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**TESTIMONY OF**  
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**ACTING COMPTROLLER OF THE CURRENCY**  
  
**before the**  
**COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**  
  
**UNITED STATES SENATE**  
  
**March 22, 2012**

Statement Required by 12 U.S.C. § 250:

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.

Chairman Johnson, Ranking Member Shelby, and members of the Committee, I appreciate the opportunity to provide the Committee with the Office of the Comptroller of the Currency's (OCC) perspectives on the international implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and on efforts currently underway to harmonize U.S. regulatory requirements with international standards and frameworks for the financial services sector. In particular, the Committee's letter of invitation requests that I testify about areas of reform that have international implications, such as orderly liquidation authority, derivatives oversight, and the prohibitions on proprietary trading and private equity and hedge fund investments commonly known as the Volcker Rule.

Since the 2008 financial crisis, the international regulatory community has taken many steps to strengthen the global financial system. In particular, the G20 governments, the Financial Stability Board, the Basel Committee on Banking Supervision, and other international regulatory bodies embarked upon an ambitious series of reforms. Standards have been developed and are being introduced to increase capital and liquidity, create better mechanisms for resolving large financial institutions, centralize derivatives clearing, and strengthen supervision in a number of other areas. National implementation of this reform agenda is underway in all the G20 countries.

The Dodd-Frank Act encompasses the U.S. response to the crisis and implements important parts of the international reform agenda. It seeks to enhance the resiliency of the U.S. financial system, among other ways, by requiring higher capital and liquidity standards for large U.S. financial institutions. In the event that a bank failure were to occur, the Dodd-Frank Act imposes steps to preclude future taxpayer bailouts and abolish

“too big to fail” by requiring orderly resolution regimes for such institutions. The Dodd-Frank Act also seeks to strengthen operations and safeguards pertaining to derivatives activities through a variety of mechanisms, including enhanced transparency through increased reporting and reduced counterparty credit risks through centralized clearing arrangements and higher margin for over-the-counter swap transactions.

Given the intersection of U.S. and international efforts, many of the Dodd-Frank Act mandates in these areas complement work underway by regulators internationally to enhance the resilience of the global financial system. While most of these efforts are still works in progress, I believe paths are available for international harmonization in many of these areas. However, even when broad consensus on international standards is reached, there will be areas of difference where policy makers in individual countries have chosen to tailor standards to their country and institutions rather than adopt the totality of the international approach. This is the case in the U.S., for example, where the Dodd-Frank Act has established certain standards – such as the prohibition on the use of credit ratings in our regulations – that will cause our implementation of the international capital standards to differ in some aspects from those of other countries.

Other provisions of the Dodd-Frank Act that impose structural and operational requirements for conducting certain financial activities have no equivalent in international workstreams or efforts to harmonize approaches. The most notable, in terms of potential international effects, is the Volcker Rule prohibitions on proprietary trading and private equity and hedge fund investments. The lack of a parallel international workstream and the resulting implications for both U.S. and foreign firms

are areas of concern that have been raised in comment letters that the OCC and other agencies have received on our proposed rulemaking.

My testimony today will describe in greater detail the intersection of Dodd-Frank and international efforts in five key areas: capital standards, liquidity requirements, orderly resolution of large and complex firms, derivatives activities, and the Volcker Rule.

## **I. Capital Standards**

Since the 1980s, the federal banking agencies have worked with their international counterparts through the Basel Committee on Banking Supervision (Basel Committee or BCBS) to develop and implement regulatory capital requirements. In 1989, the federal banking agencies first implemented minimum risk-based capital requirements for U.S. banking organizations based on the International Convergence of Capital Measurement and Capital Standards (Basel I), which was published by the Basel Committee in 1988.<sup>1</sup>

In 1997, the OCC, FDIC, and Federal Reserve Board implemented revisions to their risk-based capital rules, consistent with revisions to Basel I published the previous year by the Basel Committee. These provisions added a market risk framework requiring banks to address exposures to market risk associated with foreign exchange and commodity positions and positions located in the trading account.

On December 7, 2007, the federal banking agencies implemented the advanced approaches risk-based capital rules for the largest internationally active banks based on a

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<sup>1</sup> BCBS, International Convergence of Capital Measurement and Capital Standards (July 1988), available at: <http://www.bis.org/publ/bcbs04a.htm>.

new international capital adequacy framework (Basel II).<sup>2</sup> The advanced approaches rules were intended to promote improved risk measurement and management processes and better align minimum risk-based capital requirements with risk by incorporating certain Basel II approaches (advanced internal ratings-based approach for credit risk and the advanced measurement approaches for operational risk).

