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STATEMENT OF

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on

**INTERNATIONAL HARMONIZATION OF WALL STREET REFORM:
ORDERLY LIQUIDATION, DERIVATIVES, AND THE VOLCKER RULE**

before the

**COMMITTEE ON BANKING HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE**

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Good morning Chairman Johnson, Ranking Member Shelby and members of the Committee. Thank you for the opportunity to testify on international harmonization issues related to Wall Street reform.

The financial crisis of 2008 exposed a number of serious vulnerabilities in the U.S. financial system and in other financial systems around the world. In the years leading up to the crisis, misaligned incentives, excessive leverage and risk taking, and gaps in regulation all contributed to a serious and, at the time, unrecognized increase in systemic risk. The financial crisis that followed in 2008-09 led to the most severe economic downturn since the 1930s.

In the immediate wake of the financial crisis, the Group of Twenty (G-20) nations, through the Financial Stability Board, jointly resolved to strengthen financial regulation across jurisdictions and enhance cross-border cooperation among financial regulators.¹ This broad-based commitment to reform recognized both the highly interconnected nature of the global financial system and the enormous economic costs of the financial crisis. The intended result is to reduce the likelihood and severity of future financial crises, and to enhance the effectiveness of the international regulatory response should crises occur. As implementation of the Dodd-Frank Act proceeds in the United States, the FDIC continues to work with our international counterparts to undertake reforms that will be needed for a stronger and more stable global financial system in the future.

¹ The G-20 is comprised of the finance ministers and central bank governors from 19 countries (including the United States) and the European Union, with representatives of the International Monetary Fund and the World Bank. Collectively, the countries represent more than 80 percent of the global gross national product.

My testimony today will discuss three key areas where the post-crisis implementation of financial reforms in the United States have an important international component: (1) the cross-border resolution of large, systemically important financial institutions; (2) capital standards; and (3) capital market reforms.

Cross-Border Resolution of Large, Systemically Important Financial Institutions (SIFIs)

Section 210 of the Dodd-Frank Act requires the FDIC to “coordinate, to the maximum extent possible” with appropriate foreign regulatory authorities in the event of a resolution of a covered financial company with cross-border operations. The FDIC has been working diligently on both multilateral and bilateral bases with our foreign counterparts in supervision and resolution to address these crucial cross-border issues.

The FDIC has participated in the work of the Financial Stability Board through its membership on the Resolution Steering Group, the Cross-border Crisis Management Group and a number of technical working groups. The FDIC also has co-chaired the Basel Committee’s Cross-border Bank Resolution Group since its inception in 2007.

Key Attributes

In October 2011, the Financial Stability Board released *Key Attributes of Effective Resolution Regimes for Financial Institutions*. The Key Attributes build on the set of recommendations developed by the Cross-border Bank Resolution Group that were published in March 2010 following its assessment of lessons learned during the crisis. The Key Attributes set out the parameters of a legal and regulatory regime that would allow authorities to resolve financial institutions in an orderly manner without taxpayer

exposure to loss while maintaining continuity of vital economic functions. They address such critical issues as the scope and independence of the resolution authority, the essential powers and authorities that a resolution authority must possess, and how jurisdictions can facilitate cross-border cooperation in resolutions of significant financial institutions. The Key Attributes also provide guidelines for how jurisdictions should develop recovery and resolution plans for specific institutions and for assessing the resolvability of their institutions. The FDIC was deeply involved in the development of the Key Attributes and many of them parallel the provisions of the U.S. resolution regime under Title II of the Dodd-Frank Act. The United States has been recognized for its leadership in developing a credible resolution process for large non-bank financial companies.

In November 2011, the G-20 endorsed the Key Attributes. As a result, financial regulators from the G-20 member nations are required to move toward a resolution framework to resolve SIFIs in an orderly manner that protects global financial stability. A methodology to assess countries' progress toward implementing the Key Attributes is now under development.

Crisis Management Groups

The FDIC and its U.S. and foreign financial regulatory counterparts have formed Crisis Management Groups under the auspices of the Financial Stability Board for each of the internationally active SIFIs (termed Global SIFIs or G-SIFIs) identified by the G-20 at their November 4, 2011, meeting. These Crisis Management Groups, consisting of both home and host country authorities, are intended to enhance institution-specific

planning for possible future resolution. These groups allow regulators to identify impediments to a more effective resolution based on the unique characteristics of a particular financial company.

The FDIC has participated in Crisis Management Group meetings hosted by authorities in various foreign jurisdictions. These meetings have focused on crisis management, recovery and resolution planning, and implementation issues associated with G-SIFIs from those jurisdictions. The FDIC has also hosted Crisis Management Group meetings for the five largest U.S. G-SIFIs and met with specific foreign regulators to discuss the progress these firms have made on their recovery and resolution plans as well as other related cross-border issues. The Crisis Management Group meetings have provided opportunities for the exchange of information on resolution planning and policy. We expect these meetings to assist the FDIC in developing and refining its resolution strategies for G-SIFIs and to help regulators in identifying and overcoming impediments to resolution, particularly with respect to cross-border issues.

