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TESTIMONY OF

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The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Chairman Bachus, Ranking Member Frank, and Members of the Committee, I appreciate the opportunity to appear before the Financial Services Committee to discuss the work that the OCC is doing to implement new bank regulations in the U.S. and to harmonize those rules with those of other countries to avoid a regulatory race to the bottom. The Committee's letter of invitation has indicated your particular interest in the new capital and liquidity standards being developed by the Basel Committee on Banking Supervision. Accordingly, my testimony focuses on the efforts underway to revise bank capital and liquidity requirements, including the implementation of capital-related provisions of the Dodd-Frank Act and the new international capital and liquidity standards commonly referred to as Basel III.

Implementation of key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and the new Basel capital and liquidity requirements is particularly challenging because of the number of related provisions that must be considered together. Regulators are trying to understand not just how individual provisions will impact the international competitiveness of U.S. firms, but how the interaction of all of the various requirements of the Dodd-Frank Act and Basel III will impact U.S. firms.

In assessing the impact of the capital and liquidity requirements in Basel III and the Dodd-Frank Act, there is little reason to be concerned about an international "race to the bottom." In every major jurisdiction around the globe, regulatory requirements imposed on the financial sector are becoming more stringent. This raises two issues. First, if capital and liquidity standards are set too high, we may unnecessarily restrict financial intermediation and economic performance. Second, if some countries do not adopt the same high standards and enforce them with the same rigor, we could wind up with an unlevel playing field that gives an advantage to firms in countries with less stringent standards.

While the failure of others to act in a comparable fashion is no reason to relax our prudential standards in the U.S., it is important to analyze the individual and cumulative impact of the changes under consideration to be certain we are making sensible decisions about how far we should go domestically. Our goal must be to address the problems that led to the financial crisis without undermining the ability of our banking institutions to support a strong national economy, or placing U.S. institutions at an unfair competitive disadvantage relative to foreign competitors.

II. Changes to Domestic and International Capital and Liquidity Standards

A. Background and Overview

The new Basel III agreement, which was published at the end of 2010, is the latest version of internationally agreed standards adopted by the Basel Committee on Banking Supervision (Basel Committee). [1] Like the Dodd-Frank Act, it is designed to promote a more resilient banking sector. However, Basel III is more narrowly focused than the Dodd-Frank Act in that it is limited to strengthening global capital and liquidity requirements for internationally active banks. Basel III requires increases in both the amount and the quality of regulatory capital relative to banks' risks, including a greater reliance on common equity. As currently formulated, Basel III also will require banks to

[1] The term "Basel III," as it is used here, refers to the set of capital and liquidity standards published by the Basel Committee in December 2010, as well as those published in July 2009. A compilation of the documents that form Basel III is available at www.bis.org/list/basel3/index.htm.

hold substantially more liquidity in the form of short-term, low-risk assets and to increase their reliance on more stable long-term debt and core deposits.

Basel III introduces other significant enhancements designed to ensure that all material risks confronting financial companies – especially risks held in trading portfolios and the risks posed by complex structured-finance transactions – are appropriately reflected in regulatory capital requirements. In this respect, Basel III builds upon and further strengthens the more risk-sensitive capital regime established by the Basel II capital framework. Basel III also increases the focus on consideration of systemic risk issues in bank supervision practices and capital rules.

In developing a consistent set of standards for internationally active banks, the Basel Committee aims to enhance the safety and soundness of the global banking system and, secondarily, to facilitate a level playing field on an international basis. This is important because the largest banks in the U.S. and abroad compete with one another for business worldwide. Consistent international implementation of common standards discourages regulatory arbitrage across national boundaries.

Basel III represents the third generation of standards, building upon the Basel II framework that was designed to replace the original and much simpler Basel I standards. While there are elements of Basel III that each Basel Committee member would like to see changed, the revisions represent a significant accomplishment in that 27 countries reached a general agreement on highly technical policy issues and detailed regulatory standards.