These longstanding international cooperative efforts were stepped up in response to the financial crisis, resulting in a broad consensus across jurisdictions that it was necessary to further enhance the quality and quantity of bank capital. The OCC has been an active participant in these efforts and is working with the other federal banking regulators to implement regulations domestically.

In 2009 and 2010, the Basel Committee published revisions to both the market risk framework and the treatment of certain securitization exposures (collectively, these revisions are referred to as Basel II.5),<sup>3</sup> and in December 2010, the Basel Committee published Basel III, which represents the collective work of numerous country participants to develop new capital standards for promoting a more resilient banking sector.<sup>4</sup> As I will describe, many of the key provisions and objectives of Basel III complement key capital provisions of the Dodd-Frank Act.

Among the more significant changes in Basel III is the introduction of a new common equity tier 1 minimum risk-based capital ratio that will require banks to hold a minimum amount of common equity to total assets. The financial crisis demonstrated

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<sup>2</sup> BCBS, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, (June 2006), available at: <http://www.bis.org/publ/bcbs128.htm>.

<sup>3</sup> The Basel Committee published the revisions in two documents in 2009 and then updated them in June 2010. The 2009 documents included: *Revisions to the Basel II Market Risk Framework*, *Guidelines for Computing Capital for Incremental Risk in the Trading Book*, and *Enhancements to the Basel II Framework*. The June 2010 revisions are available at: <http://bis.org/press/p100618/annex.pdf>.

<sup>4</sup> Bank for International Settlements, Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010, revised June 2011).

that common equity is superior to other capital instruments in its ability to absorb losses. Therefore, this new requirement should enhance banks' ability to withstand periods of financial stress. As envisioned, common equity capital requirements will increase substantially from levels preceding the financial crisis.

The existing tier 1 and total risk-based capital requirements also will become more rigorous due to a narrower definition of regulatory capital that excludes funds raised through hybrid capital instruments, such as trust preferred securities, that generally do not absorb losses to the same extent as common equity. This provision is broadly consistent with section 171(b) of the Dodd-Frank Act that directs the federal banking agencies to remove these types of instruments from the definition of regulatory capital. Basel III also places strict limits on the amounts of mortgage servicing assets and deferred tax assets that may count as regulatory capital.

The amount of capital that a bank is required to hold also is a key feature of the Basel III reforms, and implementation is to be achieved, in part, through substantial increases to a bank's overall minimum required risk-based capital ratios. The Basel III reforms set higher capital requirements that essentially will move the common equity tier 1 ratio from a minimum of roughly 2 percent under current rules to 4.5 percent. These increases are to be supplemented by two regulatory capital "buffers" – a capital conservation buffer of 2.5 percent common equity tier 1 (bringing the minimum common equity tier 1 requirement to 7 percent), which a bank would be expected to draw down during times of economic stress, and a countercyclical buffer, which banking supervisors can activate to curb excessive credit growth. As a bank's capital levels near the minimum requirements and dip into the buffers, the bank will face progressively more

stringent restrictions on its ability to make capital distributions (including dividends) and to make discretionary bonus payments. The largest U.S. banks have already made meaningful progress in reaching the higher thresholds under Basel III as evidenced by the recently announced stress test results.

In the U.S., the leverage ratio has always been a key component in assessing a bank's capital adequacy, acting as a back-stop to the risk-based capital requirements. Basel III also adds an international leverage ratio requirement for the first time. The international requirement is broader than the current U.S. requirement because it will include certain off-balance sheet exposures. During the recent financial crisis it became apparent that some banks had built-up excessive on- and off-balance sheet leverage while continuing to present strong risk-based capital ratios. In fact, some of the largest financial institutions significantly increased their off-balance sheet exposures, which were not captured in the U.S. leverage ratio calculation. This led to a build-up of leverage that moved onto banks' balance sheets and, in the most critical periods of the crisis, banks were forced by the markets to reduce their leverage in a manner that significantly increased downward pressure on asset prices, exacerbating losses and leading to a reduction in capital levels and a contraction in credit availability. The scope of the Basel III leverage ratio is broadly consistent with the provisions in section 165 of the Dodd-Frank Act that directs that off-balance-sheet activities be included in the regulatory capital calculation for bank holding companies with total consolidated assets equal to or greater than \$50 billion.

