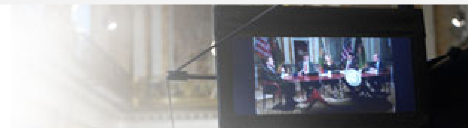
U.S. DEPARTMENT OF THE TREASURY

Press Center



Written Testimony of Under Secretary Lael Brainard before the Senate Committee on Banking, Housing, and Urban Affairs on “International Harmonization of Wall Street Reform: Orderly Liquidation, derivatives, and the Volcker Rule”

3/21/2012

As Prepared for Delivery on March 22, 2012

WASHINGTON - Chairman Johnson, Ranking Member Shelby, and members of the committee, thank you for the opportunity to discuss our international financial reform agenda.

In the wake of the financial crisis, the United States responded swiftly and aggressively. We took forceful measures to stabilize financial markets, including through transparent and groundbreaking stress tests. Congress moved rapidly to enact the Dodd-Frank Act – which provides the most significant set of financial reforms in generations. And in parallel we secured unprecedented commitments from our international partners in the G-20 and the Financial Stability Board – the same commitments from the emerging economies as from the advanced economies.

There is a vigorous debate over the merits of moving slow or fast – of moving first or last. This is an important debate with direct bearing on the pace and tone of the recovery, the safety and soundness of our financial system, and the fairness of the international playing field. The United States moved fast and first to repair and reform our financial system, and we believe that strategy is already beginning to demonstrate its effectiveness.

Some argued that strengthening the safety and soundness of our financial institutions should wait until after the recovery is complete. I disagree. A strong and stable financial system is a precondition for a growing and competitive U.S. economy. It was important to take action while the urgency of the crisis was still fresh in our memories. There are substantial lead times built into many of these reforms, allowing markets time to adapt. Now is not the time to increase uncertainty in the market by backtracking.

Making our Financial System Stronger, Safer, and More Transparent

U.S. supervisors responded early and forcefully by compelling U.S. financial institutions to build capital, reduce leverage, and strengthen liquidity buffers. Far from disadvantaging U.S. institutions and harming credit, these early actions built greater resilience and helped to safeguard credit flows in the face of elevated financial stress in the second half of 2011.

Because we acted early and fast, U.S. banks built larger and higher-quality capital buffers. Tier 1 common equity at large bank holding companies increased by more than $400 billion to $960 billion from the first quarter of 2009 through the fourth quarter of 2011, a more than 70 percent increase. The ratio of Tier 1 common equity to risk-weighted assets at these institutions has increased from 6 percent to over 10 percent during this period.

U.S. financial institutions have strengthened their funding models: short-term wholesale financial debt has decreased as a share of total financial institution assets from a peak of 29 percent in 2007 to 17 percent in the fourth quarter of 2011, and regulatory filings show that short-term wholesale funding at the four largest bank holding companies has decreased from a peak of 36 percent of total assets to 20 percent over this period. Depository institutions have built a more stable base of funding. Core deposits as a share of total liabilities at FDIC-insured institutions increased from a low of 44 percent in 2008 to 64 percent in the fourth quarter of 2011.

Risks have diminished outside of the banking sector as well. The size of the U.S. shadow banking system has fallen substantially, with prime money market funds shrinking by 32 percent and the tri-party repo market shrinking by nearly 40 percent since their peaks in 2008.

And credit availability has improved during this time, even as safety and soundness have materially strengthened. Bank credit to U.S. companies increased by annual rates of 11-12 percent in the third and fourth quarters of 2011.

By contrast, Europe opted to move more slowly on stress test disclosures and measures to build capital and improve funding. As a result, many euro area banks were less resilient in the face of shocks last year, putting pressure on funding and credit and raising financial stress in a negative spiral. Since that time, European authorities have taken steps to strengthen the capital position of euro area banks. These

actions, and the critically important actions taken by the European Central Bank to strengthen liquidity, have helped to reduce financial stress.

Far from disadvantaging our firms, the early actions to strengthen bank balance sheets and improve funding put U.S. banks in a stronger position to withstand financial stress relative to many of their international peers, while supporting credit flows to U.S. households and businesses at a critical time for the recovery.

International Convergence on Financial Reform

Some argue that by moving first, we have put the United States at a competitive disadvantage. To the contrary, by moving early, we have been able to lead from a position of strength in setting the international reform agenda and elevating the world's standards to our own. The alternative would have been to follow the reform standards set by other countries or subject our firms to a divergent set of standards. Of course, we will need to be vigilant in addressing the inevitable inconsistencies and lags on implementation. But this should not detract from the remarkable degree of convergence we are seeing on a comprehensive reform agenda spanning bank capital and liquidity, resolution, and over-the-counter (OTC) derivatives markets for the first time. This common, comprehensive set of reform commitments encompasses not only the established financial centers in advanced economies but also up-and-coming financial centers in emerging markets. Moving first and ensuring that others enact reforms consistent with our own are the best ways to reduce opportunities for regulatory arbitrage and a race to the bottom, to prevent firms from exploiting gaps in regulation, to provide a fair and level playing field for U.S. firms, and to protect our economy from risks emanating beyond our shores.

Going into the 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. Going forward, we have agreed to new global capital standards that raise the quality and quantity of capital so that banks can withstand losses of the magnitude seen in the crisis and reduce the risks of financial system collapse as a result of financial excesses. We have also secured agreement internationally to strengthen liquidity standards and limit leverage. We have identified the globally systemically important banks, agreed to a capital surcharge for these institutions, and developed a comprehensive set of enhanced prudential measures to address risks from globally active financial institutions.

