. Other national differences provide additional legitimate reasons why one country might impose a capital surcharge while another might refrain. As Secretary Geithner recently noted, the three largest U.S. banks account for 32 percent of total banking assets in the United States, in comparison to 46 percent for the three largest in Japan, 58 percent in Canada, 63 percent in the UK, 63 percent in France, 70 percent in Germany, 71 percent in Italy, and 76 percent in Switzerland.

Higher capital requirements may be more necessary in countries where the size of the banking sector rivals (or exceeds) the size of the economy, and thus where banks are "too big to save." For example, Switzerland, which has chosen to implement minimum capital requirements above Basel III levels, has a much higher concentration in its banking system than the United States; the same is true for the United Kingdom, which has advocated a high G-SIFI charge. (That said, it is worth noting that the ratio of risk weighted assets to total assets for Swiss banks is among the lowest of those measured, so a higher ratio tends to correct for that imbalance.) There are also serious concerns in the United Kingdom regarding oligopolistic pricing, and that the removal of a competitor would leave consumers without meaningful choices and with higher, oligopolistic prices, which is not the case here. (The U.K. government has established an Independent Banking Commission to consider issues of competition and stability.)

U.S. deposits are much less concentrated compared to most other countries, at least in part because of a federal law prohibiting any bank from making an acquisition that would leave it with more than 10 percent of U.S. insured deposits.

Herfindahl-Hirschman Index (HHI) of Domestic Deposits



Sources: Celent report "Too Big to Bail? Bank Concentration in the Developed World" (June 22, 2009).

Thus, even if U.S. regulators could ensure that the same capital standards would be adopted and applied consistently across the world, there are powerful, entirely legitimate reasons why the United States could and should decide to impose little or no surcharge on large banks.

Counterpoint

Let me now discuss some of the rationales we have heard offered for a G-SIFI surcharge.

Argument 1: Dodd-Frank and our existing regulatory regime focus only on firm-specific risks but not on the greater systemic risks posed by G-SIFIs, and a new surcharge is required for the marginally greater systemic impact of a G-SIFI failure.

We believe that this argument (1) seriously understates the impact of existing regulation and the Dodd-Frank Act's reforms; (2) draws the wrong lessons from the financial crisis; and (3) relies on unproven academic theories in claiming that an appropriate G-SIFI surcharge can be determined based on societal impact.

First, as described, an extraordinary amount of existing and ongoing financial regulation is designed to reduce the systemic risk of large financial institutions, particularly their wholesale operations, where there is the greatest chance of interconnectedness and therefore systemic risk. Central clearing of derivatives reduces systemic risk. Margin requirements reduce systemic risk. Reporting and supervision of positions reduce systemic risk. Subjecting all dealers regardless of charter to the same capital requirements reduces systemic risk. Basel II.5, which dramatically increases – often by 400 percent or more – the capital charge on trading positions held by large banks, decreases systemic risk, because it is in these positions that systemic risk resides. Basel III applies some of its highest capital charges for interbank trades, not because the firm specific risk is high but because their systemic risk is high. A new resolution procedure created especially for systemically important institutions, and modeled on proven methods for resolving large banks, reduces systemic risk. The creation of an FSOC specifically charged with identifying risks to financial stability should reduce systemic risk.

Certainly, no U.S. regulators objected to the Dodd-Frank Act on the grounds that it was not addressed to reducing systemic risk, and was myopically and inappropriately focused only on firm-specific risk. To the contrary, Congress was told, correctly, we believe, that Dodd-Frank would substantially reduce systemic risk.

Second, the worst moments of the financial crisis arose from a liquidity crisis. As in past crises, capital proved to be a poor and lagging predictor of failure; rather, firms that held long-term assets and short-term liabilities without a stable source of emergency liquidity were most likely to fail. While the TARP injection of preferred stock in the largest banks was an important step, the liquidity facilities and guarantees put in place to stem runs on money market funds and a complete breakdown in the commercial paper market were of at least equal importance. Higher capital levels alone would not have been an answer to this problem.

Third, attempting to quantify the impact of a firm's failure on the financial system as a whole is at this point neither art nor science. We understand that some academic papers attempting this estimate have been published, generally by their own acknowledgement neither in final form nor peer reviewed, all extraordinarily hypothetical, and none grounded in a post-Dodd-Frank regulatory framework.

Argument 2: Recent academic papers assert that, under corporate finance theory, capital requirements can be increased ad infinitum without affecting demand for bank equity because investors will be indifferent to a loss of return in exchange for reduced risk. In other words, having regulators rather than investors determine the appropriate amount of capital required for one type of company (banks) – and having regulators make that determination based on factors different from those investors would consider – will make no difference in investor appetite.

Recent, actual, investor sentiment is quite contrary to this theory. Investors uniformly report that one of the greatest depressants on banks stocks currently is uncertainty about future capital requirements, and the G-SIFI surcharge in particular – the same capital requirements and surcharge that academic theory told us should be a matter of indifference to these investors. Equity analysts recently have downgraded large U.S. banks stocks based in part on potential higher capital requirements – while theory says they should be indifferent to increased capital requirements.

Argument 3: It is good to impose handicaps on large banks because small banks can meet the same needs for funding without imposing systemic risk.

It is worth noting what a radical change to banking supervision this argument implies. It would dictate that a loan to a given company should carry a different capital charge depending solely on who makes the loan. In short, it uses capital requirements – which have always been linked to safety and soundness in general and the risk of loss in particular – as instead a mechanism for imposing competitive change. We believe this would be an extraordinarily unwise step to take, and would represent a potential politicization of banking supervision that should greatly concern policymakers.

Furthermore, as noted at the outset, it is highly unlikely that small banks would replicate large bank functions for U.S. companies. Our commercial business with medium- and large-size companies – providing credit and liquidity – will flow to foreign banks who already serve such customers in the United States. Even to serve smaller companies, small banks would need to raise substantial amounts of equity to replicate large bank lending at a similar price.

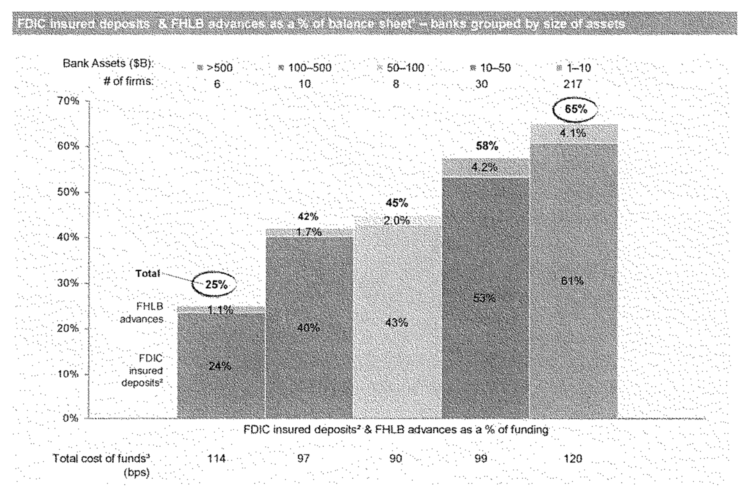
Argument 4: SIFIs are the product of artificial growth due to a funding advantage, and therefore higher capital charges will simply offset this subsidy and return them to their "normal" economic size.

As previously noted, large global banks (U.S. and foreign) reflect a global economy where corporations require cross-border funding options, and the ability to raise significant amounts of funding very quickly.

The notion that large banks have a material funding advantage over small banks appears to be incorrect. Academic studies tend to attribute any funding advantage in debt markets to a belief by debt holders that they will be bailed out in the event of default. However, these studies have not been updated to reflect recent changes to law and in any event failed to consider adequately whether larger firms' debt trades better because of liquidity or other factors.

Even leaving aside that question, however, the fact is that most small and mid-sized banks rely for their funding primarily on low-cost government guaranteed or government sponsored funds. As the chart below shows, using 2010 data, the average cost of funding for large banks is therefore *higher* than for small- or medium-sized banks. The reason is funding mix: large banks (over $500 billion in assets) derive only 22 percent of their funding from insured deposits and Federal Home Loan Bank advances; the equivalent number is 47 percent for banks between $100 and $500 billion; 53 percent for banks between $50 and $100 billion; 58 percent for banks between $10 and 50 billion; and 65 percent for banks below $10 billion.

Small banks are ~2.5x more reliant than the largest banks on government-insured and government-sponsored funding sources



Source: SNL, regulatory financials. Data as of 12/31/10. Includes all 282 listed US banks and broker / dealers with assets>$1B and available BHC financials.
1. Percentages based on a weighted average
2. Insured deposits based on banks' reported estimates where available; FDIC estimate used otherwise
3. Cost of funds equals interest expense divided by average interest-bearing liabilities plus average non-interest bearing deposits (interest-bearing liabilities include deposits, Fed funds, repos, subordinated debt, trust preferred securities and other borrowings)

JPMorgan Chase & Co.

<u>Derivatives Regulation</u>

The Dodd-Frank Act takes numerous actions to reduce the systemic risks posed by derivatives. Many of those actions – position reporting, some margin requirements – are a prudent response to the financial crisis. There are two areas, however, where we have significant concerns.

Push Out

Under section 716 of Dodd-Frank, U.S. banks must push out credit, equity, and commodity derivatives into separately capitalized subsidiaries.

Most rules imposed by Dodd-Frank involve difficult trade offs – for example, between reduction of risk and preservation of market liquidity, between safety and soundness and credit availability. The push-out rule of section 716, however, decreases market liquidity, impairs safety and soundness; increases systemic risk; and makes large banks more difficult to resolve. The only justification offered for it has been to deprive banks of a marginally better cost of funding at the bank level than they could obtain in a holding company affiliate. Not surprisingly, this requirement has not been adopted by any other country in the world, and has been publicly opposed by Chairman Bernanke, Acting Comptroller Walsh, and FDIC Chairman Bair, among numerous others.

The implications of this requirement are profound:

- Operational risks increase, as positions must be managed in multiple units.
- Costs to customers increase.
- Risk management will be more difficult, because the requirement to book transactions in multiple legal entities will result in either a proliferation of trading books or numerous intercompany transactions to reconsolidate risk into a single entity.
- Because customers prefer to face a bank as counterparty, our foreign bank competitors, not subject to such a requirement, will receive a competitive advantage.

Also under section 716, affiliates within a bank holding company will be required to post margin to each other. We believe this provision will impair rather than assist safety and soundness, and is unwise. The European Union is so concerned about such an approach that it is actively considering a specific exemption from EMIR, to avoid the need for margining in intra-group transactions, at least where individual jurisdictions are concerned.

Congress should repeal or significantly amend section 716.

Margin Requirements

Margin is a means of reducing counterparty risk in derivatives transactions. Depending on the type of counterparty, its financial strength and a firm's credit policies, a counterparty might be required to post initial or variation margin. Variation margin is collateral that a party posts to cover credit exposure arising from market movements – that is, to the extent the trade moves against one party and the other party wants to secure its exposure. Initial margin is collateral posted at the outset of a transaction as protection against potential future market movements.

While market practice has grown more conservative in the wake of the financial crisis, the margin rules proposed by the banking agencies are far more stringent. The banking agencies have recently proposed margin regulations for swaps that are not cleared. These regulations were issued pursuant to section 731 of Dodd Frank, which directs the agencies to issue rules that are "appropriate for the risk associated with the non cleared swaps . . . ." The draft regulations that have been issued will have two consequences: first, as applied (uniformly) in the U.S. market, overly stringent margin requirements will make it more difficult for our clients to manage risk by increasing the cost and risk of doing so; second, if applied overseas, and if foreign banks are able to continue adhering to current market practice, the proposed margin rules will quite simply put us out of business overseas.

The draft rules impose a highly prescriptive margining regime to uncleared swaps between swap dealers and virtually all financial end users, which require all financial end users to post initial margin and variation margin with zero thresholds. By imposing the same requirement on all financial end users, the draft rules ignore the mandate of Section 731 that the margining regime be risk based. There are significant differences in credit quality between various classes of financial end users, ranging from hedge funds at one end of the spectrum (most hedge funds already post variation margin and initial margin under current market practice) to sovereigns and supranationals at the other; many entities do not currently post margin under current market practice due to their financial strength. Imposing a "one size fits all" margining regime on all financial end users violates the intent of the statute and will impose significant and unnecessary burdens on many financial end users that will inhibit their ability to manage risk.

The draft rules also impose a margining regime on non-financial end users, despite the absence of any evidence that swaps with non-financial end users create systemic risk or contributed in any way to the financial crisis. Congress acknowledged this when it provided for a broad exemption from the clearing requirement for non-financial end users using swaps to hedge commercial risk. By requiring all non financial end users to negotiate credit support arrangements with their swap dealers, the draft rules raise the specter of margin requirements applying to the hedging activities of thousands of Main Street American companies. This has the potential to divert scarce capital from the balance sheets of these companies, inhibit job creation and impact their international competitiveness. These are all results that the Congress was clear to avoid when it exempted swaps with non-financial end users from the clearing requirements of Dodd Frank; we do not believe it intended to allow the same outcome through margin requirements.

As noted above, the draft rules also provide for uniform extraterritorial application of the margin rules on uncleared swaps, despite the clear statement in Title VII that extraterritorial application of the statute should be permitted only in unusual circumstances. The potential impact of extraterritorial application of U.S. margin rules cannot be overstated, given that adoption of similar rules is at least 18 months away in Europe, with no assurance that the eventual rules will be equally stringent. Thus, for at least the foreseeable future, if a French pension fund, a Dutch company, or an Asian sovereign wealth fund wishes to enter in a derivatives transaction, European or Asian banks will not require them to post margin; if Dodd-Frank is read to require U.S. banks to do so, we will simply lose this business. Furthermore, since most companies seeking debt underwriting require a derivative as part of their funding plan – for example, a German firm may wish to issue debt in dollars and swap to euros – we would be unable to compete in those markets as well. The competitive impact of applying the margin rules to our swap activities overseas is exacerbated by very prescriptive and restrictive rules governing what types of margin are eligible under the proposed regime. By restricting eligible margin to U.S. dollar cash, Treasuries and Agencies, the proposed rules will put U.S. banks in the position of demanding margin from our overseas clients when our competitors do not; in addition we are not permitted to accept margin in the form of, for example, Euro Cash and G7 Sovereign Debt, which are common forms of permitted collateral in European markets. The effect of this will be to kill our overseas swaps activities; even if Europe and other regulators were to subsequently adopt similar rules, it would be too late.

Congress could have passed a law prohibiting U.S. banks from operating an overseas derivatives business, but it did not. In fact, it never even considered doing so, and never would, given the vital importance of this business to U.S. financial firms. And yet the interplay of a CFTC/SEC registration requirement and a margin proposal from the bank regulators risks the same result. Under the terms of Dodd Frank, which include a specific mandate against extraterritorial application of rules in this area, the CFTC and SEC should not require a foreign branch or subsidiary of a U.S. bank to register as a U.S. swap dealer unless it is doing business in the United States. It should not be required to register if it is located overseas and only doing business with foreign companies or overseas offices of U.S. companies.

Meanwhile, European policymakers also have concerns about the extraterritorial application of Dodd-Frank. The European response appears to have been to add similar extraterritorial provisions to EMIR, in a form of quid pro quo. We understand that these issues were raised during the visit of Commissioner Barnier earlier this month, but we are concerned about the potential for an outcome in which both U.S. and EU legislation creates damaging extraterritorial effects. Such a scenario can only be to the detriment of both jurisdictions.

Role of FSOC & Congress

We are pleased that Congress has chosen to exercise oversight of these issues – particularly capital, where the stakes for our economy are so high and deliberate consideration is needed given the potential impact on U.S. competitiveness, credit availability and job creation. Clearly, the FSOC also has a role to play, given the systemic implications of these provisions, and the need to understand not just the rules of each agency but how those rules interrelate, and how they affect the competitiveness of U.S. firms.