Still, even with this agreement, details of implementation can vary from country to country. For U.S. institutions, the overlay of the Dodd-Frank Act requirements – and the existing Prompt Corrective Action (PCA) regime – adds substantial complexity in implementing the internationally agreed-upon standards.

The Dodd-Frank Act contains several provisions that affect both U.S. regulatory capital and liquidity standards. For example, the Dodd-Frank Act requires the Federal Reserve to develop more stringent prudential standards, including capital and liquidity requirements, for larger, more systemically important bank holding companies, which are generally defined as those with more than $50 billion in assets. In contrast, the Basel II advanced approaches regulations are required to be used only by banks with $250 billion or more in total assets or $10 billion or more in total foreign exposures. In addition, international agreement is still being sought to impose a surcharge above the Basel III levels for the very largest and most sophisticated global financial institutions.

Implementing all of these new standards in the U.S. poses a number of challenges. The banking regulators are currently working to determine how best to interweave the new Basel III minimum capital requirements and capital buffers, the Dodd-Frank Act capital surcharge for large U.S. institutions, and the Basel III capital surcharge for the largest global institutions into the statutory PCA framework, which requires the regulators to define separate capital levels for well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized institutions. Under the PCA framework, banks face consequences and restrictions of increasing severity as their capital levels fall, which is similar to the operation of the "capital conservation buffer" under Basel III.

The Dodd-Frank Act also addresses capital regulations by limiting the degree to which certain hybrid instruments can be included in regulatory capital. In addition, the law provides that the largest internationally active U.S. banks subject to the advanced approaches in the Basel II risk-based capital rules may not hold comparatively less capital than is required of U.S. banks generally under Basel I. The Dodd-Frank Act also establishes specific requirements relating to the leverage ratio.

Other provisions of the Dodd-Frank Act restrict reliance on credit ratings by federal agencies as a determinant of credit quality. Specifically, section 939A of the Dodd-Frank Act requires each federal agency to review their regulations and "remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations." This requirement necessitates changes to a number of the existing risk-based capital regulations and affects implementation of several of the Basel III capital and liquidity provisions, which rely on credit ratings to set specific regulatory requirements. As a result, U.S. banks' capital rules will necessarily diverge from the international standards.

B. Regulatory Capital Requirements

Basel III emphasizes the quality of capital by seeking a more stringent definition of what banks should be permitted to count as regulatory capital. The financial crisis clearly demonstrated that common equity is superior to other capital instruments in its ability to absorb losses on a going-concern basis. Innovative instruments, such as "hybrid" capital instruments that have characteristics of both debt and equity, which had become an ever-larger proportion of the capital base for banks of all sizes, were found lacking. While many of these instruments permit banks to defer or cancel dividends, which helps preserve liquidity and capital in times of stress, during the financial crisis many banks did not exercise this option out of fear that such actions would reinforce market perceptions of the bank's weakened financial condition. Many non-U.S. banks even exercised call options to redeem hybrid instruments for fear that failure to do so would send strong market signals about the deteriorating condition of the bank.

Basel III addresses these problems by defining regulatory capital more narrowly and placing greater reliance on common equity. Under Basel III, banks will be required to hold a minimum amount of common equity based on their level of risk. This common equity ratio cannot be met through the issuance of other forms of capital, even relatively high-quality capital such as non-cumulative perpetual preferred stock. Basel III also tightens the definitions of other forms of regulatory capital – Tier 1 and Tier 2 – to exclude some of the innovative hybrid capital instruments, and it places strict limits on the amounts of mortgage servicing assets and deferred tax assets that may be recognized for regulatory capital purposes.