FDIC Bilateral Discussions and Agreements

Since G-SIFIs present complex international legal and operational issues, the FDIC is also actively reaching out on a bilateral basis to the foreign supervisors and resolution authorities with jurisdiction over the foreign operations of key U.S. firms. The goal is to be prepared to address issues regarding cross-border regulatory requirements and to gain an in-depth understanding of cross-border resolution regimes and the concerns that face our international counterparts in approaching the resolution of these large international organizations. As we evaluate the opportunities for cooperation in any

future resolution, and the ways that such cooperation will benefit creditors in all countries, we are forging a more collaborative process as well as laying the foundation for more reliable cooperation based on mutual interests in national and global financial stability.

It is worth noting that although U.S. SIFIs have foreign operations in dozens of countries around the world, those operations tend to be concentrated in a relatively small number of key foreign jurisdictions, particularly the United Kingdom (U.K.). While the challenges to cross-border resolution are formidable, they may be more amenable than is commonly thought to effective management through bilateral cooperation.

The focus of our bilateral discussions is to: (i) identify impediments to orderly resolution that are unique to specific jurisdictions and discuss how to mitigate such impediments through rule changes or bilateral cooperation and (ii) examine possible resolution strategies and practical issues related to implementation of such strategies with respect to particular jurisdictions. This work entails gaining a clear understanding of how U.S. and foreign laws governing cross-border companies will interact in any crisis. Our initial work with foreign authorities has been encouraging. In particular, the U.S. financial regulatory agencies have made substantial progress with authorities in the U.K. in understanding how possible U.S. resolution structures might be treated under existing U.K. legal and policy frameworks. We have engaged in in-depth examinations of potential impediments to efficient resolutions and are, on a cooperative basis, in the process of exploring methods of resolving them.

To facilitate bilateral discussions and cooperation, the FDIC is negotiating the terms of memoranda of understanding pertaining to resolutions with regulators in various

countries. These memoranda of understanding will provide a formal basis for information sharing and cooperation relating to our resolution planning and implementation functions under the legal framework of the Dodd-Frank Act.

Resolution Planning Progress in the United States and Impact on Foreign Banking Organizations

In the United States, we are far along in the process of implementing the SIFI resolution provisions of the Dodd-Frank Act. We issued a final rule on our Title II orderly liquidation authority (OLA) in July 2011, and a joint final rule with the Board of Governors of the Federal Reserve System (Federal Reserve Board) on Title I financial company resolution plans in November 2011. These combined provisions give the FDIC new authorities and responsibilities for planning and implementing the orderly liquidation of a SIFI.

Since the enactment of the Dodd-Frank Act in 2010, the FDIC has been developing detailed resolution plans pursuant to our Title II resolution authorities. In addition, Title I of the Dodd-Frank Act requires SIFIs to submit resolution plans for review by the FDIC and the Federal Reserve Board. These plans detail how the firms could be resolved under the U.S. Bankruptcy Code. The FDIC would act under the Dodd-Frank Title II orderly liquidation authority only where the necessary parties agree that resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability. If the firms are successful in their resolution planning, the likelihood of such action would be greatly reduced.

Similar to its application to U.S. based G-SIFIs, Section 165(d) of the Dodd-Frank Act requires foreign banking organizations (FBOs) with \$50 billion or more in total consolidated assets to submit resolution plans. However, the plans submitted by the FBOs and any other specified foreign-based covered companies will focus their information and strategic analysis upon the firms' U.S. operations.

Submission of resolution plans will be staggered based on the asset size of a covered financial company's U.S. operations. Financial companies with \$250 billion or more in U. S. nonbank assets must submit plans on or before July 1, 2012. All of the SIFIs in this initial group have been designated G-SIFIs by the Financial Stability Board. Companies with \$100 to \$250 billion in total U.S. nonbank assets must submit plans on or before July 1, 2013; and all other covered financial companies must submit plans on or before December 31, 2013. A company's plan is required to be updated annually or as directed by the FDIC and the Federal Reserve Board.

As with U.S. G-SIFIs, FBOs are to submit their plans in phases according to the size of their U.S. non-bank assets. Thus, FBOs with a U.S. footprint of \$250 billion or more in U.S. non-bank assets will be required to submit plans by July 1, 2012. Those having \$100 billion or more in U.S. non-bank assets will be required to submit plans by July 1, 2013, and the remaining covered FBOs will submit their plans by December 31, 2013.

