Testimony of

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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

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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-Billey 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=/0eTxourA+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 economies 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.

United States House of Representatives
Committee on Financial Services

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