

EMBARGOED UNTIL DELIVERY

STATEMENT OF

**SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION**

on

**FINANCIAL REGULATORY REFORM:
THE INTERNATIONAL CONTEXT**

before the

**COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES**

**June 16, 2011
2128 Rayburn House Office Building**

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

Introduction

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

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

during the good times, then turned to the federal government for a bailout while millions of Americans lost their jobs and homes.

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

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

At times in the past when regulations were debated, some tended to equate our nation's competitive advantage or disadvantage to the ability of our financial institutions to grow revenue and employ leverage to boost return-on-equity (ROE). This is a fundamental conceptual error that has had grave consequences when used as the basis for regulation. Heightened leverage benefits financial institution shareholders in the good

times, but increases the risks of an eventual financial unraveling whose costs are borne by the economy at large. We are a less prosperous and less competitive country now as a result of the appetite of our largest institutions for leverage.

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

The Concept of International Competitiveness

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

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

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

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

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

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

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

The excessive leverage in the financial system entering the crisis forced a massive deleveraging. Loans and leases held by FDIC-insured institutions have declined by

nearly \$750 billion from peak levels, while unused loan commitments have declined by \$2.7 trillion. This deleveraging illustrates another danger of insufficient financial institution capital: it can deprive the broader economy of an important stabilizing source of credit during a downturn.

The pattern of excessive leverage and subsequent financial collapse is not unique to the recent U.S. financial crisis but has been repeated many times, in many places. To cite just two prominent examples, debt expanded rapidly in the U.S. during the years prior to the Great Depression, with the value of urban mortgages outstanding increasing nearly 150 percent from 1920 to 1929.¹ Similarly, in the ten years leading up to Japan's 1990 real estate crash and the "lost decade" that followed, total private sector debt outstanding in Japan grew by more than 375 percent.²

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

¹ Bernanke, Ben S. "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression." *American Economic Review*, Vol. 73, No. 3 (Jun., 1983). p. 261.

² See "Debt and Deleveraging: The Global Credit Bubble and its Economic Consequences," McKinsey Global Institute, January, 2010, p. 43.

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

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

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

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

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

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

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

Capital Requirements: What Went Wrong?

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

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

regulators began to implement several fundamental changes in capital requirements that allowed for greater leverage.

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

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

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

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

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

estimated widely divergent capital requirements for similar exposures in these tests, highlighting the inherent subjectivity of the Advanced Approaches.

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

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

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

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

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

Strengthening Capital Requirements

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

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

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

Next, Basel III increases the numerical minimum capital ratios. For the new concept of tier 1 common equity, the agreed minimum ratio was 4.5 percent of risk weighted assets. For tier 1 and total capital the Basel III minimums are 6 percent and 8 percent respectively. Capital buffers comprising common equity equal to 2.5 percent of risk-weighted assets are added to each of these minimums to enable banks to absorb losses during a stressed period while remaining above their regulatory minimum ratios. The Basel Committee’s analysis of bank loss experience in the most recent, and previous

crises, supported the need for high-quality capital at these levels to absorb losses in severe scenarios. Indeed, a number of considerations in the analysis suggested that even higher capital levels were supportable.

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

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

Another important landmark in capital regulation is Section 171 of the Dodd-Frank Act—the Collins Amendment. In my view, this is the single most important provision of the Act for strengthening the capital of the U.S. banking system and leveling the competitive playing field between large and small U.S. banks. Section 171 essentially says that risk-based and leverage capital requirements for large banks, bank

holding companies and nonbanks supervised by the Federal Reserve Board may not be lower than the capital requirements that apply to thousands of community banks nationwide. Without the Collins amendment, our current rules set a course to allow the risk-based capital requirements of our largest banks to be governed by the assumptions of bank management regarding the riskiness of their own exposures. I cannot imagine a surer way to lead us into another leverage-driven banking collapse.

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

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

concern basis and served as an impediment to recapitalizations. Regulators should avoid such devices in the future, and instead rely on tangible common equity.

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

Concerns about strengthening capital requirements

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

Capital does not consist of dollars that banks must “set aside” and not lend. Instead, capital is simply the portion of a bank’s funding that must be supplied by owners rather than creditors. Since the owners are entitled only to what is left of a bank’s profits after the creditors are paid, their stake is riskier and that is one reason the cost of equity

exceeds the cost of debt. Debt is also subsidized by our tax system, since business interest expense is deductible but dividends paid to shareholders are not.

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

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

⁶ Hanson, Samuel, Anil Kashyap and Jeremy Stein, "A Macroprudential Approach to Financial Regulation." Working paper (draft) July 2010. <http://www.economics.harvard.edu/faculty/stein/files/JEP-macroprudential-July22-2010.pdf>

See also Admati, Anat, Peter M. DeMarzo, Martin R. Hellwig and Paul Pfleiderer. "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive." Stanford Graduate School of Business Research Paper No. 2065, March 2011.

<http://www.gsb.stanford.edu/news/research/Admati.etal.html>

⁷ Marcheggiano, Gilberto, David Miles and Jing Yang. "Optimal Bank Capital." London: Bank of England. External Monetary Policy Committee Unit Discussion Paper No. 31, April 2011.

<http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031revised.pdf>

See also Basel Committee, op.cit..

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

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

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

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

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

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

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

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

⁹ “We’ll Always Have Basel,” Wall Street Journal, September 10, 2010, page A. 16.

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

Liquidity

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

ratios will provide an important opportunity for identifying unintended consequences and refining the approaches as needed.

Other Important Mandates in the Dodd-Frank Act

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

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

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

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

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

Under Title II, if a SIFI is not resolvable through a bankruptcy framework, the FDIC can resolve the institution in a manner that strictly avoids a bailout. The FDIC can conduct advanced planning, temporarily operate and fund the institution under

government control to preserve its value as a going concern, and quickly pay partial recoveries to creditors through advance dividends, as the FDIC has long done in failed-bank receiverships. The result will be a faster resolution of claims against a failed institution, smaller losses for creditors, reduced impact on the wider financial system, and an end to the cycle of bailouts.

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

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

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

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

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

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

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

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

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

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

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

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

Compensation reform - At the Pittsburgh summit in September, 2009, the G-20 leaders observed that excessive compensation in the financial sector both reflected and encouraged excessive risk-taking, rather than creating long-term value. The G-20 leaders

called for immediate reform of compensation as an essential part of increasing financial stability, and endorsed the standards of the Financial Stability Board (FSB).

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

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

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

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

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

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

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

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

Conclusion

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