Dodd-Frank requires regulators to provide the public – including the affected institutions and the clients they serve and, not incidentally, the Congress – notice and the opportunity to comment on a proposed rule *before* it is adopted, not after international negotiations have made its adoption a *fait accompli*. We believe that the FSOC's Volcker study was an important contribution, and believe that the FSOC should coordinate work in other areas as well.

Conclusion

Thank you very much for this opportunity to present the views of JPMorgan Chase, and I welcome any questions you might have.

The Clearing House

June 15, 2011

The Honorable Timothy F. Geithner,
Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Ben S. Bernanke,
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

The Honorable Sheila C. Bair,
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Mr. John G. Walsh,
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Re: Application of Surcharges to Systemically Important Financial Institutions in the United States

Dear Sir or Madam:

The Clearing House Association L.L.C. ("**TCH**"), an association of major commercial banks,[1] is deeply interested in U.S. and international initiatives to reform capital and liquidity regulation and, more broadly, in the overall debate over financial institution regulatory and resolution reform.[2] In this regard, we are writing to express concern with respect to the direction and the potential application of a capital surcharge to systemically important financial institutions ("**SIFIs**")[3] in the U.S., in the context of both the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the ongoing international cooperative efforts under the auspices of the Financial Stability Board (the "**FSB**") and the Basel Committee on Banking Supervision (the "**Basel Committee**").

Public statements from the academic and official sectors have included consideration of the imposition of a significant capital surcharge on some U.S. banking institutions[4] in an amount potentially as large as 100% of the combined Common Equity Tier 1 ("**CET1**") ratio (minimum plus macroprudential conservation buffer) required under the Basel Committee's recently finalized global capital and liquidity standards commonly referred to as "**Basel III**."[5] Because banking institutions are likely to maintain some "cushion" above required regulatory ratios to offset unexpected developments (and to accommodate the volatility introduced by Basel III's requirement that accumulated other comprehensive income ("**AOCI**") not be filtered out of Tier 1 capital calculations), as a practical matter, banks will maintain CET1 ratios at levels that exceed the amount required to satisfy the required effective CET1 ratio plus any applicable surcharge for SIFIs.

To be clear, TCH strongly supports ongoing regulatory reform efforts that aim to make the U.S. and international financial systems safer and more robust—both from a firm-specific microprudential and, to the extent applicable in the context of a particular firm, a broader systemic macroprudential risk perspective. As a key element of enhanced regulation, TCH supports strong capital and liquidity ratios and the U.S. bank regulatory agencies' objectives of minimizing systemic risk and preventing future financial crises. We believe that the financial crisis demonstrated a direct correlation between the risk of failure and the level of a bank's capital. That correlation, however, was most evident with banks that maintained capital levels *far below* the more strongly capitalized banks.

The imposition of any significant capital surcharge on U.S. SIFIs is premature in view of the substantial capital increases, and other regulatory enhancements, that in practice are being imposed on U.S. SIFIs earlier than on most non-U.S. SIFIs. We also believe that it would be imprudent to rely on academic models and theories, to the extent untested, to conclude that considerably higher capital requirements will not have significant adverse consequences on U.S. banks' capacity to support a still fragile economic recovery.

We believe that a measured, transparent and deliberate course should be pursued in connection with determining the U.S. approach to a SIFI surcharge. A presumptive rush to judgment that "more is always better" when it comes to capital should be avoided given the uncertainties and complex questions regarding the analytical underpinnings and calibration, as well as the at best uncertain marginal benefits, of a SIFI capital surcharge when compared to the risks to U.S. economic growth and jobs and the international competitiveness of U.S. banking institutions.

I. Executive Summary

As further detailed in this letter, TCH believes:

- A decision to impose a capital surcharge on U.S. SIFIs must be informed by the robust increase in capital levels already mandated by Basel III (and Basel II.5). As a result of the imposition of Basel III's quantitative, qualitative and risk-weighting requirements, the 7% minimum combined CET1 ratio under Basel III is nearly *triple* the amount of Tier 1 common equity currently required by the U.S. banking agencies for an institution to meet the "well-capitalized" requirements under their prompt corrective action regulations (that is, an implicit 4.5% Tier 1 common equity requirement under those regulations[6] compared to a 13% Tier 1 common requirement, which approximately equates to a 7% CET1 ratio under Basel III).

- The significant macroprudential reforms introduced by the Dodd-Frank Act, including orderly-liquidation authority, living wills, regular stress tests, and the migration to centrally cleared swaps, provide U.S. regulators with strong tools to minimize systemic risk and must also inform the amount and composition of any SIFI surcharge.

- The marginal utility of significant capital surcharges for SIFIs is minimal at best because the Basel III requirements, including the capital conservation buffer, in and of themselves would very likely be effective in preventing both microprudential risks to financial institutions and macroprudential risks to the global economy.

- Capital stringency should be evaluated in the context of the entire framework of capital regulation, including Basel II, the market-risk rule revisions in Basel II.5 and possible differences in the application of parts of the Basel III standards to SIFIs and other large banks versus the banking industry as a whole.

- Empirical analysis demonstrates that the marginal macroprudential benefits, if any, of a significant surcharge may be minimal given the fact that financial institutions that had capital levels at or slightly below the new Basel III effective minimum did not require extraordinary individual government assistance in the recent crisis.

- A significant SIFI-capital surcharge could impose unnecessary economic costs on U.S. banking institutions and their customers, slowing the pace of the still fragile recovery and lowering job growth. We believe it would be unwise to rely on untested academic models and theories to reach definitive conclusions to the contrary.

- A gradually phased-in approach to implementing a significant SIFI surcharge for U.S. banking institutions will not necessarily ameliorate its negative consequences. Recent experience shows that both markets and U.S. regulators expect, as a practical matter, near immediate implementation of new capital requirements.

II. Key Issues

A. Any significant capital surcharge on U.S. SIFIs is premature in view of the substantial capital increases, and other regulatory enhancements, that in practice are being imposed on U.S. SIFIs earlier than on most non-U.S. SIFIs.

Basel III has imposed a sweeping new capital regime on U.S. SIFIs. The new requirements include:

- a new CET1 standard of 7% (the 4.5% minimum requirement plus the 2.5% capital conservation buffer);

- required total deductions or 250% risk-weighting (for items that are not otherwise fully deducted) for three categories of assets that represent a far greater proportion of the assets of U.S. SIFIs than other SIFIs: mortgage-servicing rights, deferred tax assets and investments in other financial institutions;

- a requirement to multiply the asset-value correlation, used in the risk-weight formula for wholesale credit, by 1.25 for all credit-sensitive transactions between certain large financial institutions; and

- various requirements that significantly increase the risk weights of derivative exposures not cleared with central counterparties.

In addition, shortly before Basel III was proposed, Basel II.5[7] substantially revised the capital treatment of assets held in the trading book, imposing several new, overlapping risk-measurement requirements and, in the process, significantly increasing the capital charge associated with the trading book.

The new Basel III requirements will translate into a CET1 requirement of approximately $1.0 to $1.1 trillion of common equity for U.S. banking institutions in the aggregate.[8] This represents a *greater than 100%* increase from the approximately $450-$500 billion of common equity at December 31, 2007. Moreover, it is quite unlikely, due to prudential, regulatory and market pressures, that banking institutions will choose to operate at the effective minimum CET1 ratio required under Basel III. In addition, AOCI volatility serves to increase effective capital needs.[9] Under current regulatory reporting practice in the United States, unrealized gains and losses are "filtered out" from the calculation of Tier 1 capital. Under Basel III, they would no longer be. Including unrealized gains and losses when calculating the minimum required ratios and buffers under Basel III can introduce substantial volatility into a banking institution's capital ratios. Many of these securities may be classified as "available for sale," and, as a consequence, increase the volatility of these institutions' capital. As such, a more realistic estimate is that Basel III (before any SIFI surcharge) will actually require an aggregate of almost $1.2 *trillion* of common equity for the U.S. banking industry as a whole. In terms of ratios, the increase is even sharper. For example, the new 7% Basel III CET1 requirement, as indicated above, is equivalent to a Tier 1 common equity ratio of approximately 13% under the current Basel I rules.[10]

Of particular importance, the Basel III requirements are—for all practical purposes—already fully effective for U.S. SIFIs, unlike at least most non-U.S. SIFIs. Notwithstanding the prolonged Basel III phase-in period, the November 17, 2010, supervisory-capital guidance addendum (the "**Temporary Addendum**") issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), which is formally applicable to the 19 bank holding companies that were subject to the Supervisory Capital Assessment Program ("**SCAP**"), effectively implements those requirements immediately. The Temporary Addendum essentially conditioned the approval of capital plans containing increased dividends on meeting Basel III CET1 ratio requirements on a fully phased-in basis. Pursuant to the Temporary Addendum, institutions that meet the minimum Basel III capital ratios as they become applicable during the transition period but remain below the Basel III 7% CET1 ratio target are "expected to maintain prudent earnings retention policies with a view toward meeting the [7% target] as soon as reasonably possible." In addition, it is our understanding that the Federal Reserve has less formally, but no less decisively, conditioned expansion proposals on full and immediate compliance with Basel III.

B. The significant reforms introduced by the Dodd-Frank Act already provide the regulators with strong macroprudential tools to minimize systemic risk and must also inform the amount and composition of any SIFI surcharge.

The Dodd-Frank Act introduced a number of reforms specifically intended to implement the lessons learned from the financial crisis and to eliminate various perceived sources of macroprudential systemic risk, including prohibitions and restrictions on certain financial activities,[11] orderly-liquidation authority,[12] living wills,[13] regular stress tests,[14] concentration limits on expansions,[15] the migration to centrally cleared swaps,[16] the ability to require the prudential supervision of systemically important non-bank financial entities,[17] improvements to the securitization markets (including enhanced disclosures and risk retention requirements),[18] reforms of the credit rating agencies[19] and the establishment of the Financial Stability Oversight Council to coordinate detection and response to systemic risks.[20] To date, most of these reforms have not been broadly adopted by other countries, and it remains uncertain whether they will in the future. The Dodd-Frank Act goes a long way to minimize systemic risks even in the absence of a SIFI capital surcharge. As such, we strongly believe that these other systemic reforms should be taken into account when examining the issue of a U.S. SIFI surcharge.

We agree that meaningful reform must address the "risk of *disorderly failure* of SIFIs".[21] The issue is not any failure of a SIFI *per se*, but a disorderly failure. Accordingly, a pillar of regulatory reform should be the development of a system and related measures that assure that any failure of a SIFI is orderly rather than disorderly. We believe that efforts to enhance resolution regimes such as the orderly-liquidation authority in Title II of the Dodd-Frank Act provide a comprehensive and considered structure to guard against disorderly failures and should be taken into account when examining the nature and extent of a SIFI surcharge.

The Dodd-Frank Act's systemic risk provisions already have a negative competitive impact on U.S. banking institutions. This competitive disparity would be compounded if the U.S. adopted a SIFI surcharge in advance of an international consensus or in excess of such a consensus. Certainly, if the U.S. nevertheless determines to impose some form of a SIFI surcharge, this surcharge should not exceed international standards agreed upon by the FSB and Basel Committee in order to further the goal of decreasing systemic risks to the financial system because the Dodd-Frank Act's other systemic provisions already otherwise serve to bolster macroprudential soundness.

In addition, TCH strongly believes that the mandate for "more stringent" capital standards under Section 165(b) of the Dodd-Frank Act does not require an additional capital charge for SIFIs beyond the increased requirements recently imposed through the Basel III process. Capital stringency should be evaluated in the context of a comparison of the entire framework of capital regulation applicable to SIFIs, including Basel II, the market-risk rule revisions in Basel II.5 and the application of the Basel III standards to SIFIs versus the remainder of the banking industry as a whole.

C. Empirical evidence demonstrates that banking institutions on a worldwide basis that had capital levels at or slightly below the new Basel III effective minimums did not suffer serious financial distress in the recent crisis.

In analyzing the performance of banks during the recent financial crisis, McKinsey examined data concerning 124 banks worldwide with more than $68 trillion in assets in the aggregate. The study determined that no institution that entered the 2007-2009 crisis with a CET1 ratio (calculated in accordance with Basel III rules) greater than approximately 6.25% (that is, 75 basis points lower than the Basel III minimum and 150 basis points lower than where firms are likely to operate) failed, was placed into governmental receivership, was acquired under duress by another financial institution or received a substantial, individually-directed governmental capital investment.[22]

This result is also consistent with a preliminary review of publicly available data to determine how the four largest U.S. banks would perform under stress conditions using SCAP stress scenarios. Such stress conditions resulted in a 120 basis-point reduction in CET1 ratios over an eight-quarter *pro forma* time horizon. This reduction is well within the Basel III 2.5% conservation buffer.[23]

The Basel III CET1 ratio requirement would appear to have been sufficient to prevent serious financial distress at banking institutions throughout the world even through the severe disruptions of the financial crisis. The marginal utility of additional significant capital surcharges for SIFIs, therefore, is likely to be minimal because the Basel III requirements, including the capital-conservation buffer in and of themselves would very likely be effective in preventing both micro-financial risks to financial institutions and macroprudential risks to the global economy. Indeed, the primary goal of the capital conservation buffer within Basel III is macroprudential, rather than microprudential in nature.[24] The source of systemic risks proved to be institutions that were undercapitalized by the new Basel III standards or would have been wholly exempt from them. The inadequate capitalization of the weakest banking institutions during the recent crisis should not lead to the conclusion that the strongest banks now need more capital above and beyond Basel III in the form of a significant capital surcharge. Moreover, although it is true that all banks—including the strongest capitalized banks—faced liquidity pressures during the financial crisis, the formal Pillar 1 Liquidity Coverage Ratio and Net Stable Funding Ratio elements of Basel III are specifically designed to address such concerns.[25]

D. A significant capital surcharge imposes unnecessary risks of limiting SIFI lending, potentially slowing the pace of the recovery and lowering job growth.

1. A significant SIFI surcharge creates a meaningful risk of economic cost.

Material SIFI surcharges are not a cost-free proposition. Imposing materially higher capital requirements on banking institutions is likely to lead to decreased availability of credit as firms are encouraged to shrink their balance sheets (that is, by decreasing the denominator of the CET1 ratio calculation) in order to deal with the effects of such increases.[26] In addition, as higher capital requirements (that is, in the numerator of the CET1-ratio calculation) cause banking institutions' return on equity ("**ROE**") to decrease, such firms acting rationally will need to attempt to improve such results by increasing the price of credit to generate greater returns. As even some proponents of higher capital requirements acknowledge,[27] these bank actions could potentially have material negative effects on the economy, slow the pace of the recovery and lower job growth at a particularly difficult juncture for our country.

Although these potential negative economic effects are present in connection with increased bank-capital requirements in general, and are not unique to the imposition of a significant capital surcharge, they are most likely to occur in connection with "marginal" capital requirements (that is, those above both economic-capital requirements and the requirements imposed by competition), such as large surcharges. The key question from a policy perspective should be whether the potential benefits associated with a significant SIFI-capital surcharge outweigh the potential disadvantages. Given the uncertain utility of such a surcharge in light of the robust nature of the Basel III capital framework and other regulatory requirements as described above, we believe that the macroprudential benefits, to the extent applicable in the context of a particular firm, of a significant SIFI-capital surcharge are not likely to outweigh the very real risks such a surcharge would pose to the U.S. economy. At minimum, the introduction of such a surcharge is premature at this time.

2. The hypothetical mitigating factors of the costs of a significant capital surcharge are uncertain at best and pose their own macroprudential systemic risks in practice.

First, in contrast to what some proponents of a significant SIFI surcharge have posited, there is substantial uncertainty as to whether smaller banking institutions would be able to fulfill the credit needs that SIFIs no longer can due to higher capital requirements as described above. Furthermore, many of these smaller institutions in the U.S. continue to struggle with their own asset quality problems and need to raise additional capital.[28] The availability of these activities as a service to customers (whether a credit product or another service) will thus diminish or shift to "shadow" entities outside not just regulatory capital requirements, including the SIFI surcharge, but are outside the broad framework of prudential regulation entirely.

