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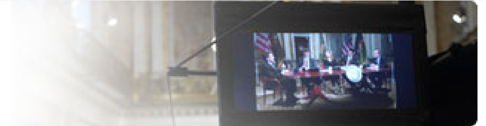

Testimony of Under Secretary for International Affairs Lael Brainard Before the House Committee on Financial Services

6/16/2011

"Financial Regulatory Reform: The International Context"

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

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

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

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

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

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

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

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

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

Strengthening Capital, Liquidity, and Leverage Standards

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

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

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

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

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

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

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

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

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

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

Addressing Large, Interconnected Firms

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

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

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

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

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

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

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

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

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

Facilitating Orderly Resolution

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

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

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

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

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

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

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

Regulating OTC Derivatives

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

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

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

At the international level, work is proceeding in numerous standard setting and regulatory bodies to promote international convergence and develop supervisory cooperation arrangements. In addition, we are actively engaged with our counterparts in Europe and Asia to encourage them to adopt equally robust standards that live up to our G-20 commitments. We coordinate especially closely with Europe to ensure consistency and non-discriminatory approaches to our regulatory rules.

Both the U.S. and the European Commission are developing margin requirements for OTC derivatives that are not centrally cleared. Secretary Geithner recently proposed a global agreement on specific minimum standards for margins on un-cleared derivatives in order to prevent regulatory arbitrage. As part of this initiative, I traveled in the last two weeks to London and to Frankfurt to secure agreement with our foreign counterparts that the international standard setting bodies should start working on a new global margin agreement.

If we do not have consistent margin standards for un-cleared trades, we run the risk that activities will migrate to jurisdictions with lower standards that do not incentivize central clearing. The posting of margin is an important risk management tool that helps counterparties cover current and future exposures to the OTC derivative contract. The net result is reduced risk to the global financial system.

The Agenda Ahead

The examples above highlight areas where international convergence is imperative to preserve global financial stability. In other areas, the international regulatory system has long recognized differences in the institutional structure of national financial systems, reflecting different laws and histories.

As we continue the implementation of historic financial regulatory reform in the United States, aimed at improving the safety and soundness of the system and preventing another banking crisis, we must simultaneously lead a global "race to the top," and work to level the playing field across all major and emerging financial centers. We have been working tirelessly to do so. And we will remain fully engaged with our counterparts in Europe, Asia, and elsewhere to help promote a level playing field in which all firms – U.S. and foreign – can compete fairly.

We appreciate the leadership and support of this Committee on these key challenges, and we look forward to working with Congress as we engage with our international partners, challenging them to match the strength and sweep of American reforms. Together, we can help ensure a more vibrant and competitive U.S. and global economy for future generations of Americans by addressing these critical issues today.