

Testimony of Michael S. Barr  
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Before the House Financial Services Committee  
Subcommittee on Oversight and Investigations  
Hearing on Financial Regulation and U.S. Competitiveness  
March 5, 2014

Chairman McHenry, Ranking Member Green, I am pleased to appear before you today to discuss financial regulation and U.S. competitiveness.

In 2008, the United States plunged into a severe financial crisis that shuttered American businesses, and cost millions of households their jobs, their homes and their livelihoods. The crisis was rooted in unconstrained excesses and prolonged complacency in major financial capitals around the globe. And the crisis demanded a strong regulatory response as well as fundamental changes in financial institution management and oversight.

Two years later, the Dodd-Frank Act created the authority to regulate Wall Street firms that pose a threat to financial stability, without regard to their corporate form, and bring shadow banking into the daylight; to wind down major firms in the event of a crisis, without feeding a panic or putting taxpayers on the hook; to attack regulatory arbitrage, restrict risky activities, regulate short-term funding markets, and beef up banking supervision; to require central clearing and exchange trading of standardized derivatives, and capital, margin and transparency throughout the market; to improve investor protections; and to establish a new Consumer Financial Protection Bureau (CFPB) to look out for the interests of American households.

### **The Path of U.S. Reforms**

Since enactment, the new CFPB has been built and is helping to make the marketplace level and fair. New rules governing derivatives transactions have largely been proposed. Resolution authority and improvements to supervision are being put in place. The Financial Stability Oversight Council has begun to take on the shadow banking system by designating non-bank firms for heightened supervision and at the end of the year regulators finalized the Volcker Rule.

To continue to make progress on reform, the Federal Reserve needs to use its authority under Dodd-Frank to finalize its rules for tough new oversight, including requiring limits on counterparty credit exposures, and imposing a cap on the relative size of liabilities held by the largest firms. The Fed must speed up reforms to repo and other short-term funding markets that were at the heart of the financial panic five years ago. It must also use its authority under Dodd-Frank to bolster resiliency in clearance and settlement of foreign currency markets.

Five years after the money market fund industry faced a devastating run, stopped only with a \$3 trillion taxpayer bailout, we still do not have fundamental reform of that sector, with the necessary buffers to prevent a financial collapse.

And we need legislation to determine the ultimate fate of the government-sponsored enterprises in a way that protects taxpayers while assuring that the mortgage system works for American families.

Strong and effective regulation in the United States is crucial to a safer and fairer financial system, but it is not enough. We also need global reforms.

### **Global Capital Rules**

Strong capital rules are one key to a safer system. There's already double the amount of capital in the major US firms than there was in the lead up to the financial crisis. Globally, regulators are developing more stringent risk-based standards and leverage caps for all financial institutions, and tougher rules for the biggest players.

In the U.S., regulators have proposed an even stronger leverage requirement for the largest U.S. firms, and other countries are putting in place stricter approaches when warranted by their local circumstances. In my judgment, the local variation based on a strong minimum standard is healthy for the system, taking into account the different relative size of financial sectors and differing local economic circumstances. There's been progress on the quality of capital—focusing on common equity—and on better and more comparable measures of the riskiness of assets, but more could be done to improve transparency of capital requirements across different countries and to make them stronger buffers against both asset implosions and liquidity runs. And in Europe, there is still a long way to go in implementing tough and transparent stress tests and in forcing the largest firms to hold sufficient capital to withstand these tests.

Improved capital regulation alone, however, is not enough.

### **Structural Reform and Resolution**

Globally, much more work needs to be done to make resolution of an international firm a practical reality. In the U.S. and Europe, further work is needed on implementing structural reforms, such as the U.S. Volcker rule, the U.K.'s Vickers Report, and Europe's Liikanen Group, that could reduce risks, improve oversight, and make the largest firms more readily resolvable in the event of a crisis.<sup>1</sup>

First, having a clear sense of who is in charge of what is vital when it comes to management and supervision, especially in times of stress. Structural reform and

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<sup>1</sup> This section draws heavily from Barr & Vickers, Banks Need Far More Structural Reform to be Safe, Financial Times, July 21, 2013.

“living wills” can be used to help clarify lines of authority, align business risk with organizational form, and simplify structures of complex financial institutions.

Second, structural reform can help to bolster “horizontal buffers”, which can help stop crises spreading when they start. Limits on the activities of retail deposit banks, restrictions on transactions between retail banks and their affiliates, independent capital, and caps on counterparty credit exposures can help minimize contagion.

Third, paying attention to structure will help to resolve companies when they get into distress. The FDIC is developing a “single point of entry” model for resolution that would allow it to wind down a complex financial conglomerate through its holding company with “resolution-ready” debt and equity, while permitting solvent subsidiaries to continue to operate. Similar approaches are being discussed in Europe. Structural reform will make it much more likely that complex financial companies can be credibly resolved in a crisis.

While different countries are taking different approaches to structural reform, there is also convergence on the importance of the approaches.

The US has long used the bank holding company structure to try to separate banking from other financial activities within a complex group. The Dodd-Frank Act strengthened the wall between banks and other parts of a financial group, moved some derivatives activities to affiliates, and pushed proprietary trading and significant hedge fund investing outside the holding company entirely. The UK is moving forward with reforms based on the recommendations of the Independent Commission on Banking, which will move Britain more towards the US approach of using bank holding companies with separate subsidiaries. The retail banking subsidiary would have more restricted activities and would be ring-fenced from other units. Europe is considering similar reforms proposed by the Liikanen report.