Even if the shadow banking system could conceivably fill any unmet credit needs, in view of the shadow banking system's role in lowering credit standards during the last decade[29] and the absence of regulation and transparency, a migration to that system, even if it occurred, would have negative implications for the macroprudential health of the financial system as a whole.[30] In addition, the shadow banking system can exhibit volatile and intermittent flows compared with the traditional banking system's credit intermediation function, and this lack of reliability as a source of funding would subject borrowers to marketplace vagaries, often at the time of greatest need. Contrary to the objective of a SIFI surcharge, neither of these outcomes is likely to decrease systemic risk, and each may in fact contribute to it.

Second, proponents of significant SIFI surcharges have also argued that, as a result of higher capital requirements, investors will accept lower rates of return and thus offset the decreased ROE that will likely result from having to hold additional capital.[31] We believe that the theory of lower leverage leading investors to require lower ROE from banking institutions is unlikely to hold true in practice. For equity investors to be willing to accept lower returns for holding a banking institution's equity, they would need to conclude that, as a result of holding more capital, the firm's level of risk had lessened by an offsetting amount that warrants lower returns. Such a conclusion appears unlikely to be true. Moreover, in the experience of our members, equity investors, whether in banking institutions or other types of entities that compete for investable funds, are not low ROE investors. If these investors wanted to lower the expected return of their investment portfolios in exchange for a reduced risk of loss, there are a variety of bond and other fixed-income products that would allow them easily to accomplish this result more effectively.

We believe that any decreases in ROE (on a percentage basis) are likely to far exceed any offsetting benefits in the form of lower cost of equity ("**COE**"). In analyzing this issue, McKinsey estimates that, under the increased capital requirements of Basel III (even before any SIFI surcharge), ROE is expected to fall by approximately 250-300 basis points, with each additional percentage-point increase from the proposed SIFI surcharge reducing ROE by an additional 50 basis points.[32] Even when assuming that lower leverage does in fact lead to decreased COE, the resulting hypothetical decrease resulting from Basel III would likely only be approximately 80 basis points, with each additional percentage-point increase in capital from a significant SIFI surcharge decreasing COE by only an additional approximately 20 basis points. As such, the expected hypothetical decrease in COE would be significantly less than the very real expected ROE drop resulting from a significant SIFI surcharge.

Regardless of whether the premise regarding some relationship between lower leverage and COE proves correct, the imposition of a significant SIFI capital surcharge can be expected to further decrease ROE substantially. Such an additional decrease in ROE will pose heightened challenges for attracting capital to U.S. banking institutions as they seek to meet the crucial financial intermediation needs of our economy.[33]

E. A gradually phased in approach to implementing a significant SIFI surcharge will not, as a practical matter, ameliorate its potential negative consequences due to regulatory pressure and market expectations.

The proponents of a significant SIFI-capital surcharge have maintained that the effect would be ameliorated by a phased in transition period. This transition period is apparently meant to deal with acknowledged concerns regarding COE issues and the perceived difficulty that banking institutions subject to the surcharge may experience in trying to raise the additional needed CET1 in the short term. Recent experience with regulatory implementation and market expectations with the increased Basel III capital requirements, however, demonstrates that such a transition period is likely to be illusory.

Although the Basel III capital requirements are subject to a prolonged phase-in provision (from January 1, 2013 to January 1, 2019) and the U.S. banking agencies are just now in the process of drafting their proposed regulations implementing Basel III, for all practical purposes Basel III is already fully effective for U.S. SIFIs as a result of the Temporary Addendum as discussed above. The Federal Reserve stated in the Temporary Addendum that it expects banking institutions to "demonstrate with great assurance that they could achieve the ratios required by the Basel III framework, inclusive of any proposed dividend increases or other capital distributions, as those ratios come into effect in the United States." It is obviously very difficult for a bank to be in the position of not increasing its dividends or engaging in expansion transactions for a number of years. In addition, even in the absence of such regulatory incentives, investor and market expectations have tended to internalize higher Basel III-based capital expectations immediately in evaluating firms irrespective of formal transition periods.[34] We see no reason to conclude that the same would not occur in connection with a significant SIFI surcharge.

F. There are significant uncertainties and open questions regarding the analytical underpinnings and proper calibration of any SIFI surcharge.

As even most proponents of a SIFI surcharge readily acknowledge, there are significant uncertainties and open questions regarding the analytical underpinnings and proper calculation of any SIFI surcharge. For example, the three analytical lines of inquiry the Federal Reserve appears to be pursuing in connection with the creation of a SIFI surcharge[35] seem to produce a wide range of results depending on which assumptions are selected. The empirical measurement of systemic importance is in its infancy and academic commentators pursuing this research regularly caution against directly adopting their work as part of a regulatory framework.[36] There has been limited research regarding capital surcharges affecting only the largest institutions. The majority of research focuses on the impact of Basel III or system-wide optimal capital levels. In addition, societal benefits of large financial institutions have not been analyzed thoroughly.[37] Finally, and perhaps most significantly, the full potential combined impact of the current financial-services regulatory reforms in the U.S., including the Dodd-Frank Act, Basel III and the contemplated significant SIFI surcharge, has not yet been fully analyzed, as public sector officials have acknowledged.[38] The cumulative effects of these complex rules, with their web of potentially unknown interrelationships, could very well have economic costs and other unintended consequences and risks that are not readily apparent.

In addition, many of the analytical underpinnings of and academic theories concerning the contemplated significant SIFI surcharge are open to reasonable interpretation and debate. Such assertions and arguments include:

- *There is little evidence that the size, complexity, and scope of SIFIs are necessary to realize economies of scale and scope.*

There is considerable evidence that there are meaningful scale and scope advantages to large banking institutions.[39] A generation of banking mergers suggests that there are substantial cost synergies available to larger institutions. Moreover, there is a strong *a priori* case for expecting such cost synergies, given the high and increasing fixed costs to which financial institutions are subject.

Indeed, this may not even be the most relevant question. Even if banks themselves do not benefit from increased size and scope, it would appear that a number of their customers do benefit. We are not aware of any definitive research that challenges the existence of such benefits.[40]

- *There would be significant negative externalities in the event of a disorderly failure of any SIFI, distinct from the costs incurred by the SIFI and its stakeholders.*

An asserted rationale for imposing a SIFI-capital surcharge is based on the cost of a SIFI failure to other institutions, the underlying premise that firms do not have an incentive to, and have not, already addressed such externalities, and the belief that these costs should therefore be addressed through extraordinarily stringent macroprudential regulation. The assumed costs of a SIFI failure include direct losses on counterparty exposures and assumed losses on assets that are subject to fire-sale prices as firms sell assets into a declining market. Proponents of a significant SIFI surcharge reason that, by increasing capital, the surcharge will make SIFIs less prone to failure and thereby reduce the likelihood that these costs will occur. As discussed above, there is little evidence to suggest that a significant SIFI surcharge, as compared with the current Basel III enhanced capital requirements, including the explicitly macroprudential capital conservation buffer, will have more than marginal utility in decreasing such macroprudential risk by preventing SIFI failures. Capital alone is not the solution.

Moreover, the assertion above concerning the negative externalities of a SIFI failure does not answer several important questions, such as whether a more measured and effective solution would be to ensure proper counterparty-risk-management practices instead of using the blunt instrument of a significant SIFI-capital surcharge. Another question relates to the true magnitude of a "fallen domino" risk due to counterparty exposure. Even a 15% loss on such exposures would not reduce the counterparties capital by 5%, unless the counterparties exposure exceeded 33 1/3% of its capital. Although crucial to understanding whether a SIFI surcharge is warranted and, if so, how it should be calibrated, these and other pertinent questions have apparently not yet been fully examined and debated.

In addition, the systemic impact of an institution's failure will vary based upon a number of factors, including notably the interconnectedness of the institution with the rest of the financial system.[41] Any SIFI surcharge must be properly calibrated to account for the differences in true systemic risk posed by different institutions.

We believe a measured, transparent and deliberate course should be pursued in connection with determining the U.S. approach to a SIFI surcharge. TCH welcomes an open and spirited discussion and debate concerning the various issues surrounding a SIFI surcharge—a debate in which all affected parties have an opportunity to make their views heard—before decisions are made. A presumptive rush to judgment that "more is always better" when it comes to capital should be avoided, given the uncertainties and complex questions regarding the analytical underpinnings and calibration, as well as the questionable marginal benefits, of further increases in capital levels when compared to the potential risks and economic costs.

Even accepting, as a theoretical and very simplistic matter, that more capital will reduce the risk of failure and the losses of creditors if failure occurs, that cannot be the ultimate analysis. The appropriate analysis, which is far more complex, incorporates two basic questions which require the most thoughtful consideration: to what extent are the risk of failure and losses reduced by marginal capital requirements; and how does any such value relate to the risk of an adverse impact on banks' ability to issue capital and their competitive position, the impact on borrowers in terms of credit availability and cost, and the effect on the broader economy. Significant surcharges should not be imposed until those questions are satisfactorily answered.

* * *

If you have any questions, or need further information, please contact Paul Saltzman, President and General Counsel of TCH, at (212) 613-0318 (e-mail: paul.saltzman@theclearinghouse.org), Joseph Alexander, Senior Vice President and Deputy General Counsel of TCH, at (212) 612-9234 (e-mail: joe.alexander@theclearinghouse.org) or Eli Peterson, Vice President and Regulatory Counsel of TCH, at (202) 649-4602 (email: eli.peterson@theclearinghouse.org).

Respectfully submitted,

J D Aramanda

James Aramanda
Chief Executive Officer
The Clearing House Association and Payments Company

Paul Saltzman

Paul Saltzman
President of The Clearing House Association
EVP and General Counsel of The Clearing House Payments Company

cc: The Honorable Tim Johnson
Chairman
Senate Committee on Banking, Housing & Urban Affairs

The Honorable Richard Shelby
Ranking Member
Senate Committee on Banking, Housing & Urban Affairs

The Honorable Spencer Bachus
Chairman
House Committee on Financial Services

The Honorable Barney Frank
Ranking Member
House Committee on Financial Services

The Honorable Janet L. Yellen
Vice Chairman
Board of Governors of the Federal Reserve System

The Honorable Elizabeth A. Duke
Governor
Board of Governors of the Federal Reserve System

The Honorable Sarah Bloom Raskin
Governor
Board of Governors of the Federal Reserve System

The Honorable Daniel K. Tarullo
Governor
Board of Governors of the Federal Reserve System

The Honorable Gene Sperling
Director
National Economic Council

The Honorable Neal Wolin
Deputy Secretary
Department of the Treasury

The Honorable Jeffrey A. Goldstein
Under Secretary of the Treasury for Domestic Finance
Department of the Treasury

The Honorable Martin J. Gruenberg
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ENDNOTES

1 Established in 1853, The Clearing House is the United States' oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. TCH is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs, and white papers the interests of its member banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. *See* TCH's web page at www.theclearinghouse.org.

2 TCH has striven to inform its views with independent and empirically based quantitative analysis. To this end, we retained McKinsey & Company, Inc. ("**McKinsey**") to assist TCH in its analysis of the impact of Basel III and the SIFI surcharge on U.S. banking institutions. McKinsey had access to the quantitative-impact studies and other confidential data provided by 11 large financial institutions, accounting for 59% of U.S. banking assets at June 30, 2010. Those sample data and other sources were used to extrapolate certain estimates for the U.S. banking industry at large and in other aspects of the quantitative analyses set forth herein, as applicable. In addition, TCH and McKinsey are in the process of conducting other empirically-based analyses on: (i) how bank-capital levels would be affected by more adverse economic environments, considering current bank portfolios and the Basel III capital requirements; (ii) how bank-capital levels would have been affected during the last crisis had Basel III been in place before the beginning of the crisis; and (iii) what economic and social benefits are attributable to larger financial institutions and what particular economies of scale and economies of scope larger banks provide. The analyses in clauses (i) through (iii) above will leverage proprietary bank information—both historical and forward-looking—collected from TCH member banks to provide analysis that is unavailable outside the banks themselves.

3 For purposes of this letter, we use the term SIFI generically to refer to both "systemically important financial institutions" and the so-called "global systemically important financial institutions," or "**G-SIFIs**." Section 165(b) of the Dodd-Frank Act generally applies to banking institutions having more than $50 billion in total consolidated assets. It bears noting that the degree of systemic importance and the potential costs of failure can vary greatly among banking institutions with more than $50 billion in total consolidated assets. The FSB and the Basel Committee have not yet released their final criteria with respect to what constitutes a SIFI or a G-SIFI.

4 As noted above in endnote 3, Section 165(b) of the Dodd-Frank Act generally applies to banking institutions having more than $50 billion in total consolidated assets; however, it appears that the largest surcharge may be contemplated only for some yet to-be-determined subset of the largest U.S. financial institutions.

5 *See* Basel Committee on Banking Supervision, Bank for International Settlements, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010) ("**Basel III—A Global Framework**").

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6 The U.S. banking agencies' existing regulations require that common equity be the "predominant" component of Tier 1 capital. Their prompt corrective action regulations require that an institution have at least a 6% Tier 1 capital ratio in order to be "well-capitalized," which under the predominance test translates into approximately a 4.5% Tier 1 common ratio.

7 "**Basel II.5**," as used in this letter, refers to revisions set forth in the Basel Committee's June 2009 publication, *Revisions to the Basel II Market Risk Framework and Guidelines for Computing Capital for Incremental Risk in the Trading Book*, in its July 2009 publication, *Enhancements to Basel II Framework*, and in its February 2011 publication, *Revisions to the Basel II Market Risk Framework—Updated as of 31 December 2010*. The U.S. banking agencies published a joint notice of rulemaking earlier this year (76 Fed. Reg. 1890 (Jan. 11, 2011)) addressing the U.S. implementation of Basel II.5. The comment period expired on April 11, 2011, and implementation is expected by year-end.

8 U.S. financial institutions with more than $250 billion in total consolidated assets, in the aggregate, account for approximately 85% of the aggregate CET1 required under Basel III.

9 Under U.S. GAAP, certain unrealized gains and losses on securities in the investment portfolio that are classified as "*available for sale*" are recorded directly to equity, as opposed to being treated as income or expense items for income statement purposes. AOCI volatility may be exacerbated by the need for these banking institutions to acquire additional investment securities in order to comply with Basel III's liquidity ratio requirements.

10 See pages A-1 through A-5 of **Annex A** attached hereto for further information.

11 *See* Sections 619 and 716 of the Dodd Frank Act.

12 *See* Title II of the Dodd-Frank Act.

13 *See* Section 165(d) of the Dodd-Frank Act. The Dodd-Frank mandate for resolutions plans, as proposed, would be a far-reaching strategic exercise for SIFIs.

14 *See* Section 165(i) of the Dodd-Frank Act; Capital Plans, Docket No. R-1425 (proposed June 10, 2011), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110610a1.pdf (proposing amendments to 12 CFR part 225 to require large bank holding companies to submit capital plans on an annual basis and to require such bank holding companies to provide prior notice under certain circumstances before making a capital distribution).

15 *See* Title VI of the Dodd-Frank Act.

16 *See* Title VII of the Dodd-Frank Act.

17 *See* Section 113 of the Dodd-Frank Act.

18 *See* Subtitle D of Title IX of the Dodd-Frank Act.

19 *See* Subtitle C of Title IX of the Dodd-Frank Act.

20 *See* Subtitle A of Title I of the Dodd-Frank Act.

21 Daniel K. Tarullo, Remarks at the Peter G. Peterson Institute for International Economics, Washington, D.C. (June 3, 2011) (transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm) (emphasis added).