However, there is much more work that needs to be done. We must remain vigilant against attempts to soften the national application of new capital, liquidity, and leverage rules. It is essential for banks across the world to measure risk-weighted assets similarly, to ensure that markets and investors can be confident that the capital adequacy ratios stated by banks are consistent across borders. The United States is pursuing comparability by urging greater visibility into supervisors’ scrutiny of how banks measure risk-weighted assets. We are pleased that the Basel Committee has added this important work to its agenda for 2012.

Going into the crisis, few understood the magnitude of aggregate derivatives exposures in the system because derivatives such as credit default swaps (CDS) were traded over the counter on a bilateral basis and without transparency. Going forward, we have agreed to stronger international standards for the OTC derivatives markets, including requiring greater transparency, moving their trading onto exchanges, and requiring them to be centrally cleared.

Now we must ensure that national authorities continue to coordinate closely to align implementation; our frameworks for derivatives must be tightly aligned or differences could lead firms to move activities to jurisdictions with lower standards, increasing risks to the global financial system. We must guard against fragmentation of the global payments infrastructure, ensuring that global infrastructure is adequately safeguarded, and avoid geographic mandates for clearing. It is critical that others across the globe follow the U.S. lead and accelerate timetables where needed.

We must also finalize work on a global standard for posting collateral (or margin) on uncleared derivatives transactions. To reinforce the push towards central clearing and enhance safety and soundness, the charges associated with uncleared derivative transactions must exceed those on cleared transactions. Both the United States and the European Commission are developing margin requirements for OTC derivatives that are not centrally cleared, and the G-20 and the FSB have committed to developing a global standard.

Going into the crisis, countries lacked tools to resolve systemically important financial institutions, effectively rendering them too big to fail. Going forward, we have reached an important agreement that all major financial jurisdictions should have the tools to resolve large cross-border firms without the risk of severe disruption or taxpayer exposure to loss. The FSB is working actively to see that this international commitment is implemented on a national level to ensure that in addition to national resolution regimes, regulators and the major global banks develop cross-border recovery and resolution plans by the end of 2012; develop criteria to improve the “resolvability” of systemically important institutions; and negotiate institution-specific cross-border resolution cooperation arrangements.

Strengthening cross-border resolution is a difficult issue given the diverse national laws and the infeasibility of a single global bankruptcy regime. The U.K., Germany, and Canada have already passed resolution legislation, and the European Commission is developing a draft for the second quarter of 2012. We are working to put in place cross border cooperation agreements; establish cross border crisis management groups for the largest, most complex institutions; and finalize recovery and resolution plans by the end of this year.

Going into the crisis, supervisors and market participants did not have adequate visibility into the buildup of concentrations of risky activities in the financial markets. Going forward, a global Legal Entity Identifier (LEI) system will uniquely identify parties to financial transactions, ensuring greater transparency and more efficient data collection across the global financial system, and enabling better

understanding and management of systemic risk. Working with our international counterparts and the financial industry, we must finalize the global LEI framework and the reporting systems to support it by the G-20 Leaders Summit in June.

New laws and rules aimed at the home market of any major financial center will inevitably impact other jurisdictions, given the globalized nature of cross-border flows. In these circumstances, aligning the substance and timing of reforms across jurisdictions will be critical. Regulators will have to sort out whose rules apply, how, and where. We need to figure out sensible ways to apply and enforce rules across major jurisdictions in consistent ways. The greater the degree of convergence around high quality standards, the greater the scope for deferring to foreign jurisdictions that have regulatory regimes as strong as that of the United States.

Regulators are grappling with common issues pertaining to the structure of risk-taking in their national markets. The Volcker rule, which limits proprietary trading and hedge fund activities for banks, is a good example of where the United States has moved ahead of others, continuing in a long tradition of recognizing structural differences across countries, reflecting national history and laws. The U.S. federal depository insurance net – which has served our country well – was not designed to be extended to the riskiest trading activities of U.S. banks. But even in this instance, while regulators are sifting through the 16,000 comments that were submitted on the rule, other jurisdictions are grappling with the same issues. In the U.K., the Vickers Commission proposed rules to insulate core financial intermediation activities from riskier business lines in order to promote financial stability. In the European Union, Commissioner Barnier has assembled a commission to explore possible regulations for proprietary trading.

Conclusion

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 if firms seek to move overseas where regulation is weaker. It means a race to the bottom for standards and protections. And it may mean a heightened risk of a future financial crisis if riskier activities migrate to areas with less transparency and laxer supervision.

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 regulation of derivatives markets – the three areas with the greatest potential for discrepancies in national regulations to create disproportionate dislocations in global markets that could negatively impact our economy and our firms. This is a necessary response to the crisis.

Since the outset of the crisis, the G-20 and the FSB have played an increasingly critical and welcome role, alongside the international standard setting bodies, in shaping the international regulatory reform agenda and promoting sound regulation and more resilient financial markets. Recognizing there will be discrepancies when it comes to implementation at the national level, the Treasury and U.S. regulatory agencies buttress our cooperation through the G-20 and the FSB with extensive bilateral engagement. Each day, we talk with our colleagues in Europe and conduct ongoing dialogues across the major financial centers. This helps us get the details right. Additionally, the FSB and the standard-setting bodies have jointly developed an implementation monitoring framework that will report annually on our collective progress to the FSB, the G-20, and the public.

Undoubtedly, we will not attain perfect alignment and we will not get everything right. Despite this, nothing could be more costly than backtracking on reforms. We cannot lose sight of the costs of the last crisis – millions of jobs and trillions of dollars in lost wealth. Nor can we lose sight of the causes – inadequate risk management, imprudent-risk taking, opaque instruments whose risks were not understood or overseen, and failures by our regulators. This is why it is necessary to complete the work that is underway in the United States and internationally. The system is stronger today and will continue to strengthen in the future as a result of our efforts.

###