Another key element of the Basel III package is a substantial increase in minimum risk-based capital ratios – requiring banks to hold more capital for every dollar of risk exposure. The Basel III reforms set higher capital requirements that essentially will move the Tier 1 common ratio from a minimum of roughly 2 percent under current rules to 4.5 percent. They also set a 2.5 percent conservation buffer of capital above the 4.5 percent minimum requirement, bringing the total requirement to 7 percent. This capital buffer is intended to ensure that banks are well-positioned to withstand economic downturns or stresses that are unique to their portfolio. For example, a bank that had capital equal to, or in excess of, 7 percent of risk-weighted assets during strong economic times might dip into its buffer during a period of economic stress, while still maintaining capital levels that should not lead to concerns about its viability. Though the capital buffer could be used during a period of stress, there also would be a constraint associated with that use. One of the consequences of dipping into the buffer would be progressively more stringent capital distribution restrictions as the bank's capital levels erode and approach the minimum thresholds.

This formulaic response to falling capital levels will create the appropriate incentive for banks to maintain a healthy buffer during benign economic times, and also limit the ability of banks to dissipate capital when their capital ratio is deteriorating. This works much like the restrictions in the current PCA framework, but the agencies still must consider whether, and/or how, to combine the two. For example, in light of the Basel Committee's stated intention that banks be able to draw on the conservation buffer in times of stress, the banking regulators must determine whether or not to define the PCA "well capitalized" category in a way that allows a bank to be considered "well capitalized" even if its capital levels fall below the buffer but remain above the minimum requirements.

All together then, the minimum requirement for Tier 1 common capital will rise to 7 percent by the end of the decade. The recent crisis demonstrated that market analysts were particularly focused on common equity ratios, and banks that had higher and stronger ratios tended to avoid the intense market speculation and fears that plagued some of those with weaker ratios. Some of the banking organizations that struggled the most during the turmoil had capital levels below the 4.5 percent minimum standard.

The Basel III changes, discussed previously, tighten the definition of what can count as capital. As discussed in greater detail below, they will also require more capital for certain risks than the current standards, and they substantially increase the allowable minimum capital ratios that banks must maintain. All of this is to say that the 7 percent requirement represents a significant strengthening of our capital standards.

Large U.S. banks have already raised large amounts of capital since the peak of the crisis and are very highly capitalized by traditional measures. We expect that these increases in actual capital levels, combined with an extended phase-in period for the higher capital standards of Basel III, should allow banks to transition to the higher capital requirements in a reasonable manner without causing undue stress on the current economic recovery. However, we are concerned with how much more we can and should turn up the dial on our banks without having negative effects on lending. Our concerns on this front are most evident in the context of the surcharges being contemplated for systemically important firms, which are discussed in more detail below.

Another key element of the Basel III reforms is the introduction of an international leverage ratio. The financial crisis witnessed the build-up of excessive on- and off-balance sheet leverage in the banking system. To address these problems, the international leverage ratio requirement will serve as a backstop to the risk-based measures. Though similar in many respects to the existing U.S. leverage ratio calculation, the international leverage ratio also will capture off-balance sheet exposures that, during the crisis, led to a build-up of leverage, which eventually came cascading onto some banks' balance sheets.

The Basel III reforms also greatly improve the assignment of capital to the exposures that proved most problematic during the crisis. Certain securitization positions, such as CDO-squared instruments and CDOs of MBS, will see greatly increased capital requirements under the Basel III revisions. Similarly, the capital requirements for trading activities will be increased substantially. In addition, the calibration of the bank-generated measure of potential counterparty credit exposures from derivative transactions has been significantly enlarged. Capital requirements also are being increased more generally for bank exposures to other large financial firms to address concerns with interconnectedness and possible contagion effects. Taken together, these changes will result in significant increases in the capital requirements for those risks and sources of losses that were most prominent during the crisis.

We support the Basel III capital requirements, which we believe will materially enhance the resiliency of the banking sector, as well as the broader financial system. It is crucial to recognize, however, that the Basel framework requires these standards to be applied to *internationally active banks*. This scope of application is critical to the issue of how many banks should be subject to the requirements for systemically important financial institutions, and how much of a capital surcharge should be applied. It is also crucial to how we approach application of the new Basel III standards to the several thousand other banks and thrifts that are not internationally active. For those institutions, application of the Basel III standards is at the discretion of U.S. bank regulators.

