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To The Committee on Financial Services

U.S. House of Representatives on

"Financial Regulatory Reform: The International Context"

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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

[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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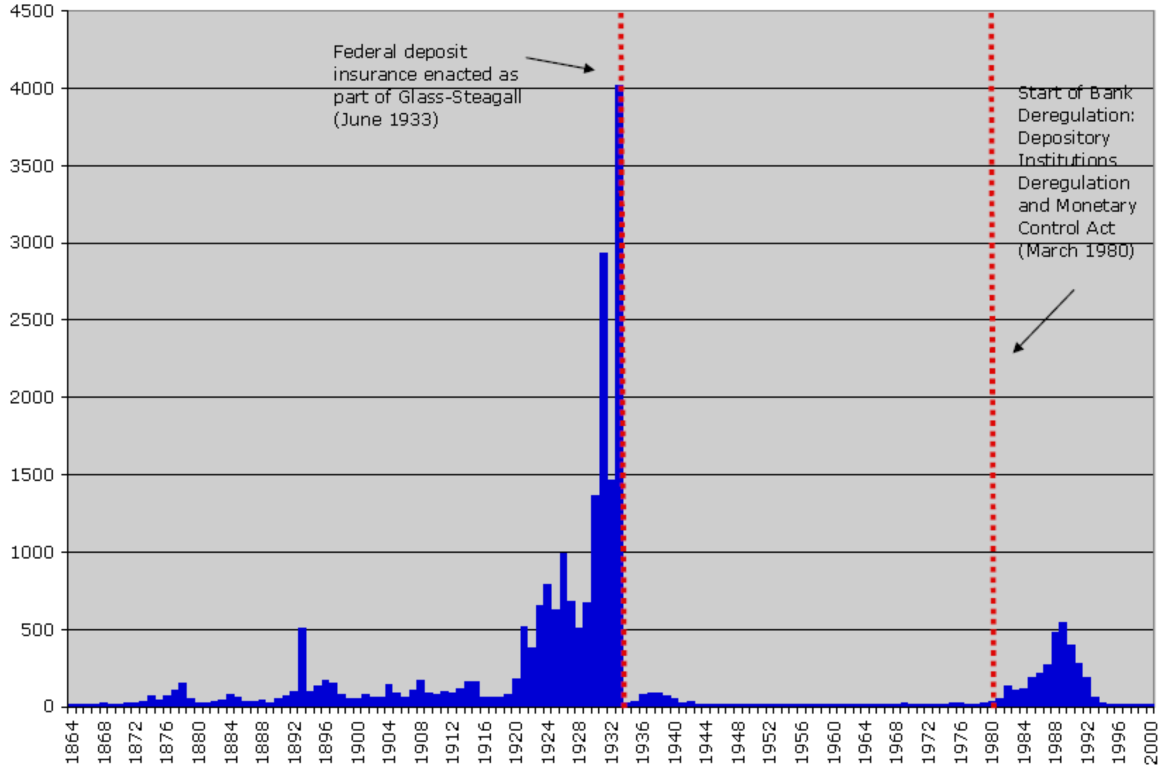
[14] Roddy Boyd, The last days of Bear Stearns, CNN Money (Mar. 31, 2008) *available at* http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/; The end of Wall Street, CNN Money (Sept. 21, 2008) *available at* http://money.cnn.com/2008/09/15/news/companies/lehman_endofwallstreet_tully.fortune/index.htm;

[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.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Damon A. Silvers	AFL-CIO, Americans for Financial Reform
3. Business Address and telephone number:	
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4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☒ No	☐ Yes ☒ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
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