22 See pages A-7 through A-11 of **Annex A** for further information regarding, and a description of the methodologies employed in, this study. For purposes of McKinsey's study, a "substantial direct governmental capital investment" is defined as a total government capital investment greater than 30% of the banking institution's Tier 1 capital as of December 31, 2007. Such 30% threshold generally filters out institutions that accepted TARP funds as mandated during the U.S. government's response to the financial crisis.

23 See page A-12 of **Annex A** for additional information concerning this preliminary assessment.

24 *See* Basel Committee on Banking Supervision, Bank for International Settlements, *Guidance for National Authorities Operating the Countercyclical Capital Buffer* (Dec. 2010).

25 TCH has also undertaken significant analysis on the calibration of the liquidity coverage ratio (the "**LCR**") and the net stable funding ratio (the "**NSFR**"), and our work has shown that the calibration of the ratios is more conservative than the experience of our member institutions (including failed legacy institutions) during the crisis. TCH shared its perspectives with the Financial Stability Oversight Council in an unsolicited comment letter dated November 5, 2010. We are continuing work on the LCR and NSFR, focusing on the impact of the ratios as currently calibrated on the cost and availability of credit to end users, and look forward to sharing our findings with supervisors and policymakers.

26 The banks in the sample reported that they will meet the capital requirements under Basel III by, among other things, reducing risk-weighted assets by approximately $821 billion through a variety of actions, including by winding down existing portfolios, decreasing low rated securitizations in the trading book and decreasing certain businesses (for instance, correlation trading). See page A-6 of **Annex A** for further information.

27 *See generally* Macroeconomic Assessment Group, Bank for International Settlements, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, at 2 (Dec. 2010) (discussing the potential decline in GDP and the transactional costs of heightened capital requirements) ("**The BIS Macroeconomic Impact Assessment**"); Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig and Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is* Not *Expensive*, at 1, 2 (Mar. 2011), https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf (stating, "It is more expensive for banks to fund assets with capital than with deposits or wholesale debt. This suggests that, while banks facing stronger capital requirements will seek to increase capital levels by retaining earnings and issuing equity as well as reducing non-loan assets, they may initially increase the interest rates they charge borrowers and reduce the quantity of new lending. Any increase in the cost and decline in the supply of bank loans could have a transitory impact on growth, especially in sectors that rely heavily on bank credit.") ("**Myths in the Discussion of Capital Regulation**").

28 *See* Federal Deposit Insurance Corporation, *Quarterly Banking Profile: First Quarter 2011* (May 2011), at 3, http://www2.fdic.gov/qbp/2011mar/qbp.pdf.

29 *See* Financial Stability Board, *Shadow Banking: Scoping the Issues: A Background Note of the Financial Stability Board* (April 12, 2011), at 3, http://www.financialstabilityboard.org/publications/r_110412a.pdf.

30 *Cf.* Zoltan Pozsar, Tobias Adrian, Adam Ashcraft and Hayley Boesky, *Federal Reserve Bank of New York Staff Reports: Shadow Banking*, Staff Report no. 458, at 69 (July 2010) (questioning whether the economically viable parts of the shadow banking system "will ever be stable through credit cycles in the absence of official credit and liquidity puts").

31 *See, e.g.*, David Miles, Jing Yang and Gilberto Marcheggiano, *Optimal Bank Capital*, Discussion Paper No. 31: Revised and Expanded Version, at 9, 10 (Apr. 2011), http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031revised.pdf; Myths in the Discussion of Capital Regulation, *supra* endnote 27, at i.

32 See pages A-13 through A-15 of **Annex A** for further details concerning this analysis.

33 Specifically, for example, payment system reforms are likely to decrease banking industry ROE more generally. Based on an analysis of publicly available financial data by Novantas, a private consulting firm, on behalf of TCH, such reforms embodied in the CARD Act, overdraft charge changes in Regulations E and DD of the Board of Governors of the Federal Reserve System (the "**Board**"), and applicable Federal Deposit Insurance Corporation guidelines, as well as Regulation II of the Board (debit interchange regulations), if fully implemented in 2009, would have reduced 2009 bank industry revenue by more than $35 billion. This translates to an after-tax reduction of bank industry ROE by approximately 1.5%. This estimate does not reflect any other regulatory impacts of the Dodd-Frank Act or other changes affecting payments or other parts of the banking industry.

34 *Cf.* The BIS Macroeconomic Impact Assessment, *supra* endnote 27, at 38 (noting that some private sector analysts have predicted that "once supervisors announce the parameters for capital requirements, markets are likely to press banks to achieve these ratios rapidly regardless of the official implementation date").

35 *See* Daniel K. Tarullo, Remarks at the Peter G. Peterson Institute for International Economics, Washington, D.C. (June 3, 2011) (transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm) (discussing three different approaches to calibration, including the "expected impact" approach, "long-run economic impact" approach and the approach that tries to determine how much additional capital would be needed "to offset any reduction in funding costs associated with the perceived too-big-to-fail status of SIFIs"). In addition, TCH would caution against basing a SIFI surcharge on risk-weighted assets given jurisdictional differences in the calculation of risk-weighted assets and the risk that U.S. banking institutions would be disadvantaged by these differences.

36 *Cf.* John B. Taylor, *Systemic Risk in Theory and Practice*, at 51 (stating that systemic risk is still not well defined and that reform proposals relying on systemic risk to determine in advance whether a firm should be deemed systemically significant "are not ready for prime time") (2010), http://www.stanford.edu/~johntayl/Onlinepaperscombinedbyyear/2010/Defining_Systemic_Risk_Operationally.pdf.

37 To remedy this knowledge gap, TCH has retained McKinsey, as discussed in additional detail in endnote 2, to study what economic and social benefits are attributable to larger financial institutions, among other things.

38 *See* Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke's Speech on the U.S. Economic Outlook (June 7, 2011) (transcript available at http://video.cnbc.com/gallery/?video=3000026289) (noting that no one had yet done an analysis of the impact of the recent financial reform on credit and stating, "It's just too complicated. We don't really have the quantitative tools to do that.").

39 As discussed in additional detail in endnote 2, TCH has retained McKinsey to study the economic and social benefits attributable to larger financial institutions.

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40 Another benefit of SIFIs is their capacity to acquire larger troubled institutions and thereby prevent the otherwise self-fulfilling prophecy of proponents of large surcharges.

41 *See, e.g.*, Financial Stability Board, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: Interim Report to G20 Leaders*, at 6 (June 2010), http://www.financialstabilityboard.org/publications/r_100627b.pdf (noting that an "important reason for public intervention to avoid the failure of a financial institution is its interconnectedness with market participants").

ANNEX A

Contents

This report is based on results from the 11 US based participating banks, which account for 59% of total US banking assets

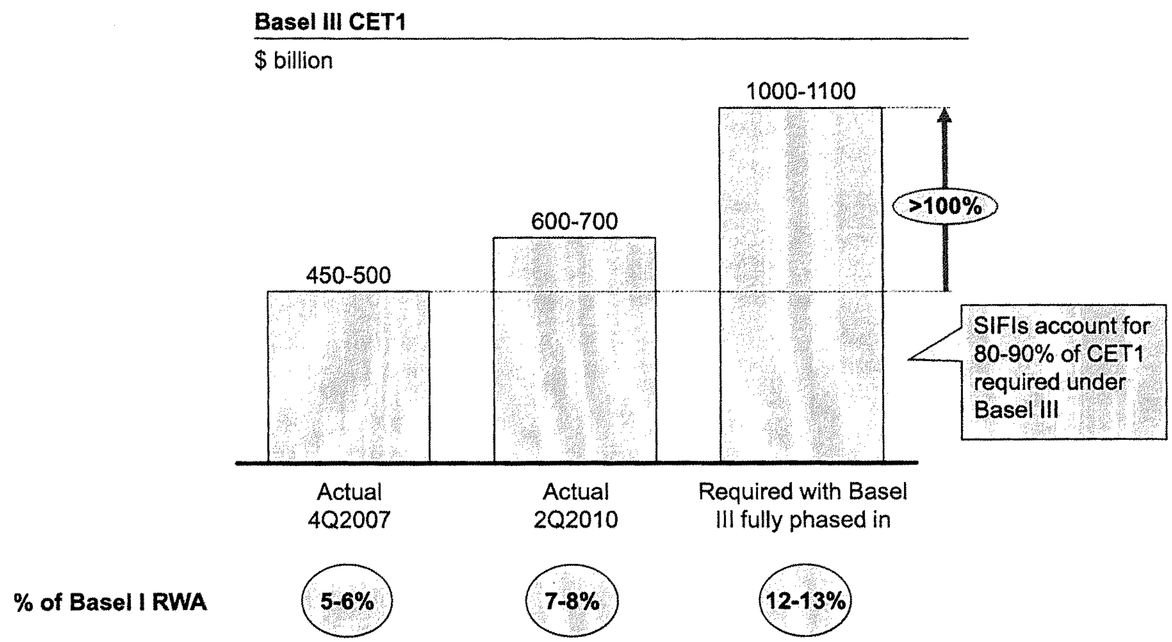
Banks for whom we have capital & liquidity data

Bank of America	Goldman Sachs	Capital One Bank
JPMorganChase	usbank Five Star Service Guaranteed	BB&T
citi	PNC BANK	Comerica Bank
WELLS FARGO	BNY MELLON	

Total assets USD billions (% of US market)	9,363 (59%)

SOURCE: BHCPR assets data from 2009 Q4

Relative to pre-crisis levels, Basel III requires US banks in aggregate to hold over 100% more common equity relative to pre-crisis levels of capital

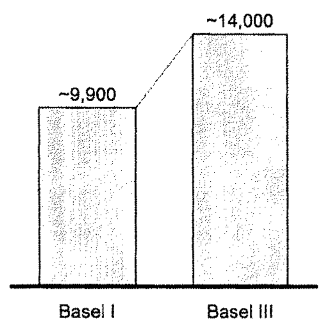


SOURCE: TCH QIS6 member data, SNL

How we estimate that Basel III is equivalent to 12-13% capital under Basel I

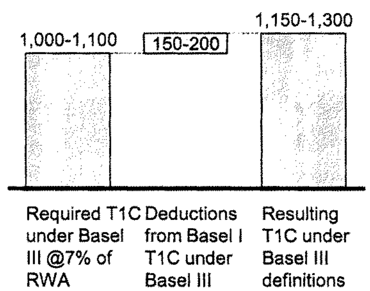
Tier 1 common equity and RWA under Basel I and Basel III

Industry RWA
$ billions, as of 6/30/2010



Basel III RWA (including changes under Basel II and Basel II.5) is an increase, of approximately 40% over Basel I RWA, as of 2Q 2010

Industry Tier 1 common capital
$ billions, as of 6/30/2010



The $1,000-1,100 of required T1C under Basel III equates to $1,150-$1,300 once Basel III deductions from T1C are removed

Capital ratio calculations

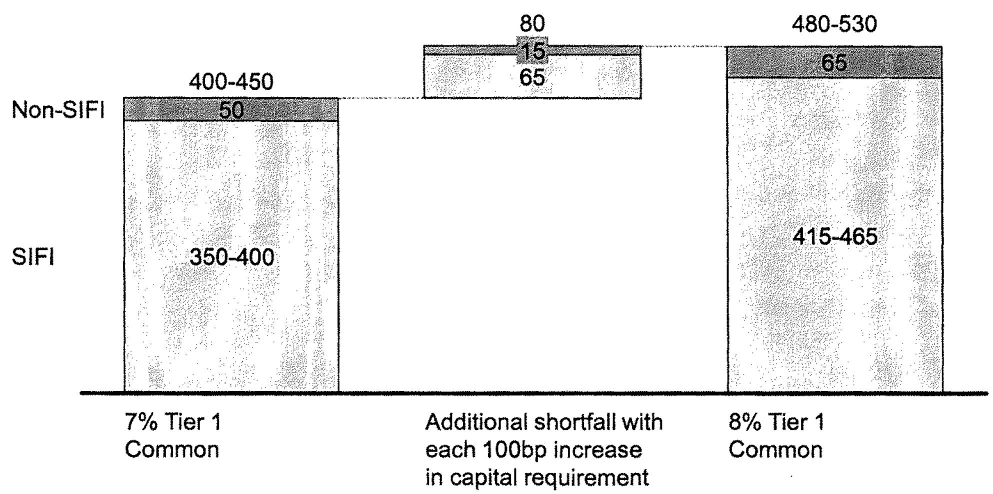
Basel III CET1 (adjusted) as % of Basel I RWA
= Basel III T1C with deductions / Basel I RWA
= 1,150/9,900
= 12%

= 1,300/9,900
= 13%

SOURCE: TCH QIS6 member data; SNL

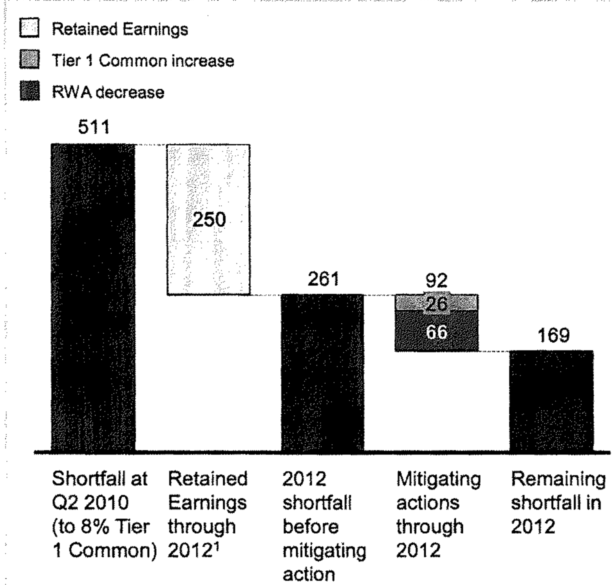
For US banks, each additional percentage point of capital requirement increases required T1C by ~$80 billion

Capital shortfall estimates for US banking industry, $ billions



Banks indicate that they are likely to reduce their Tier 1 Common shortfall in part through asset sales and RWA reductions

Tier 1 Common shortfall in 2012 after RWA reduction, asset sales and retained earnings
USD billion



- **Banks indicate that they may reduce their Tier 1 common shortfall to Basel III requirements, in part by reducing RWA** ($821 billion in RWA; $66 billion in capital at 8% Tier 1 Common ratio) and **increasing Tier 1 Common** through asset sales ($26 billion)
- **Banks may reduce RWA and assets using measures such as:**
  - Winding down existing portfolios, as many banks have publically announced
  - Decreases in low rated securitization in the trading book (and rating "unrated" securities)
  - Decrease in certain businesses, including correlation trading, sub-prime retail (e.g., credit cards)
- **Increases in Tier 1 Common may include:**
  - Sales of unconsolidated financial subsidiaries
  - DTA realization of net operating losses
  - Sales of MSRs above the 10%/15% cap

1 Bloomberg estimated net income for banks with capital shortfalls from Q2 2010-2012

Contents

Methodology for analyzing the relationship between pre-crisis bank capital ratios and the likelihood of a bank going into distress

Approach

- Analyzed the relationship between capital ratios of large global banks, at the onset of the financial crisis (defined as December 2007), and subsequent Bank distress during the crisis
  - Initial capital ratios as defined in both Basel III and Basel I terms used to study relationship to Bank distress

Banks in sample

- 124 large global banks with minimum asset size of $30 billion
  - Represent $68.2 trillion in total assets
  - About 85% of developed-market banking and 65% of total banking assets worldwide
  - Broker-dealers excluded as risk-weighted assets data unavailable in December 2007.