Recently, the Federal Reserve proposed rules for foreign banking organizations operating in the U.S. Under the rules, large foreign banking organizations will need to put non-branch assets under a U.S. intermediate holding company. Under many circumstances, foreign firms will need to meet U.S. capital and liquidity rules and prudential standards with respect to their U.S. operations. In my judgment, these rules are consistent with national treatment and prudent as measures to reduce systemic risk and improve the safety and soundness of the U.S. financial system. Nonetheless, they have been met with significant controversy.

None of these approaches is perfect, or perfectly aligned, and all are evolving. Structural reform involves difficult trade-offs: introducing rigidity may decrease efficiency and increase the risks faced by individual banks, while reducing the potential harm done to the system as a whole. In response to these trade-offs, the US, UK and Liikanen approaches all accept that forms of universal banking can be efficient but see the need for it to have structural safeguards and limitations. Further global progress on these measures would be well warranted.

Ring fencing by itself, of course, will not bring financial stability. We had forms of ring fencing before the crisis, where it blinded regulators to the dangers of shadow banking. Non-bank financial institutions engaged in increasingly risky activities with too little oversight and far too much leverage. So structural reforms need to be part of a broader change in supervision and capital requirements, including resolution procedures for large financial companies regardless of their corporate form, and much needed reforms to derivatives markets. Ring fencing is no excuse to avoid regulating non-bank firms and markets that can pose a risk the financial system.

### **Derivatives and Other Markets**

One such important reform is regarding the derivatives markets. During the financial crisis, over the counter derivatives transactions contributed to the panic. And in the lead up to the crisis, OTC derivatives grew significantly in size without enough margin and capital in the system as buffers against losses. OTC derivatives were traded without transparency, and regulators, market participants and the public at large were left in the dark about the true extent and nature of risks.

The US led reforms of derivatives markets, and pushed for strong G-20 commitments for global reform. The Dodd-Frank Act moves derivatives markets towards central clearing, exchange trading, strong capital and margin rules, market-wide transparency, and sound business conduct standards. Europe agreed to implement similar reforms and is engaged in two important policy initiatives—the European Market Infrastructure Regulation and the Markets in Financial Instruments Directive—to further these reforms. While many in the US remain concerned about whether Europe’s rules will end up strong enough, and many in Europe worry about whether the US will extend the reach of its rules too far, the global system is moving towards a more coordinated approach for derivatives.

Other market reforms still need much more work. Global rules on liquidity, including governance of repo markets and other short-term funding mechanisms, are still in flux. Hot money is still a big risk to stability. Furthermore, global coordination to strengthen the resiliency of foreign currency markets is in order. In addition, apparently widespread manipulation of global rates, including LIBOR and foreign currency trading, has not yet been met with the fundamental changes required to restore trust and confidence—and veracity, to global rates.

### **Global Financial Regulatory Coordination**

The United States has taken a strong lead in pursuing global reforms, galvanizing the G-20, pushing for the creation of the global Financial Stability Board, and pursuing strong global reforms on capital, derivatives, and other matters.

Yet some want to sidetrack reforms through a new trade-focused process. Recently, the United States and the European Union have embarked on a new round of trade

talks that may bring real benefits on both sides of the Atlantic. But the talks should not be used to weaken US financial reforms that are just taking root.

The financial industry is pushing the talks as a way to overturn the rules being implemented in the US under Dodd-Frank. Some commentators and academics, moreover, view the talks as another forum for cooperation, hoping that trade negotiations will improve coordination among financial regulators.

The US has wisely rejected that view. Now is not the time to place America's hard-fought financial reforms at risk. Shadow banking is coming into the light; new derivatives regulation is entering into force; capital requirements are going to be higher; structural reforms and resolution authority are reducing subsidies; and investors and consumers are better protected.

To be sure, there have been sharp disagreements between the US and Europe over elements of reform. Until recently, the US Commodity Futures Trading Commission had been at odds with Europe over the territorial scope of US derivatives rules. Likewise, the Federal Reserve's capital, liquidity and holding-company requirements for foreign firms operating in the US – while better than national treatment and, in my judgment, prudent – angered the European Commission. And the US has been concerned about providing for national treatment in European rules governing derivatives, as well as rules regarding hedge fund managers.

Yet there are plenty of other fora in which to resolve disagreements between US and European regulators, including the bilateral process that ultimately resulted in the agreement between the US and Europe on a framework for derivatives regulation.

The G-20 has been driving financial reforms at a global level; the Financial Stability Board pursues agreement among regulators; and technical teams at the Basel Committee on Banking Supervision, the International Organization of Securities Commission, and the International Association of Insurance Supervisors hash out industry-relevant reforms. These mechanisms should be strengthened and improved, not bypassed.

While the process of reaching global agreement has at times been quite messy, divisive, and incomplete, the last thing we need is another process, particularly one not focused on how to prevent another financial meltdown like the one from which the US and Europe are still trying to recover. Trade talks would merely serve as a one-way ratchet to pull back from reforms, not advance them.

## **Conclusion**

Globally, there is much work still to be done. On bank resolution, the US has a solid framework in place, but is still working through how to make winding down a major financial firm plausible; in Europe, there is agreement on the need for resolution authority, but a lot more to do to make this authority work within the context of EU

member states' legal and political frameworks. On derivatives, there is now general agreement on how to approach trading, clearing, and transparency, but much more work to do on capital requirements, margin requirements, clearinghouse supervision, determination of equivalency across national borders, and other issues. Capital rules are taking shape, but a final agreement on liquidity and leverage must still be worked out, and transparent and tough stress testing in Europe and consistent implementation globally will be critical going forward.

Strong US financial rules are good for the US economy, American households and businesses, but we also need a stronger, harder push to reach global agreement on core reforms. In fact, such an approach is essential in order to reduce the chances of another devastating global financial crisis.