What does the experience of U.S. banks during the crisis suggest about which of the Basel III changes should be applied generally to U.S. banks? Regarding the definition of capital, if we believe a capital instrument is not loss absorbing, it should not be recognized for regulatory purposes regardless of whether a bank is internationally active or not. Thus, a greater regulatory focus on common equity should make sense for all banks.

Less obvious is whether it makes sense to impose the same minimum capital ratio that applies to large internationally active banks on the majority of U.S. banks that are not internationally active and have relatively simple balance sheets and risk profiles. A final decision on this issue has yet to be reached as the federal banking regulators are continuing to consider and weigh the merits of a wide application of all the changes contemplated under Basel III.

Capital Surcharge for Systemically Important Financial Institutions

At the international level, the Basel Committee and the Financial Stability Board (FSB) are not yet finished setting capital requirements. These groups have on-going projects to define global systemically important banks (G-SIBs), and global systemically important financial institutions (G-SIFIs), respectively, and to assess how much additional "loss absorbing capacity" these institutions need to maintain. Notably, the Basel Committee is continuing to debate decisions on identifying which institutions should be designated G-SIBs and the potential application of a capital surcharge to those firms. It also continues to assess the role that contingent capital might play in such a surcharge. This work is expected to be completed by the end of 2011.

We support the application of a surcharge of common equity for the very largest globally significant banks, but we believe the amount of the surcharge should recognize that it is adding to a base – Basel III – that is already designed to address risks presented by these very same large, internationally active banking institutions. In fact, the design of the components of Basel III was based exclusively on analyses of the capital requirements for our largest and most complex institutions, and based on lessons learned from the recent, severe financial crisis. Based on our analysis of the capital levels needed to protect the largest institutions from failure under stressed conditions, the OCC believes a moderate surcharge may be appropriate to protect the financial system against the failure of systemic banks.

A further important consideration for determining the appropriate capital surcharge for a category of large and potentially systemically significant institutions is the regulatory environment in which they operate. In many other countries, large internationally active banking institutions are extremely large relative to the domestic economy, as measured by GDP, and the risk to the national economy of problems at those institutions is much more fundamental. The largest banks in the UK, for example, have assets roughly equal to the UK GDP, and assets of the largest Swiss banks substantially exceed that country's GDP. Such countries may prudently add an additional buffer on top of international standards to mitigate the high risk posed to their domestic economy by banks of this scale. In contrast, the U.S. is unique in the international community in applying caps on deposit concentrations in the U.S. banking industry and now, under the Dodd-Frank Act, imposing special concentration limits on large financial firms. No U.S. bank exceeds these caps, and even our largest institutions are only a fraction of U.S. GDP.

All Basel capital levels are minima, including the surcharges for the largest banks. Since individual countries have freedom to set higher capital levels appropriate to their individual circumstances, we should consider whether a surcharge intended for general application should be importantly influenced by conditions in countries with unique financial characteristics. As we weigh these considerations in determining appropriate capital surcharges for systemically important institutions, we must also take into account that higher capital requirements are not without costs. Attempting to wring risk out of the banking system through the device of high capital requirements must be weighed against the costs of less intermediation and potentially lower economic growth. Finding that tipping point involves as much judgment as calculation, and the right outcome is probably not a simple average of national preferences resulting in an international one-size-fits-all answer.

A particular concern in light of recent experience in the U.S. is the risk that excessive capital requirements will cause lending and investing to move from the regulated banking sector into other less regulated sectors, which could serve to reduce the effectiveness of the enhanced bank capital standards. The largest of these less-regulated "shadow banking" entities are expected to be subject to the enhanced supervision and oversight that the Dodd-Frank Act envisions, but there remains a substantial concern that a new batch of "shadow banking" firms will emerge to fill any void left by depository institutions. While moving certain risks out of deposit-taking institutions may be a desirable result, these less regulated sectors do not face comprehensive capital requirements, enhanced liquidity and disclosure standards, or the same level of regulatory scrutiny that will apply to banks, and there is the danger that risks could be more easily hidden in these pockets of the financial system. And it's not obvious that a shift of financial activity into the shadow banking system protects the financial safety net; we saw the apparent extension of that safety net into that space during the recent financial crisis. Among the lessons we must learn from the financial crisis is that we cannot tolerate the re-emergence of a risky parallel or "shadow" banking system.