Definition of distress

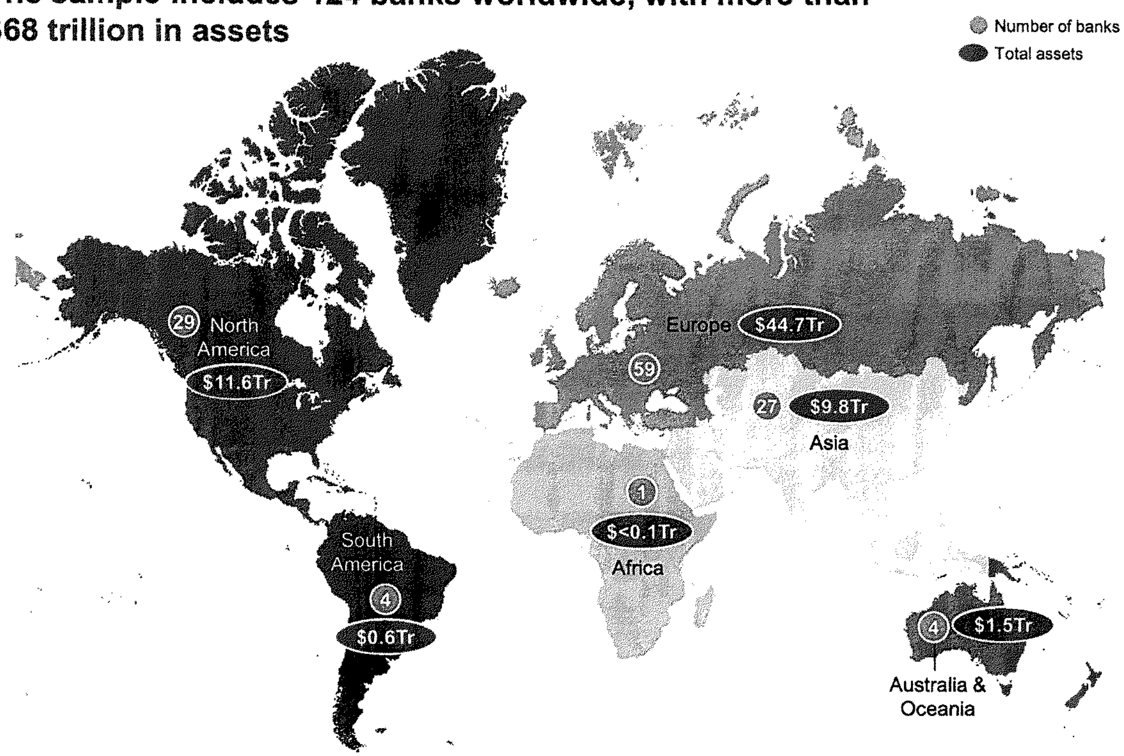
- An institution is defined as distressed if any of the following conditions was met 2007-09:
  1. Bankruptcy
  2. Government takeover or placement into government conservatorship
  3. Merger under duress with another bank
  4. Receipt of a substantial direct government capital investment or bailout[1]
- Using the above definition, a total of 28 banks were deemed distressed (23% of banks in the sample, covering 30% of the assets)

Adjustments for Basel III

- Adjustments developed to convert December 2007 capital and RWA for each bank into estimates of what Basel III capital ratios would have been, had Basel III rules existed at the time
  - Adjustment factors estimated for different type of banks (e.g., by country, by mix of business such as wholesale vs. retail, trading assets)

1 Defined as total government capital investment greater than 30% of the bank's starting Tier 1 capital as of December 31, 2007

The sample includes 124 banks worldwide, with more than $68 trillion in assets

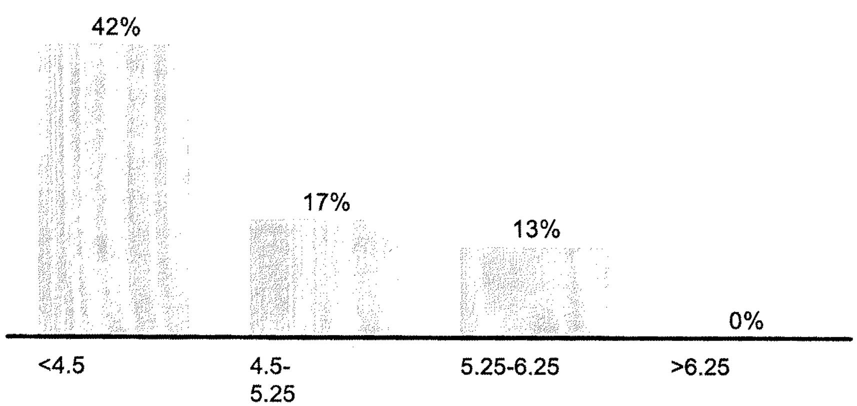


Measured under Basel III definitions, no bank with a Basel III common equity to RWA over 6.25% experienced distress

PRELIMINARY

Likelihood of Distress vs. Starting Capital Ratio, Percent

Banks entering distress vs. starting CET1/RWA (percent)



Estimated pre-crisis ratio of Basel III CET1 to Basel III RWA

Bins chosen to have approximately equal number of banks per bin
SOURCE: Company 10Ks, regulatory filings, team analysis

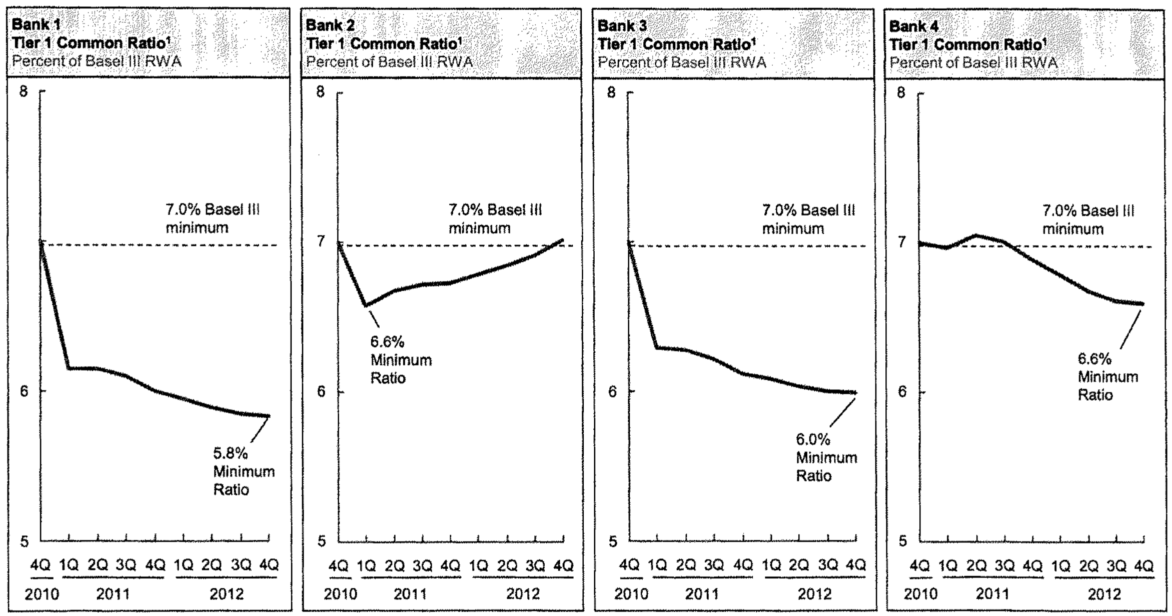
Questions to be answered through additional work

PRELIMINARY

Questions	Additional work to do
1 *Even if some banks didn't fail, how much capital was depleted and how close were they to distress?*	Analyze capital ratios over time for surviving firms, measure how much they fell, and how does this compare to the Basel III minimums today including the capital conservation and countercyclical buffers
2 *For failed banks, how much more capital did they need?*	Analyze capital ratios and estimated losses over time for distressed/failed firms during the 2007-09 period, and how does this compare to the Basel III minimums today including the capital conservation and countercyclical buffers
3 *Even if capital ratios didn't fall much during the crisis, what about future stresses?*	Analyze performance of current portfolio and how much capital ratios would fall given hypothetical stress events, and how this compares to Basel III minimums including the capital conservation and countercyclical buffers

Initial stress test analysis: based on publicly available US S-CAP results, the top 4 US banks see estimated reductions of at most 1.2% of CET1

ALL NUMBERS PRELIMINARY



1 Assumes that each of the 4 banks start at the 7% Basel III minimum (including conservation buffer) fully phased-in as of 4Q 2010

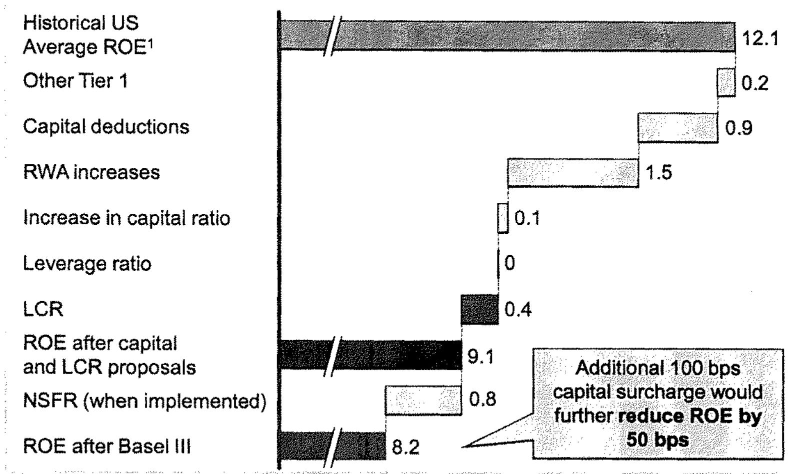
SOURCE: Federal Reserve Supervisory Capital Adequacy Assessment Program, May 2009

Contents

- Impact of Basel III capital requirements
- Assessing capital needs from crisis experience
- **Impact on returns and cost of equity**

The capital and liquidity proposals could reduce RoE by 300-390 bps, depending on implementation of the NSFR

ROE impact of Basel III capital and liquidity proposals
Percentage points



Other potential changes not included in modeling

- Living wills
- "Volcker rule"
- Central clearing of OTC derivatives
- Bank taxes/levies
- Accounting
- Consumer protection
- ...

- Key **question as to where the incidence** of regulatory changes **will fall**; i.e.,
  - **On customers**, through higher loan pricing
  - **On banks**, through cost reduction (e.g., compensation, consolidation among small banks)
  - **On shareholders**
- Analysis does not consider likely business model changes
- Even in an environment where banks are better capitalized and more liquid, the reduction in return on equity will likely be greater than the reduction in cost of equity

1 Using consensus 2012 analyst forecasts does not materially change the results

SOURCE: BIS; Bloomberg

The declining ROE may be minimally mitigated by a lower COE (~80 bps) due to lower beta for the industry

Effect of Basel III on the cost of equity (COE)

Theoretical foundation

- **Modigliani-Miller**'s principle of conservation of risk suggests that an **increase in capital should reduce systematic risk** (i.e., beta)

Empirical estimation

- Kashyap et al (2010) **empirically estimate the effect of additional capital on beta** by regressing beta on the ratio of equity to assets with a 1976-2008 panel dataset
- They find that a **one percentage point increase of the equity ratio reduces beta by 0.045**

Specific Basel III implications

- We estimate that banks will **increase their Tier 1 Common ratio by 3.5 percentage points** (of total assets) in response to Basel III
- Using the empirical estimates from above, this **implies a 16bps decline in beta or a 80bps decline in the COE** (at a market risk premium of 5%)[1]

- Empirical estimates suggest that the **COE may fall by 80 bps** if banks increase their capital to meet 8% Tier 1 Common ratio
  - Additionally, each 100 bps of capital surcharge is likely to result in further COE decline of 20 bps
  - Note, there are several factors that will impact COE which are not accounted-for by this estimate
- Using historical 10.2% COE for banks as the baseline, **this implies a 9.4% COE post- Basel III**
- The expected decrease in ROE (300-390 bps) is over 3-4x the reduction in the Cost of Equity
- Thus, **banks will need to take significant steps to increase their income** and ROE

1 The Kashyap et al (2010) study considers the effect of the equity to assets ratio on beta. We are interested in the effect of changing the Basel III-defined Tier 1 Common ratio on beta. However, it is not possible to estimate this relationship historically - the data that would be required to calculate this Basel III Tier 1 Common ratio is not available. We thus use the Kashyap et al. estimate as the best available proxy.

SOURCE: internal estimates; Kashyap, Stein and Hanson (2010) "An Analysis of the Impact of "Substantially Heightened" Capital Requirements on Large Financial Institutions"

Statement for the Record
by the
Institute of International Bankers
for the hearing before the
Committee on Financial Services
of the
United States House of Representatives

"Financial Regulatory Reform: The International Context"

June 16, 2011

Chairman Bachus, Ranking Member Frank and members of the Committee, the Institute of International Bankers (IIB) appreciates the opportunity to submit this statement for the record for the June 16, 2011 House Financial Services hearing entitled "Financial Regulatory Reform: The International Context". The IIB represents internationally headquartered financial institutions from over 35 countries around the world; our members include international banks that operate branches and agencies, bank subsidiaries and broker-dealer subsidiaries in the United States. International banks provide an important source of credit for U.S. borrowers and enhance the depth and liquidity of U.S. financial markets. Their U.S. operations contribute billions of dollars each year to the economies of major cities across the country through the employment of over 250,000 U.S. citizens and permanent residents and through other operating and capital expenditures.

The IIB and its members support the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) objectives of reducing systemic risk and increasing transparency in the financial markets. We also support the commitments of the G-20 leaders to setting high, internationally consistent requirements for OTC derivatives and avoiding overlapping regulations.

Background

As a general matter, the international framework for the supervision of cross-border banking activities is based on considerations of comity and appropriate allocation of supervisory responsibilities across home and host country supervisors. As applied in the United States, this framework is reflected in the longstanding policy of national treatment, *i.e.*, there should be parity of treatment between U.S. banks and international banking firms that operate in the United States, and the understanding that international banking firms are subject to primary supervision by their home country authorities with U.S. authorities, primarily the Federal Reserve Board (FRB), as host country supervisors, exercising appropriate oversight of international banking firms' U.S. operations. Accordingly, the U.S. banking and nonbanking operations of our members, like their U.S. counterparts, are subject to extensive U.S. regulation and supervision by the federal banking agencies, the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), as appropriate.

Swap Dealer Registration and Regulation

As noted above, our members support Title VII's objectives of reducing systemic risk and increasing transparency. Together, we have developed a proposal on the cross-border application of Title VII that we hope will assist global regulators to develop a workable regime for supervising U.S. and foreign firms that operate global swap businesses.

Before turning to a discussion of that proposal, it is important to note that Title VII's effective date of July 16^{th} is just a few short weeks away. The possibility that many of that Title's provisions may be deemed self-effectuating and, thus, may become effective on July 16^{th}

without rulemaking or further action on the part of the SEC or CFTC has led to great uncertainty among global swap dealers and other market participants. We appreciate the CFTC's proposal on Tuesday to alleviate this uncertainty, which we are currently reviewing, as well as the recent announcement made by the SEC that it also intends to clarify the requirements that will apply on July 16^{th}.

However, even if the agencies clarify that compliance with Title VII largely is not required on July 16^{th}, there will still be considerable uncertainty surrounding basic elements of Title VII which make preparing for compliance extremely difficult. In particular, until the agencies provide guidance about the extraterritorial application of Title VII, internationally active firms, regardless of where they are headquartered, will be unable to complete the analysis that is needed to determine how to structure their cross-border derivatives activities. Specifically, many firms do not yet have the guidance necessary to determine through which entities activities may continue to be conducted under the new regime.

Our proposal was developed in the spirit of addressing that uncertainty. Before describing the proposal's details, it is important to note that foreign banks and U.S. banks alike seek to minimize the number of legal entities through which they conduct swap dealing activities and, where possible, to use a single legal entity to transact with swap counterparties globally. This increases efficiency and decreases risk by permitting the bank and its counterparties to net and offset their exposures. It also allows counterparties to transact with a more creditworthy entity, which for foreign banks is usually located and supervised outside the U.S. The personnel who have relationships with U.S. customers or manage U.S.-related portfolios on behalf of their head office are often, however, located inside the U.S.