If a resolution plan does not meet the statutory standards, after affording the covered company an opportunity to remedy its deficiencies, the agencies may jointly decide to impose more stringent regulatory requirements—such as increased liquidity requirements or limits on credit exposures—on the covered company. Further, after two

years following the imposition of the more stringent standards, if the resolution plan still does not meet the statutory standards, the FDIC and the Federal Reserve Board may—in consultation with the Financial Stability Oversight Council (FSOC)—direct a covered financial company to divest certain assets or operations.

In addition, in January 2012, the FDIC issued a final rule requiring any FDIC-insured depository institution with assets of \$50 billion or more to develop, maintain, and periodically submit contingency plans outlining how depository institutions could be resolved under the FDIC’s traditional authority in the Federal Deposit Insurance Act. While not required by the Dodd-Frank Act, this complements the joint final rule on resolution plans for SIFIs.

These two resolution plan requirements are designed to ensure comprehensive and coordinated resolution planning for the insured depository institution, its holding company and any affiliates in the event that an orderly liquidation is required. Both of these requirements will improve efficiencies, risk management and contingency planning at the institutions themselves. The process of developing resolution plans also provides the FDIC important information for the refinement of our potential resolution strategies for SIFIs under the OLA.

FSOC Joint Rulemaking and Guidance on SIFI Designations

While all bank holding companies with more than \$50 billion in assets are automatically designated as SIFIs by the Dodd-Frank Act, the Act also authorized the FSOC to determine whether a nonbank financial company is systemically important. The FDIC has been working with the other FSOC members to finalize the rule and

interpretative guidance to implement this authority. When the rule and guidance are finalized, which is expected in the near future, the FSOC will begin the process of evaluating nonbank financial companies to determine whether material financial distress at one or more of them would pose a threat to the financial stability of the United States. The nonbank designation rule applies to U.S. nonbank financial companies and to foreign nonbank financial companies operating in the United States. Once designated as a SIFI, a nonbank financial company will be subject to all the supervisory and resolution requirements that apply to systemically important bank holding companies.

Improvements in Capital Standards

In the aftermath of the financial crisis, there has been an intensive international effort to strengthen bank capital standards. The result of these efforts is the Basel III capital agreement. In broad terms, the Basel III capital standards aim to improve the quality and increase the level of bank capital. Collectively, Basel III and other standards published by the Basel Committee address a number of features of capital regulation that allowed for an excessive use of leverage in the years leading up to the crisis. There are a number of such issues that are being addressed by Basel III and in a complementary way by the Dodd-Frank Act.

One of the lessons of the crisis was that high quality, loss-absorbing capital is essential to ensuring the safety and soundness of financial institutions. Basel III addresses this by establishing regulatory capital as “common equity tier 1.” This results in a measure that is much closer to pure tangible common equity than the present tier 1 definition. Meeting regulatory requirements for common equity tier 1 capital will

provide a much more realistic and meaningful assurance of a bank's ability to absorb losses.

In addition to the definition and quality of capital, Basel III also addresses the level of capital. At the beginning of the crisis, as today, the minimum tier 1 risk-based capital requirement was 4 percent of risk-weighted assets. Tier 1 capital was required to be “predominantly” equity. Thus, equity could comprise as little as 2 percent of risk-weighted assets.

Basel III increases the numerical minimum risk-based capital ratios. For the new concept of common equity tier 1, the Basel III minimum ratio is 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.

Basel III also includes a “counter-cyclical buffer” intended to act as a stabilizer against significant asset bubbles as they develop. Specifically, regulators could increase the capital buffers by up to an additional 2.5 percent if they deem the economy to be in a period of excessive credit creation.

Basel III establishes, for the first time, an international leverage ratio. The Basel III leverage ratio is an important tool to ensure that capital exists to cover losses that the risk-based rules may categorize as minimal, but that can sometimes materialize anyway. The Basel Committee has also agreed that the largest internationally active banks should be subject to additional capital charges ranging from 1 percent to 2.5 percent of risk-

weighted assets to account for the additional risk they pose to the financial system should they experience difficulties.²

In addition, to strengthen capital standards for trading book risk, the U.S. banking agencies issued a Notice of Proposed Rulemaking (NPR) in January 2011, to implement important reforms agreed to by the Basel Committee. These reforms will increase capital requirements to levels more appropriate for trading book assets. A second Market Risk NPR was issued in December 2011 to respond to section 939A of the Dodd-Frank Act. This NPR provides an alternative to credit ratings in computing trading book capital requirements. We are committed to working with our fellow regulators to finalize the important reforms to trading book capital requirements as soon as possible upon reviewing and appropriately addressing the public comments we receive.