Section 171 of the Dodd-Frank Act – Risk-Based Capital Floor

An example of legislation unique to the U.S. that will result in more stringent standards for U.S. firms and an uneven playing field is section 171 of the Dodd-Frank Act (the "Collins Amendment"). The Collins Amendment establishes a floor on the capital requirements for U.S. banks based on current Basel I-based capital standards. In practical terms, this will limit the incentives for large internationally active U.S. banks to undertake the complex and costly task of implementing the Basel II framework, since the simpler Basel I framework will still govern.

Notably, the primary reason the Basel Committee decided to replace the Basel I framework – the framework that was in place during the financial crisis in the U.S. – was its lack of risk sensitivity. By removing incentives for reducing risk, the OCC is concerned that the implementation of section 171 may lead to perverse incentives for U.S. banks. If an institution can take on additional risk without triggering an additional capital charge under the Basel I standards, it may be tempted to do so if Basel I is the bank's operative constraint. For example, lending to a large, highly diversified multinational corporation or a small startup with an unproven business strategy would have the same charge under Basel I, and banks would have an incentive to take on the riskier loan to generate higher returns. Similarly, the bank may have less incentive to look favorably on safer loans, due to the lack of any reduction in required capital.

Section 939A of the Dodd-Frank Act – External Credit Ratings

The OCC recognizes that issues surrounding credit ratings were a significant factor in market overconfidence that contributed to subsequent losses in the markets for various structured and complex products, including mortgage-backed securities, in 2008 to 2009. The Dodd-Frank Act includes a number of important remedial measures to address this problem, including structural changes at the rating agencies, greater SEC oversight of the ratings process, and loan-level disclosures to investors in asset-backed securities. As I have stated in previous testimony, in the context of enhanced regulation provided by the Dodd-Frank Act, the absolute prohibition against any references to ratings under section 939A goes further than is reasonably necessary.

Because no other jurisdiction is subject to a similar limitation, section 939A is impeding our efforts to achieve international consistency in the implementation of Basel III. The Basel III framework, together with the Basel II framework on which it is built, makes use of external ratings in several areas including securitizations, assessment of counterparty credit risk, and trading book positions. Because of section 939A, the banking regulators' proposal to amend the risk-based capital rules for market risk, published on January 11, 2011, did not include these ratings-based provisions that would have significantly increased the amount of capital required to be held against traded assets. More broadly, the federal banking regulators' inability to implement this important provision of the international standards may hamper our credibility in future negotiations for global standards.

Potential for Inconsistent Implementation of Basel III

In addition to the provisions of the Dodd-Frank Act that will result in different application of certain aspects of the revised Basel framework, a level playing field for U.S. banks may be difficult to achieve if Basel III is unevenly implemented across jurisdictions, despite the very detailed prescriptions it contains.

For example, the Basel II qualification requirements have been implemented with varying degrees of rigor in different countries. While many international regulators permitted large banks in their jurisdictions to move to the Basel II framework several years ago, U.S. supervisors have enforced very stringent standards on U.S. banks in order for them to qualify to use Basel II. No U.S. bank has qualified yet. The more conservative approach taken by U.S. supervisors relative to our non-U.S. counterparts is evident in many aspects of the Basel II implementation process, and experience has shown that even small differences in implementation can still lead to measurable differences in capital requirements.

Of course we should not lower our standards domestically for these reasons, but these points illustrate that international consistency will be very challenging to achieve in practice. In fact, some differences are so fundamental that it may simply not be possible to achieve the goal of a level playing field.