Our proposal, which would apply Title VII to this and other common ways in which international derivatives dealers operate, has been guided by the following considerations:

(1) We have sought to be faithful to the statute; we are not asking for an exemption from swap dealer registration. Any time that swap dealing activities occur directly with U.S. customers or from within the U.S., a U.S.-registered swap dealer would be involved. Additionally, the personnel interacting with U.S. customers would be employed by a U.S. registrant subject to supervision and examination by the CFTC and the SEC.

(2) We have sought to protect U.S. customers. We believe that U.S. regulations that apply to particular transactions, such as U.S. clearing, trading, reporting and business conduct and similar requirements should apply to transactions entered into with a U.S. counterparty or from within the U.S. Transactions entered into with foreign counterparties from abroad should, of course, be subject to the rules of the relevant foreign jurisdictions, rather than U.S. rules.

(3) We have sought to be sensitive to the resource constraints of U.S. regulators. One of the key ways for U.S. regulators to address these constraints is to leverage effective foreign supervision while retaining their full enforcement authority. So, we believe that, if U.S. regulators determine that home country capital and other similar entity-wide regulations are sufficiently comparable to U.S. regulations, then compliance with those regulations should constitute compliance with U.S. requirements, and failure to comply should be treated as noncompliance with U.S. requirements, enforceable by U.S. regulators. This is consistent with the FRB's current proposal for swap dealer capital requirements.[1]

[1] We believe a similar approach is warranted for foreign non-bank swap dealers subject to comparable home country capital requirements, with comparability determined based on well-established benchmarks (such as pre-existing evaluations of the home country regulator's supervisory framework by the FRB or whether the home country

(4) We have sought to support and encourage international harmonization. We believe that our proposal would encourage foreign regulators to adopt regulations comparable to the U.S and to open access further to U.S. banks. In particular, we believe it would be consistent with the approach of recognizing equivalent third country regimes that is currently under consideration by the European Union (EU).[2]

(5) Further to this last consideration, under our proposal, if a branch of a U.S.-headquartered bank were engaged in off-shore derivatives activities, that country's regulators would allow the branch to comply with U.S. capital and other entity-wide rules so long as they were deemed comparable to those applied by the regulators to firms headquartered in that country. Assuming the branch entered into a swap transaction with a foreign counterparty, the foreign regulators' transaction rules, *e.g.*, business conduct, clearing, etc., would apply, and U.S. rules would not. Also, a foreign affiliate of a U.S.-headquartered bank would be treated just like a foreign bank, *i.e.*, U.S.

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regulator administers a capital regime consistent with the Basel Accord). This is necessary to level the playing field between non-bank subsidiaries of U.S. bank holding companies, which could use a risk-based approach to capital under the CFTC's current swap dealer capital proposal, and non-bank subsidiaries of foreign bank and financial holding companies, which under that proposal would be subject to rules-based capital requirements that are inconsistent with requirements applied by home country supervisors.

[2] Since the EU has not historically had exemptions for OTC derivatives similar to what were in place in the United States prior to enactment of Dodd-Frank, most EU derivatives dealers are already subject to comprehensive prudential supervision and prohibitions against abusive market conduct. Consistent with the G-20 commitments, the EU is working to adopt mandatory clearing requirements (under the proposed European Market Infrastructure Regulation (EMIR)) and trading and reporting requirements (under proposed revisions to the Markets in Financial Instruments Directive (MiFID)) in the December 2012 timeframe, with mandatory clearing on track to be implemented first. As part of the MiFID reform, the European Commission has proposed to allow third country firms subject to equivalent regulation to access the EU common market. If adopted, this proposal would allow U.S.-headquartered banks to access the entire EU directly without registering in the EU or using an EU subsidiary. We believe that the EU is unlikely to adopt this aspect of the proposal unless the United States also takes a similar approach with respect to institutions headquartered in the EU.

We note further that there are also some areas, such as business conduct standards for advice to pension plans and the timing for public trade reporting, where the rules under Dodd-Frank may diverge from the approach taken in the EU. Accordingly, we believe that U.S. requirements under Dodd-Frank should apply to U.S.-related transactions, and EU requirements under the applicable regulations and directives should apply to EU-related transactions.

regulations that apply to particular transactions would apply to transactions with U.S. counterparties, but transactions by the foreign affiliate with foreign counterparties from outside the U.S. would be subject to relevant foreign rules.[3] U.S. regulators would also defer to comparable foreign entity-wide rules for the foreign affiliate.

We believe that this proposal will help maintain the preeminence of the U.S. as a leading international financial center by maintaining the liquidity of the U.S. derivatives market. By contrast, if Title VII were to effectively require foreign banks to conduct their derivatives dealing activities in the U.S. through separately incorporated subsidiaries, U.S. customers and foreign banks would face inefficiencies and additional costs of transacting in derivatives through multiple legal entities. The significant negative impacts on capital, netting and risk management resulting from conducting derivatives trading through multiple U.S. and non-U.S. legal entities could also reduce the liquidity available to U.S. market participants.

Moreover, in our view, the best way to guard against offshoring of derivatives activities is to make sure that Title VII is applied sensibly and in a manner that does not require U.S. regulators to supervise swap activity across the entire world. Consistent with this objective, our proposal calls for application of Title VII's requirements to common ways that cross-border swap activity is currently conducted. The proposal has been carefully crafted to ensure that U.S. customers are protected by dealing with a U.S.-registered swap dealer that is responsible for compliance with U.S. clearing, trading, reporting and business conduct standards. As described

[3] We note that the banking agencies' margin proposal would treat both U.S. and foreign banks the same if they are entering into transactions from the U.S. or with U.S. persons – in such cases, U.S. rules under Title VII would apply. The one area where there would be different treatment is for swaps entered into from abroad with a foreign counterparty. While the banking agencies would distinguish between a U.S. and foreign-controlled entities – with U.S. entities' non-U.S. operations subject to U.S. margin rules and foreign controlled entities subject to rules of the applicable foreign jurisdiction – we believe that all transactions entered into between foreign counterparties, regardless of whether conducted by a U.S. entity's non-U.S. operation or by a foreign-controlled entity, should be subject to primary supervision by foreign regulators, not U.S. regulators.

above, the registered swap dealer would also be subject to comparable home country prudential supervision.

In contrast, the real danger lies in applying inconsistent or duplicative U.S. rules and supervision to every institution whose swap-related activities has a connection to the U.S. Offshoring is more likely if foreign banks are forced to set up separate trading operations in the United States and abroad, since that would encourage trading to move to the more liquid offshore market rather than staying in the United States where it is now conducted.

Thus, we believe that, under our proposal, Title VII can be applied fairly to all derivatives dealers in a way that does not cause undue disruption and increased costs to customers and the overall financial system.

Swaps Push-Out and Swap Dealer Definition

The IIB would also like to raise two other provisions of Title VII, specifically Section 716 of Dodd-Frank, also known as the swaps "push-out" provision, and the definition of "swap dealer" under Section 1(a)(49) of the Commodity Exchange Act. While we are concerned about the adverse impacts on capital, netting and risk management that will result from the swaps push-out provision, we are most concerned with the unequal treatment accorded to foreign banks under this provision.

Section 716 contains exceptions from the push-out provision for FDIC-insured banks; those exceptions do not extend to uninsured U.S. branches or agencies of foreign banks. When Dodd-Frank was enacted, members of Congress recognized that this oversight was unintentional Left uncorrected, it will, contrary to U.S. policy, prevent foreign banks from conducting bank-permissible businesses and managing risks through their U.S. branches. It also will cause serious market and business disruptions as foreign banks are not included within the provision's grandfather and, thus, will be forced to assign and re-document entire portfolios booked in their U.S. branches. We strongly support extending Section 716's exception and grandfather provisions to U.S. branches and agencies of foreign banks.

Finally, the IIB would support revisions to the definition of "swap dealer" that would allow uninsured U.S. branches and agencies of international banks, like FDIC-insured depository institutions, to enter into swaps with customers as an adjunct to their loan origination activities without having to register as a swap dealer. Branches and agencies of international banks are significant credit providers in this country and account for approximately 18% of all U.S. commercial and industrial loans. To permit these institutions to enter into swaps with their customers only as a registered dealer puts them at a competitive disadvantage to U.S. firms and, more importantly, could discourage further lending in this country by foreign banking institutions.

Systemic Risk, Capital and Other Prudential Standards

The global legislative and regulatory environment is moving towards heightened prudential standards and supervision for all systemically important financial institutions, with increased capital and liquidity requirements, stress tests, "living wills", risk management and disclosure requirements, and corporate governance and incentive compensation standards. The application of these requirements to foreign banking institutions with U.S. banking operations raises complex issues that require a deliberative, cross-jurisdictional approach. Coordination and cooperation among international regulators and deference to home country regulation wherever comparable standards exist is key.

Congress made a determination that these enhanced supervision and prudential standards should apply to those bank holding companies with $50 billion or more in consolidated assets

($50 Billion Asset Threshold) and to certain nonbank financial companies in order to prevent or mitigate risk to the financial stability of the U.S. Congress did not prescribe a specific means for measuring the $50 Billion Asset Threshold and, instead, left this determination to the FRB's discretion.

Unfortunately, the recent proposal on living wills issued jointly by the FRB and the Federal Deposit Insurance Corporation (FDIC) under authority of Section 165(d) of Dodd-Frank takes a fairly expansive view and proposes to define the $50 Billion Asset Threshold by reference to a foreign banking institution's worldwide assets, rather than on the basis of the assets of their U.S. operations. The IIB believes that the Agencies' view is contrary to Congressional intent.

Specifically, as expressed in the plain language of Section 165, the Congressional intent underlying the resolution plan requirement and the other enhanced prudential standards prescribed under Section 165 is to "prevent or mitigate risks to the *financial stability of the United* States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions" (emphasis added). Of the estimated 124 banking institutions subject to the Agencies' living wills proposal, 98 of them are foreign banking institutions. Of those 98, the IIB estimates that approximately 20 institutions have U.S. operations with total consolidated assets of $50 billion or more. Of the remaining 78 foreign banking institutions, the IIB estimates that almost all have U.S. operations whose total consolidated assets are less than $25 billion (and of these approximately 20 have less than $1 billion in assets).

Implementing Section 165 in a manner such that nearly 80% of the banking organizations subject to its enhanced prudential requirements would be institutions headquartered outside the

United States cannot be what Congress intended. It is also difficult to imagine that Congress intended the regulators to devote their precious supervisory resources in this way. Rather, it would be more consistent with Congressional intent, as well as principles of national treatment and equality of competitive opportunity, if the prudential standards were to apply to those foreign banking organizations with $50 billion or more in U.S. assets.

With respect to capital and liquidity generally, we take comfort in the FRB's recent statement that it, together with the other Federal banking agencies, expects to issue in 2011 proposed rules outlining how Basel III-based requirements will be implemented for all institutions with a view towards finalizing Basel III-based capital requirements in 2012 and implementation in 2013.[4] It is important that the global regulators coordinate and work closely to ensure that the Basel III agreement is implemented globally in a consistent and comprehensive manner.

However, the Basel III capital and liquidity rules raise a host of complexities, not the least of which is the interconnectedness of these reforms with those under contemplation by global regulators for systemically important financial institutions. It is important that the global regulators address these issues carefully and with a complete understanding of their impact on the ability of banks as financial intermediaries to continue to serve their clients and the global economy as a whole.

Volcker Rule

The Volcker Rule generally prohibits banking entities, including international banks, from engaging in proprietary trading or sponsoring, acquiring or retaining an interest in a hedge or private equity fund. Congress deliberately limited the extraterritorial effects of the Volcker

[4] Board of Governors of the Federal Reserve System, Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies, 76 Fed. Reg. 22662, 22665 (April 22, 2011).

Rule by permitting international banks to engage in these activities outside of the U.S. Permitting international banks to so engage in these activities is consistent with the policy objectives of the Volcker Rule, which generally focus on protecting U.S. banks, the stability of the U.S. financial system and U.S. taxpayer funds from what Congress deemed to be inappropriate risks. It is also consistent with longstanding principles of international bank supervision, reflected in U.S. federal banking laws, which limit unwarranted extraterritorial application of U.S. banking laws and accord appropriate deference to home country bank supervision.

Governments and supervisors in other countries are actively debating these issues and may make different judgments about bank proprietary trading and fund activities. If the Volcker Rule were applied in such a manner as to reach international banks' non-U.S. proprietary trading and fund activities, it could result in the imposition of overlapping and inconsistent regulatory regimes on foreign banking institutions' non-U.S. operations.

Conclusion

The international bank supervisory framework has long recognized that host country supervisors are inherently limited in their ability to effectively oversee activities in a bank's home country and other jurisdictions, and the legitimate interests of home country regulatory authorities in discharging their responsibilities, as primary supervisors of foreign banking institutions, should be not be dismissed lightly. Nor should the global implications of overreaching by U.S. authorities be ignored. International regulators may well be forced to take a similar stand with respect to U.S.-headquartered financial institutions. Finally, it is imperative from a risk and reward perspective that the U.S. and other countries work together to develop a rational and workable supervisory regime for both U.S. and foreign banking institutions that operate on a global basis. Without such an approach, foreign banking institutions may determine to pare back their U.S. operations, which may well have a significant impact on credit availability, employment and the continued preeminence of the U.S. as a leading financial center.

From Congressman Stephen Fincher

Question for the Honorable Gary Gensler
Many of the larger financial institutions and multinational corporations will be better equipped to deal with the new derivatives regulations than some of our nation's smaller institutions. If the derivatives regulations are too burdensome and expensive to service small customers, how will community banks be able to enter the derivatives market and meet the credit needs of their customers, particularly in rural areas? Will community banks be able to compete with the larger institutions, especially foreign investment firms and banks, in the derivatives market?

Response: The Dodd-Frank Act requires the CFTC to consider whether to exempt farm credit system institutions, depository institutions and credit unions with total assets of $10 billion or less from the clearing mandate. The CFTC issued a proposed rulemaking with respect to the non-financial end-user exception from the clearing requirement that also requested comment regarding such small financial institutions. The CFTC has received substantial public comment in response. Staff will analyze, summarize and consider public comments before the CFTC proceeds further.

The statutory definition of the term "swap dealer" includes a *de minimis* exception that instructs the CFTC to exempt from designation as a swap dealer an entity that engages in a *de minimis* amount of swap dealing. The definition also provides that an insured depository institution (IDI) is not to be considered a swap dealer to the extent it transacts in swaps with a customer in connection with the making of a loan. The CFTC and SEC jointly issued a proposed rulemaking to further define the term "swap dealer." The rulemaking release provided proposed interpretive guidance, and requested comment, regarding the IDI exclusion. It also proposed factors for the *de minimis* exemption based on the aggregate effective notional amount of an entity's trades, its level of trading activity with special entities, the number of counterparties it transacts with, and the number of swaps it trades. The Commissions requested that the public provide comments regarding the proposal with respect to the *de minimis* exemption.

In the same rulemaking release, the CFTC and SEC also proposed to further define the term "major swap participant." The proposal provides that determinations as to whether an entity meets the definition are to focus on the market impacts and risks associated with an entity's swap positions.

To date, there are more than 180 comments responding to the proposal to further define the terms "swap dealer" and "major swap participant." The CFTC will address these issues in the final joint rulemaking with the SEC, after taking the comments into account.

Response to questions from
the Honorable Steve Stivers
by the Federal Deposit Insurance Corporation

Q1. European regulators instituted risk retention rules on January 1, 2011. They are materially different from the notice of proposed rulemaking (NPR) in the U.S. I am concerned this will create roadblocks for U.S. issuers who would like to access European investors, as well as roadblocks for European issuers who would like to access U.S. investors. What consideration was given to rules around the world? What is the scope for the inclusion of some sort of mutual recognition or other acceptance of existing rules in Europe?