The Basel Committee agreed that Basel III would be phased-in over a five-year period starting in 2013, and the banking agencies are drafting an NPR to implement Basel III in the United States. We believe that most U.S. banks currently hold sufficient capital to meet the Basel III capital standards. Banks that need more time by and large appear well positioned to meet the standards far ahead of the Basel timeline and mostly with retained earnings. Now that agreement has been reached on a more robust international capital standard, it is vital that the standard be implemented in a uniform manner. A comprehensive monitoring framework will be coordinated by the Basel Committee's Standards Implementation Group and will rely on peer reviews. It entails a review of members' domestic adoption and implementation timelines for the Basel regulatory capital framework.

² The Basel Committee also established an “empty bucket” with a 3.5 percent additional capital charge designed to discourage banks from becoming more systemic.

Capital Market Reforms in the Dodd-Frank Act

Beyond the development of an effective resolution regime for SIFIs, and the capital reforms of Basel III, two provisions of the Dodd-Frank Act with potential international implications are Section 619, relating to proprietary trading, and the margin and capital requirements for over-the-counter derivatives found in Title VII.

The Volcker Rule

Section 619 of the Dodd-Frank Act, known as the Volcker Rule, is designed to strengthen the financial system and constrain the level of risk undertaken by firms that benefit, either directly or indirectly, from the federal safety net provided by federal deposit insurance or access to the Federal Reserve's discount window. The Volcker Rule prohibits proprietary trading by banking organizations and limits investments in hedge funds and private equity funds that they organize and offer, subject to certain exemptions for such permissible banking activities as underwriting, market making, and risk-mitigating hedging.

The challenge for regulators in implementing the Volcker Rule is to prohibit the types of proprietary trading and investment activity that Congress intended to limit, allowing banking organizations to provide legitimate intermediation in the capital markets and maintain market liquidity.

Last November, the FDIC, jointly with the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC), published an NPR requesting public comment on a proposed regulation implementing the Volcker Rule requirements. On December 23, 2011, the agencies

extended the comment period for an additional 30 days until February 13, 2012. The comment period was extended as part of an interagency effort to allow interested persons more time to analyze the issues and prepare their comments, and to facilitate coordination of the rulemaking among the responsible agencies.

The agencies have received a significant number of comments from international banking organizations and foreign financial services regulators regarding concerns about the potential extraterritorial reach of the Volcker Rule and the proposed regulations. Commentators have raised concerns about the proposed regulation's potential effects on foreign sovereign debt markets, the ability of foreign organizations to continue to utilize U.S. market infrastructure, and the difficulties associated with properly distinguishing permissible foreign funds from impermissible funds. The agencies are in the process of reviewing and carefully considering all of the comments received as we work toward the development of a final regulation.

As of February 13, 2012, the agencies had received approximately 17,500 comment letters from a wide variety of stakeholders. The FDIC is committed to developing a final rule that meets the objectives of the statute while preserving the ability of banking entities to perform important underwriting and market-making functions, including the ability to effectively carry out these functions in less-liquid markets.

Margin and Capital Requirements for Covered Swap Entities

In June 2010, the G-20 leaders reaffirmed a global commitment to clearing standardized OTC derivatives through a clearinghouse, and this commitment was incorporated into the Dodd-Frank Act. For derivatives that lack sufficient standardization

for clearing, the Dodd-Frank Act requires dealers and major participants in such transactions to register with the Commodities Futures Trading Commission or SEC, as applicable. The Dodd-Frank Act also requires the prudential regulators—the FDIC, the Federal Reserve Board, the OCC, the Farm Credit Administration, and the Federal Housing Finance Agency—to jointly adopt margin requirements for uncleared OTC derivatives entered into by entities they regulate that also fall within the Dodd-Frank Act’s dealer and major participant terms. In May 2011, the prudential regulators published an NPR proposing these margin requirements and have received numerous comments that are being carefully considered.

Since the issuance of the NPR, the Federal Reserve Board has initiated an effort to develop an international convergence in margin requirements for uncleared OTC derivatives and has asked the Basel Committee, in conjunction with the International Organization of Securities Commissions, to develop a consultation document by June 2012. Staffs from the FDIC and the other banking agencies are actively participating in the Working Group on Margin Requirements initiative. In order to reduce competitive concerns, the agencies intend to take into consideration, to the extent possible, the margin recommendations in the consultative document in the development of a final uncleared OTC derivative margin rule.

Conclusion

Today’s testimony highlights the work of the FDIC, in conjunction with other U.S. regulators and our international counterparts, to improve resolution and regulatory regimes for the global financial system. As the global reach of the financial crisis made

clear, cross-border cooperation and harmonization are essential for effective implementation of reforms. The FDIC is committed to working with our fellow federal agencies as well as our foreign counterparts to achieve this important goal.

Thank you. I would be glad to respond to your questions.