C. Liquidity Requirements

The recent financial crisis highlighted the importance of effective liquidity management to the proper functioning of financial markets and the banking sector. In fact, during the early phase of the financial crisis, many banks – despite adequate capital levels – still experienced difficulties because of inadequate liquidity.

In 2010 the federal banking regulators, in conjunction with the Conference of State Bank Supervisors, issued a policy statement on expectations for sound funding and liquidity risk management practices. This policy statement summarized the principles of sound liquidity risk management issued previously and, where appropriate, supplemented them with Basel's 2008 "Principles for Sound Liquidity Risk Management and Supervision."

With Basel III, the Basel Committee raised the bar by introducing explicit minimum liquidity standards. These standards are designed to achieve two separate but complementary objectives. The first is to promote short-term resilience by ensuring that a bank has sufficient high quality liquid resources to offset cash outflows under acute short-term stresses. The Basel Committee developed the Liquidity Coverage Ratio, with a one-month time horizon, to achieve this objective. The second objective is to promote longer-term resilience by creating additional incentives for a bank to fund its on-going activities with stable sources of funding. The Net Stable Funding Ratio has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities. Its goal is to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items.

Although the goal of setting common minimum liquidity standards is laudable – sound liquidity management is fundamental to the safety and soundness of all banks – the proposed new standards and required ratios have so far produced counterintuitive results in testing and clearly need to be recalibrated. For this reason, the Basel Committee has elected to phase in these standards over time to allow for further calibration and more robust testing. The OCC supports the cautious and deliberative approach that the Basel Committee is taking in implementing these important standards. It is fair to say that the tougher standards have already had a favorable impact on liquidity management practices at most banks as liquidity across most all measures within the banking system is at historically high levels.

We are concerned, however, that overly conservative stress calibrations could lead to changes in funds management practices that are detrimental to sound banking practices and that unduly restrict banks' balance sheet capacity for lending activities. To address some of these concerns, there is a joint interagency effort underway to assess the economic impact of Basel liquidity requirements on the industry's capacity to lend. The validity of various assumptions about deposit arrangements between banks, relationships with government sponsored entities, and the offering of liquidity and credit facilities are examples of some of the critical factors that are being assessed. We support this analysis which is timely and prudent in light of concerns regarding potentially adverse impacts on a relatively weak economic recovery.

Again, we are also mindful of the interaction among various provisions of the Dodd-Frank Act. For example, we have to ensure that enhanced capital and liquidity requirements do not interact in such a way that banks are incented to invest solely in low-risk, highly liquid, sovereign debt instruments at the expense of making other loans to businesses and consumers that support economic growth. Likewise, the margin requirements associated with the newly proposed derivatives regulations, established under Title VIII of the Dodd-Frank Act, have the potential to effectively <u>decrease</u> liquidity at the same time we are considering a new regime designed to <u>increase</u> the liquidity requirements imposed on our banks.

III. Conclusion

In the post-crisis environment, as the financial system works toward full recovery, there are strong reasons for the largest financial firms to hold additional capital and enhanced liquidity. We fully support raising the bar for these firms.

In addition to heightened capital and liquidity requirements, Congress and the banking regulators have responded to the financial crisis by introducing other equally significant reforms, including frequent mandatory stress tests, enhanced resolution authority, limits on leverage, concentration limits, margin requirements on derivatives, and restrictions on high-risk activities (including restrictions on proprietary trading, such as making investments in hedge funds).

While we are working to more fully assess the potential impact of the new capital and liquidity standards, it is difficult to gauge how all of the Dodd-Frank Act and Basel III reforms, acting in concert, will affect the financial system. As we consider further increases to minimum capital and liquidity requirements, we need to consider all of the various reforms being introduced to increase the ability of the financial system to absorb losses and to reduce the probability and potential impact of the failure of large institutions. Failure to consider and balance the combined impact of all of the changes will have real consequences to the extent that constraints on liquidity translate into constraints on bank lending and the availability of credit within the economy.