A1. The European risk retention rules, known as Article 122a, and the United States' (U.S.) *Credit Risk Retention Notice of Proposed Rulemaking* (*Risk Retention NPR*) differ in some respects, but provide advantages to the securitization market by reducing the possibility that issuers will engage in cross-border regulatory arbitrage. Article 122a requires that securitization originators retain a five percent un-hedged credit risk position. If this risk retention requirement is not met, the investor is subjected to an additional capital requirement of up to 1,250 percent of the invested amount. Article 122a essentially mandates that no European investor can purchase (or provide credit support to) a securitization where the originator does not have five percent risk retention.

Section 941 of the Dodd-Frank Act imposes a risk retention requirement on the securitizer, which the *Risk Retention NPR* defines as a sponsor. Essentially, a U.S. sponsor can only issue a securitization if the sponsor retains five percent of the credit risk, unless the assets are otherwise exempt under the proposal. In addition, European sponsors who sell more than ten percent of an issue in the U.S. are subject to U.S. requirements, as well as non-U.S. affiliates who purchase more that 25 percent of securitized assets from U.S. affiliates. These requirements dovetail with Article 122a in eliminating cross border arbitrage. U.S. issuers will need to structure transactions to include risk retention by the originator (which, under the *Risk Retention NPR* is available if the originator contributed more than 20 percent of the assets in the pool) to satisfy Article 122a, and European issuers must include risk retention to satisfy the *Risk Retention NPR*.

We agree that there may be some impediments for U.S. issuers in the European markets and vice versa. For example, Article 122a does not include any exemptions allowed under the *Risk Retention NPR*, such as the exemption for Qualified Residential Mortgages (QRMs) or other assets exempt from risk retention, and does not provide flexibility to European regulators to augment exemptions. A U.S. sponsor that issues an asset-backed security that is exempt from risk retention would not be able to sell that security to European investors.

Moreover, not all U.S. sponsors would meet the definition of sponsor under Article 122a. Similarly, European issuers who issue index-based securities (exempt from risk retention under Article 122a) would not be able to sell the securities to U.S. investors as these transactions are not exempt from risk retention under the proposal.

The FDIC has considered the impact of the *Risk Retention NPR* and Article 122a on the securitization market's stakeholders. The differences in the rules will affect the sale of asset-backed securities in that the U.S. Agencies[1] are not able to accept the risk retention requirements implemented through restrictions imposed on investments, and European regulators cannot expand exemptions available under Article 122a. The FDIC has concluded that Section 941 of the Dodd-Frank Act and Article 122a do not provide the U.S. and European regulators with the ability to mutually recognize each other's rules.

Q2. It is clear that analysis was done for some aspects for the risk retention proposal. However, I am concerned there has not been much attention to what the proposal means for borrowers, housing markets, or for the economy in general. There is also little to no discussion of other major issues in housing markets, such as the resolution of the GSEs and changes to capital standards, and how all of these interact with the retention proposal. Would you discuss the process by which data was collected and analyzed, and also explain why the NPR shows so little evidence of an economic impact analysis of the proposed rules? Do you think that uncertainty of regulation is a major factor holding back lending, securitization, and housing market more generally?

A2.

Data Collection and Analysis

The Dodd-Frank Act directed the Agencies to define the term qualified residential mortgage, or QRM, "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default..." To meet this mandate, the Agencies examined data from several sources. For example, the Agencies reviewed data on mortgage performance supplied by the Applied Analytics division (formerly McDash Analytics) of Lender Processing Services (LPS). To minimize performance differences arising from unobservable changes across products and focus on loan performance through stressful environments, the Agencies considered data for prime fixed-rate loans originated from 2005 to 2008. This data set included underwriting and performance information on approximately 8.9 million mortgage loans.

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[1] The term "agencies" refers to the FDIC, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, U.S. Securities and Exchange Commission, Federal Housing Finance Agency, and the Department of Housing and Urban Development.

The Agencies also examined data from the 1992 to 2007 waves of the triennial Survey of Consumer Finances (SCF).[2] This data set included information on approximately 1,500 families. In addition, the Agencies examined a combined data set of loans purchased or securitized by the government-sponsored enterprises (GSEs) from 1997 to 2009. This data set consisted of more than 75 million mortgage loans and included data on loan products and terms, borrower characteristics (*e.g.*, income and credit score), and performance data through third quarter 2010.[3] The *Risk Retention NPR* also contains tables that show the estimated effects of the proposed QRM standards based on data for all residential mortgages purchased or securitized by the GSEs between 1997 and 2009.

Economic Impact Analysis

As in all releases for proposed and final regulations, the Agencies considered the potential economic impact of the *Risk Retention* NPR. We understand that the securitization market is important to credit creation in the U.S. and we have and will continue to closely consider the views of commenters on how all stakeholders in this market are affected by the proposed rule.

We recognize that the standards in the QRM exemption, such as debt-to-income ratios and loan-to-value requirements, have raised concerns about access to affordable mortgage credit for low- and moderate-income (LMI) borrowers. The FDIC shares these concerns and seeks to ensure that LMI borrowers continue to have access to affordable mortgage credit. It is for this reason that the Agencies have sought to ensure the non-QRM segment of the market will be cost-effective for LMI borrowers and large enough to ensure a vibrant and liquid secondary market. The Agencies are seeking comment on the impact of the QRM standards on these borrowers. In particular, the Agencies welcome comment on whether and how the Agencies can assure the unique needs of LMI or first-time homebuyers can be met.

Factors Affecting the Markets

Financial institutions have voiced concerns about how the Agencies will implement the Dodd-Frank Act, including the credit risk retention requirements of Section 941. Moreover, market participants have expressed a concern that the interaction of various requirements under the Dodd-Frank Act could have unintended consequences that could increase unnecessary burden and regulatory compliance costs beyond currently projected levels.

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[2] The SCF is conducted every three years by the Board, in cooperation with Treasury, to provide detailed information on the finances of U.S. families. The SCF collects information on the balance sheet, pension, income, and other demographic characteristics of U.S. families. To ensure the representativeness of the study, respondents are selected randomly using a scientific sampling methodology that allows a relatively small number of families to represent all types of families in the nation. Additional information on the SCF is available at http://www.federalreserve.gov/pubs/oss/oss2/method.html.

[3] Additional information concerning the GSE data used by the Agencies in developing the proposed QRM standards is provided in Appendix A to this Supplementary Information.

Concerns also have been raised regarding plans to establish a private-market solution to the GSEs, which currently hold or guarantee more than half of all U.S. home mortgage debt. The *Risk Retention NPR* recognizes that the guarantee on GSE securities results in 100 percent risk retention. However, recognition of the GSEs' guarantee for purposes of the risk retention requirement is permitted only as long as the GSEs are operating under the conservatorship or receivership of FHFA with capital support from the U.S. government. Therefore, new mortgage loans guaranteed by a GSE after it emerges from conservatorship may be subject to risk retention unless a different exemption applies. It is currently unclear how the migration of mortgage loans to a non-GSE, non-exempt mortgage category would affect the cost and availability of mortgage loans.

Implemention of the Basel III capital standards would not directly affect the risk weights assigned to residential mortgages. The most important regulatory capital implication of risk retention requirements would be the need for the securitization sponsor to hold capital against the retained risk; this result appears consistent with the policy goal of risk retention to promote accountability by securitizers for the quality of loans being sold.

Q3. The risk retention notice of proposed rulemaking (NPR) includes a concept called "premium capture." As proposed, this would force securitization issuers to hold back all profit earned at the time a securitization was done, and force it to be held back until all bonds in the deal are paid off, which could be 15 or 30 years down the road. The reaction to this proposal has been negative, with concern that securitization won't happen if they cannot be profitable (just like any other business). Could you explain where this proposal came from, why it is expected that securitizers will essentially do their business without profit, why you supported it, and how you plan to fix it?

A3. The premium capture reserve account is designed to realign incentives toward quality underwriting by eliminating the ability of a securitizer or originator to immediately capture the profit from a securitization. Even though some risk retention typically was a common feature of securitizations historically, the ability to capture a large profit or gain immediately upon sale meant that retained risk had little influence on underwriting standards and asset quality, and made risk retention largely meaningless. Securitizers' ability to capture the profit upfront drove increased origination volumes in the "originate to distribute" model--at the expense of quality lending.

To prevent a securitizer from reducing or negating the effects of risk retention by monetizing excess spread, the *Risk Retention NPR* requires the issuer to create a premium capture reserve account to hold upfront profits or sale premiums on asset-backed securities. Funds deposited into this account must be used to cover losses on the underlying assets before the losses are allocated to any other securitization interest. The premium capture reserve account requirement complements risk retention by ensuring a securitizer's interests remain aligned with the underlying performance and quality of assets, while providing the securitizer with an opportunity for profit contingent on the performance of the underlying assets.

If the underlying assets perform poorly and the securitization's investors take losses, the *Risk Retention NPR's* premium capture restrictions will prevent the securitizer from making a profit. If the underlying assets perform satisfactorily, the securitization will be profitable to the securitizer, who will receive the same amount of profit after the more senior tranches have been paid. If, because of the premium capture reserve account, a securitizer does not issue premium tranches, it would receive the profits over time as the loans perform.

The FDIC has engaged in a dialogue with various stakeholders during the *Risk Retention NPR's* comment period to discuss industry concerns regarding the premium capture reserve account. We have, and will continue to consider these concerns as the Agencies formulate the final rule.

Responses from Under Secretary Brainard, U.S. Department of the Treasury, to questions submitted by Representative Stivers

1. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   European regulators instituted risk retention rules on January 1, 2011. They are materially different from the notice of proposed rulemaking (NPR) in the US. I am concerned this will create roadblocks for US issuers who would like to access European investors, as well as roadblocks for European issuers who would like to access US investors. What consideration was given to rules around the world? What is the scope for the inclusion of some sort of mutual recognition or other acceptance of existing rules in Europe?

Response:

Treasury defers to the regulatory agencies on this question, as they are best placed to answer detailed questions about their rule-writing processes.

2. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   It is clear that analysis was done for some aspects for the risk retention proposal. However, I am concerned there has not been much attention to what the proposal means for borrowers, housing markets, or for the economy in general. There is also little to no discussion of other major issues in housing markets, such as the resolution of the GSEs and changes to capital standards, and how all of these interact with the retention proposal. Would you discuss the process by which data was collected and analyzed, and also explain why the NPR shows so little evidence of an economic impact analysis of the proposed rules? Do you think that uncertainty of regulation is a major factor holding back lending, securitization, and housing market more generally?

Response:

Treasury defers to the regulatory agencies on this question, as they are best placed to answer detailed questions about their rule-writing processes.

3. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   The risk retention notice of proposed rulemaking (NPR) includes a concept called "premium capture." As proposed, this would force securitization issuers to hold back all profit earned at the time a securitization was done, and force it to be held back until all bonds in the deal are paid off, which could be 15 or 30 years down the road. The reaction to this proposal has been negative, with concern that securitization won't happen if they cannot be profitable (just like any other business). Could you explain where this proposal came from, why it is expected that securitizers will essentially do their business without profit, why you supported it, and how you plan to fix it?

Response:

Treasury defers to the regulatory agencies on this question, as they are best placed to answer detailed questions about their rule-writing processes.

Financial Regulatory Reform: The International Context
Questions to be submitted for the record by Rep. Stivers
June 16, 2011

1. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   European regulators instituted risk retention rules on January 1, 2011. They are materially different from the notice of proposed rulemaking (NPR) in the US. I am concerned this will create roadblocks for US issuers who would like to access European investors, as well as roadblocks for European issuers who would like to access US investors. What consideration was given to rules around the world? What is the scope for the inclusion of some sort of mutual recognition or other acceptance of existing rules in Europe?

Response: This question and the two that follow are more appropriately answered by others on the panel.

2. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   It is clear that analysis was done for some aspects for the risk retention proposal. However, I am concerned there has not been much attention to what the proposal means for borrowers, housing markets, or for the economy in general. There is also little to no discussion of other major issues in housing markets, such as the resolution of the GSEs and changes to capital standards, and how all of these interact with the retention proposal. Would you discuss the process by which data was collected and analyzed, and also explain why the NPR shows so little evidence of an economic impact analysis of the proposed rules? Do you think that uncertainty of regulation is a major factor holding back lending, securitization, and housing market more generally?

3. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   The risk retention notice of proposed rulemaking (NPR) includes a concept called "premium capture." As proposed, this would force securitization issuers to hold back all profit earned at the time a securitization was done, and force it to be held back until all bonds in the deal are paid off, which could be 15 or 30 years down the road. The reaction to this proposal has been negative, with concern that securitization won't happen if they cannot be profitable (just like any other business). Could you explain where this proposal came from, why it is expected that securitizers will essentially do their business without profit, why you supported it, and how you plan to fix it?

"Financial Regulatory Reform: The International Context"
House Committee on Financial Services Hearing
Responses by Chairman Schapiro

1. **Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh**

   European regulators instituted risk retention rules on January 1, 2011. They are materially different from the notice of proposed rulemaking (NPR) in the US. I am concerned this will create roadblocks for US issuers who would like to access European investors, as well as roadblocks for European issuers who would like to access US investors. What consideration was given to rules around the world? What is the scope for the inclusion of some sort of mutual recognition or other acceptance of existing rules in Europe?

   In making its recommendations, the staff of the Commission, working with the staff of our fellow regulators, closely analyzed and considered the developments in foreign markets related to risk retention, and in particular, Article 122a of the European Union capital requirements directive relating to securitizations. As stated in footnote 55 of the Notice of Proposed Rulemaking (NPR) published by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Department of Housing and Urban Development and the Securities and Exchange Commission (hereinafter "the Agencies") a variation of the vertical, horizontal, seller's interest, and representative sample options that are permitted forms of risk retention under the proposed rules are also forms of eligible risk retention under Article 122a. In this regard, while we recognize that the structure of the European risk retention regime is fundamentally different than the U.S. risk retention regime (as required by statute, the U.S. rules apply to securitizers of asset-backed securities, while the European rules apply to European credit institutions that invest in asset-backed securities), it appears that a sponsor choosing the U.S.-proposed vertical or horizontal form would in many cases also comply with the comparable form under the European risk retention regime.

   While the Agencies did not propose to incorporate a mutual recognition framework in the NPR, the Agencies have received comments from certain trade associations and some members of the public that provisions should be built into both the U.S. risk retention regime and the EU risk retention regime to permit mutual recognition. We look forward to analyzing the comment letters on the proposed rules concerning this topic and will consider all comments received as we move forward with this interagency rulemaking.

2. **Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh**

   It is clear that analysis was done for some aspects for the risk retention proposal. However, I am concerned there has not been much attention to what the proposal means for borrowers, housing markets, or for the economy in general. There is also little to no discussion of other major issues in housing markets, such as the

resolution of the GSEs and changes to capital standards, and how all of these interact with the retention proposal. Would you discuss the process by which data was collected and analyzed, and also explain why the NPR shows so little evidence of an economic impact analysis of the proposed rules? Do you think that uncertainty of regulation is a major factor holding back lending, securitization, and housing market more generally?

We recognize that there are many aspects of Section 941 of the Dodd-Frank Act, and the rules required to be promulgated thereunder, that may directly or indirectly affect borrowers, the housing market, and our economy generally. The Commission is sensitive to the costs and benefits imposed by its rules, and in this regard, it included a discussion in the NPR focused on the costs and benefits of the decisions made by the Commission, together with the other Agencies, to fulfill the mandates of Section 941 within its permitted discretion.

As noted in the NPR, in considering how to determine the definition of "qualified residential mortgage," the Agencies examined data from several sources. For example, the Agencies reviewed data on mortgage performance supplied by the Applied Analytics division (formerly McDash Analytics) of Lender Processing Services (LPS). To minimize performance differences arising from unobservable changes across products, and to focus on loan performance through stressful environments, for the most part, the Agencies considered data from prime fixed-rate loans originated from 2005 to 2008. This dataset included underwriting and performance information on approximately 8.9 million mortgages. As is typical among data provided by mortgage servicers, the LPS data did not include detailed information on borrower income and on other debts the borrower may have in addition to the mortgage. The NPR explains that for this reason, the Agencies also examined data from the 1992 to 2007 waves of the triennial Survey of Consumer Finances (SCF). Because families' financial conditions will change following the origination of a mortgage, the analysis of SCF data focused on respondents who had purchased their homes either in the survey year or the previous year. This dataset included information on approximately 1,500 families. The Agencies also examined a combined dataset of loans purchased or securitized by Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (the "Enterprises") from 1997 to 2009. The Enterprises data set consisted of more than 75 million mortgages, and included data on loan products and terms, borrower characteristics (e.g., income and credit score), and performance data through the third quarter of 2010.

With respect to your final question, we understand and appreciate that some industry participants and members of the public are concerned about the impact of future financial regulations and, with respect to the risk retention rule, how this rule may impact future securitization and the housing market generally. We are mindful of these concerns and are working expeditiously to implement the rules required by section 941(b) of the Dodd-Frank Act in a timely manner while also ensuring a thoughtful, deliberative process to consider all comments we receive on the NPR.

3. **<u>Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh</u>**

The risk retention notice of proposed rulemaking (NPR) includes a concept called "premium capture." As proposed, this would force securitization issuers to hold back all profit earned at the time a securitization was done, and force it to be held back until all bonds in the deal are paid off, which could be 15 or 30 years down the road. The reaction to this proposal has been negative, with concern that securitization won't happen if they cannot be profitable (just like any other business). Could you explain where this proposal came from, why it is expected that securitizers will essentially do their business without profit, why you supported it, and how you plan to fix it?

As stated in the NPR, the Agencies proposed the premium capture cash reserve account in order to assure that the rules achieve the goals of risk retention of Section 941(b) of the Dodd-Frank Act. The proposed premium capture cash reserve account was intended to prevent sponsors from structuring around the minimum 5% risk retention requirement. The NPR notes that without a mechanism similar to a premium capture cash reserve account, a sponsor could effectively negate or reduce the economic exposure it is required to retain under the proposed rules. Furthermore, as noted in the NPR, the Agencies believed that prohibiting sponsors from receiving compensation in advance of excess spread income expected to be generated over time should better align the interests of sponsors and investors and promote more robust monitoring by the sponsor of the credit risk of securitized assets, thereby encouraging the use of sound underwriting in connection with securitized loans. The Agencies also believed that it should promote simpler and more coherent securitization structures.

While we recognize that some industry participants have been critical of the proposed premium capture cash reserve account, this criticism is largely related to the proposed formula used to determine whether the creation of an account would be required by the rule. The criticism in general has not been directed toward the basic principle behind the account, which is to prevent sponsors from structuring around the 5% risk retention requirement. The NPR includes many requests for comment on this aspect of the proposal, and the Agencies specifically seek the public's input on whether the method of calculating the account is appropriate or whether there are alternative methodologies that would better achieve the purpose of the account. We look forward to analyzing the public's feedback to these questions and will carefully consider comments received on the proposed premium capture cash reserve account in crafting rules that are consistent with the purposes of risk retention and the statute.

Questions for The Honorable Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System, from Representative Stivers:

1. European regulators instituted risk retention rules on January 1, 2011. They are materially different from the Notice of Proposed Rulemaking (NPR) in the U.S. I am concerned this will create roadblocks for U.S. issuers who would like to access European investors, as well as roadblocks for European issuers who would like to access U.S. investors. What consideration was given to rules around the world? What is the scope for the inclusion of some sort of mutual recognition or other acceptance of existing rules in Europe?

The European Union's risk retention requirements are embodied in Article 122a of the Capital Requirements Directive (CRD) (the "EU risk retention rules"). The EU risk retention rules, similar to section 941 of The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), generally require that an originator, sponsor, or original lender retains at least a five percent interest in a securitization transaction.

The EU risk retention rules and the Dodd-Frank Act take different implementation approaches to risk retention. However, the EU risk retention rules take an "investor-based" approach, where investors--that is, the buyers of asset-backed securities--have the responsibility to ensure that a sponsor, originator, or original lender retains no less than five percent of the nominal value of the securitized exposures. In contrast, the Dodd-Frank Act directs relevant federal agencies to prescribe regulations that apply to securitizers.

The agencies issued the Notice of Proposed Rulemaking (NPR) to implement the risk retention requirements on March 30, 2011. The comment period was extended to August 1, 2011. The NPR proposes that U.S. sponsors issuing asset-backed securities abroad comply with the U.S. retention requirements in order to prevent arbitrage of regulatory regimes. Similarly, European sponsors who issue securities in the U.S. would generally have to comply with the U.S. risk retention requirements, unless a foreign transaction has limited connections with the United States and U.S. investors, and qualifies for the proposed safe harbor.

The agencies are in the process of receiving and reviewing comments, including comments related to the safe harbor for foreign-related transactions. The agencies will consider commenters' concerns and suggestions on how to address cross-border issues in a consistent manner.

2. It is clear that analysis was done for some aspects for the risk retention proposal. However, I am concerned there has not been much attention to what the proposal means for borrowers, housing markets, or for the economy in general. There is also little to no discussion of other major issues in housing markets, such as the resolution of the GSEs and changes to capital standards, and how all of these interact with the retention proposal. Would you discuss the process by which data was collected and analyzed, and also explain why the NPR shows little evidence of an economic impact analysis of the proposed rules? Do you think that uncertainty of regulation is a major factor holding back lending, securitization, and housing market more generally?

As mentioned, section 941 requires that the relevant agencies prescribe regulations that require securitizers generally to retain at least a five percent interest in securitized assets. In addition, the Dodd-Frank Act directs the regulators to define "qualified residential mortgages" (QRM) which are exempt from risk retention. In defining the QRM, the Dodd-Frank Act directs regulators to "take into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default."

In considering how to define QRM for purposes of the NPR, the relevant agencies relied in part on the large body of academic and practitioner literature on mortgage risk management. The NPR contained references to several of the more recently published studies. The overwhelming consensus of this literature is that a borrower's equity in a property and credit score, along with a few other factors, are key predictors of default. In addition to the existing literature, the proposed rule also relied on work done by analysts at various agencies using proprietary datasets that may not be available to academics or practitioners. Using data supplied by Lender Processing Servicers Applied Analytics covering the bulk of mortgages originated in the U.S. since 2005, the agencies analyzed the key variables associated with default. As an example, the NPR contains a graph showing default rates by loan-to-value (LTV) ratios based on these data; this graph shows that at LTVs above 80 percent, default rates jump significantly. Similarly, analysts from the Federal Housing Finance Agency (FHFA) used data on mortgages guaranteed by the government-sponsored enterprises (GSEs) to compute the additional default rates associated with relaxing various QRM criteria. All of this analysis was considered by the agencies in the QRM definition contained in the NPR, and was discussed in the preamble to the proposed rule.

The proposal also aimed to minimize the excess costs to borrowers falling outside the narrow QRM definition. The proposed QRM definition was not designed to be a minimum underwriting standard for prime mortgages. The rationale for keeping the proposed definition of QRM narrow was that loans would not be stigmatized for falling outside the definition and thus that the market for non-QRMs could remain liquid with little or no pricing difference between QRMs and non-QRMs related just to risk retention. In addition, the menu of risk retention options in the NPR is designed to accommodate a variety of market practices, seeking to make it relatively manageable for issuers to satisfy the risk retention requirement. Finally, it is noteworthy that the few private-label mortgage-backed securities (MBS) deals that have come to market since the financial crisis featured substantial risk retention. As the market revives further and investors once again begin purchasing private-label MBS, it is likely they will continue to demand significant risk retention by issuers regardless of the security's status as a QRM deal. Indeed, meaningful risk was routinely retained by issuers prior to the surge in MBS issuance that started around 2004, although this retention was often opaque and the form and amount varied across issuers.

The agencies carefully considered a variety of mortgage characteristics that are associated with higher rates of default and the potential impact of the proposed rules on lending. Given the complexity of the risk retention rules, the NPR asked for detailed comments on the proposed rules' impact on the market, housing prices and lending rates. These comments will be carefully considered prior to completion of the rule-making process. In addition, the agencies have noted their intent to return to this rule when the GSEs exit conservatorship and the role for private capital in the mortgage market becomes clearer.

3. The risk retention notice of proposed rulemaking (NPR) includes a so-called "premium capture." As proposed, this would force securitization issuers to hold back all profit earned at the time a securitization was done, and force it to be held back until all bonds in the deal are paid off, which could be 15 or 30 years down the road. The reaction to this proposal has been negative, with concerns that securitization won't happen if they cannot be profitable (just like any other business). Could you explain where the proposal came from, why it is expected that securitizers will essentially do their business without profit, why you supported it, and how you plan to fix it?

It is the agencies' expectation that issuers will be able to continue to profitably issue ABS and MBS and, in general, not trigger the premium capture provision of the rule. This provision seeks to prevent circumvention of the retention requirement.

More specifically, the premium capture account attempts to ensure that the risk retention required by the Dodd-Frank Act is economically meaningful by aligning the compensation of a sponsor with that of a balance sheet lender in order to encourage the sponsor to receive its profit over time. As a result, a portion of the sponsor's profit would be tied to the performance of the underlying collateral, instead of the sponsor earning all of its profits upfront in a riskless manner at the time when the transaction is closed.

The agencies have requested comments on all aspects of the risk retention proposal, including premium capture, and will carefully consider all comments as they move forward with finalizing the risk retention rule.

Financial Regulatory Reform: The International Context
Questions submitted for the record by Rep. Stivers

1. European regulators instituted risk retention rules on January 1, 2011. They are materially different from the notice of proposed rulemaking (NPR) in the US. I am concerned this will create roadblocks for US issuers who would like to access European investors, as well as roadblocks for European issuers who would like to access US investors. What consideration was given to rules around the world? What is the scope for the inclusion of some sort of mutual recognition or other acceptance of existing rules in Europe?

The NPR proposes a flexible approach to satisfying the base risk retention requirement, so that securitizers can structure their retention in a way that meets investor demand. This flexibility allows securitizers to structure their retention obligations in ways that satisfy foreign risk retention requirements as well.[1] Beyond this central flexibility, there are other accommodations for international commerce under the NPR as well. The agencies, in drafting the NPR, were informed by the European Union Capital Requirements Directive, but formulated the substance of the proposal based on the particular requirements of section 941 and the experiences in the U.S. market during the financial crisis.

The NPR also includes a safe harbor intended to exclude transactions in which the effects on U.S. interests are sufficiently remote so as not to significantly impact loan underwriting standards and risk management practices in the United States or the interests of U.S. investors. Under this safe harbor, a foreign affiliate of a U.S. firm may sponsor a securitization transaction in a foreign jurisdiction without complying with the proposed U.S. risk retention requirements, so long as no material portion of the ABS are sold to U.S. investors.[2] The same safe harbor is available to foreign firms.

This safe harbor is based on existing safe harbors under the U.S. securities laws. Under this proposed approach, U.S. investors will be assured of the investor protection benefits of the statute, and foreign investors will receive the investor protection benefits afforded by their governments under their laws.

2. It is clear that analysis was done for some aspects for the risk retention proposal. However, I am concerned there has not been much attention to what the proposal means for borrowers, housing markets, or for the economy in general. There is also little to no discussion of other major issues in housing markets, such as

[1] For example, please refer to footnote 55 of the NPR, discussing how several of the proposed forms of risk retention are eligible forms of retention for purposes of the European Union requirements.

[2] In order to prevent evasion of the risk retention requirements, the safe harbor does not apply if the foreign affiliate acquired 25 percent or more of the securitized loans from a consolidated affiliate located in the U.S. The safe harbor also does not apply if the securitization transaction would be required, for some reason, to be registered under the Securities Act of 1933, or if the transaction as a whole is designed to evade the risk retention rules.

the resolution of the GSEs and changes to capital standards, and how all of these interact with the retention proposal. Would you discuss the process by which data was collected and analyzed, and also explain why the NPR shows so little evidence of an economic impact analysis of the proposed rules? Do you think that uncertainty of regulation is a major factor holding back lending, securitization, and housing market more generally?

At present, several macroeconomic factors are dampening key sectors of the MBS market. Investor uncertainty about the value of mortgage collateral and the practical ability to foreclose on it, broad market conditions that don't trigger "yield chasing" by investors, and an absence of excess investor liquidity are examples of these factors. Other sectors of the ABS market, such as credit cards, remain robust. That being said, it is critical to develop a regulatory structure for risk retention with the inherent flexibility to meet investor demands, so that the infrastructure will be in place when negative macroeconomic factors dissipate. The NPR was designed to achieve that objective.

With respect to other major issues in the housing markets, and the GSEs in particular, the NPR acknowledges the need for, and importance of, their reform, and the Agencies commit to reassess their treatment once the GSEs' future is clarified by Congress. With respect to capital requirements, the NPR addresses this through its flexibility as to the various possible forms of retention, and discusses how these different forms will variously dictate whether the securitization assets are consolidated with the assets of the securitizer under existing accounting guidance or represent recourse for risk-based capital purposes.

The NPR addresses borrowers and housing markets through the QRM criteria and the flexible retention requirements, and discusses how they were designed to provide sponsors with several options for complying with the risk retention requirements of section 15G so as to reduce the potential for the QRM definition to disrupt securitization markets, including those for non-QRM residential mortgages, or materially affect the flow or pricing of credit to borrowers and businesses. The NPR also discusses the proposal's design to ensure that the amount of non-QRM residential mortgages should be sufficiently large, and include enough prudently underwritten loans, so that ABS backed by non-QRM residential mortgages may be routinely issued and purchased by a wide variety of investors. As a result, the market for such securities should be relatively liquid, and the broader the definition of a QRM, the less liquid the market ordinarily would be for residential mortgages falling outside the QRM definition. As the agencies move forward with consideration of the public comments and finalization of the rule, the OCC will be focused on whether this balance has been appropriately struck.[3]

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[3] In connection with the NPR, the OCC also prepared an economic analysis of estimated opportunity costs of the proposed risk retention rules to national bank securitizers. *See* section VIII.E of the NPR, *OCC Unfunded Mandates Reform Act of 1995 Determination*; Treasury Department Office of Inspector General Information Report No. OIG-CA-11-006, *Dodd-Frank Act: Congressional Request for Information Regarding Economic Analysis by the OCC* (June 13, 2011, available at http://www.treasury.gov/about/organizational-structure/ig/Documents/OIG-CA-11-006.pdf).

3. The risk retention notice of proposed rulemaking (NPR) includes a concept called "premium capture." As proposed, this would force securitization issuers to hold back all profit earned at the time a securitization was done, and force it to be held back until all bonds in the deal are paid off, which could be 15 or 30 years down the road. The reaction to this proposal has been negative, with concern that securitization won't happen if they cannot be profitable (just like any other business). Could you explain where this proposal came from, why it is expected that securitizers will essentially do their business without profit, why you supported it, and how you plan to fix it?

The premium capture proposal was not intended to force securitizers to hold back all profits until the bonds are paid off. It was intended to restrain the ability of securitizers acting as middlemen to make a quick, up-front profit by stripping excess yield off high-interest-rate loans – which command such high rates because they feature inherently higher credit risk – and leave securitization investors to suffer principal losses if those loans later default. Premium capture puts the securitization sponsor more in the position of a balance sheet lender that decides to make a higher-risk, higher-yield loan, knowing that they will only benefit from that higher yield if the loan performs as expected. The proposal was intended to curtail aggressively-engineered ABS structures that exploited asymmetries of information between securitizers and investors, realign the incentives of both sides of the transaction, and foster other ABS structures that allow securitizers to profit from transforming the cash flows on the underlying assets into securities that have higher value to investors because of their particular terms and characteristics. The NPR requests comment whether the details of the proposed approach presents unintended operational impediments for securitization, and the OCC will be focused on this issue in consideration of the public comments and structuring the final rule.

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