Another way in which the capital framework was strengthened in response to the crisis is reflected in section 171 of the Dodd-Frank Act, the "Collins Amendment," which

requires bank holding companies to be subject to strict bank-level capital requirements. In the lead up to the crisis, capital requirements applicable to banks were more rigorous in certain respects than those applied to bank holding companies. The Dodd-Frank Act requires the application of the same requirements to both banks and bank holding companies. This is important because even though banks were generally well capitalized leading up the financial crisis, their holding companies suffered substantial losses, and it is the bank holding companies that were the primary focus of efforts to shore up the financial system at that time and of the Dodd-Frank Act's new enhanced resolution framework.

Finally, the financial crisis focused attention on the risk that large internationally interconnected firms present to global financial stability. Both Basel III and the Dodd-Frank Act address this concern, but they take different approaches. Basel III calls for adopting a capital surcharge that would apply only to the 29 largest global, systemically important banks, 7 of which are U.S. entities. Section 165 of the Dodd-Frank Act requires the Federal Reserve Board to consult with the other federal banking regulators and implement heightened prudential standards, including capital requirements, for the 34 U.S. bank holding companies with total consolidated assets of \$50 billion or more.

The federal banking agencies have been working diligently to assess the key features of Basel III and to translate them into a workable and effective set of capital standards for U.S. financial institutions. While there are many common elements between Basel III and the capital provisions of the Dodd-Frank Act, the Dodd-Frank Act introduces several capital related provisions unique to U.S. financial institutions and,

therefore, the U.S. capital standards necessarily will deviate from the international standards in several significant respects.

The Collins Amendment, as previously noted, requires the federal banking agencies to apply the same generally applicable minimum capital requirements to all banks and bank holding companies. But in addition, in a statutory requirement unique to the U.S., the Collins Amendment provides that any regulatory capital requirement that the federal banking agencies apply to any subset of banks (such as the advanced approaches rules, which are required only for large internationally active banks) is permitted to increase the capital requirements relative to the generally applicable minimum capital requirements, but is not permitted to decrease them. Additionally, the Collins Amendment requires that the generally applicable minimum capital requirements may never be “quantitatively lower” than the current Basel I-based minimum capital requirements.

Thus, for large internationally active U.S. banks, the simpler generally applicable minimum capital rules will still govern even though they are undertaking the complex and costly task of implementing the more risk-sensitive advanced approaches risk-based capital framework. Without the risk sensitivity of the advanced approaches, banks will have less incentive to pursue safer loans or lower risk securities because they will not obtain the capital benefit of doing so. And a foreign bank pursuing the same strategy and operating without the floor would enjoy a market advantage over their U.S. counterparts.

Another divergence from Basel III arises from section 939A of the Dodd-Frank Act, which requires all federal agencies to remove references to, and requirements of reliance on, credit ratings from their regulations and to replace them with appropriate

alternatives for evaluating creditworthiness. Basel III, in contrast, continues to rely on credit ratings in many areas, making it difficult to implement those provisions domestically.

On December 29, 2011, the federal banking agencies published a notice of proposed rulemaking to revise their market risk capital rule consistent with enhancements made by the Basel Committee and with section 939A of the Dodd-Frank Act. This proposal, which built on a proposal that the agencies published in January 2011, was the federal banking agencies' first proposal to replace references to credit ratings in their risk-based capital regulations. The federal banking agencies are reviewing the comments received on the December 2011 proposal and are considering how best to implement the market risk rule in final form. The agencies also expect to propose to replace references to credit ratings more generally in the coming months.

A common set of standards or rules is only one aspect of international harmonization. Equally important is how those standards or rules are implemented in practice. As I have highlighted in previous testimony, different countries have implemented the advanced approaches qualification requirements with varying degrees of rigor.<sup>5</sup> While many international regulators permitted large banks in their jurisdictions to move to the advanced approaches framework several years ago, the federal banking agencies have held U.S. banks to more stringent standards and have yet to approve a single U.S. bank to apply the advanced approaches.

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<sup>5</sup> Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Financial Services, United States House of Representatives (June 16, 2011), available at: <http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-73-written.pdf>.

To address the inconsistent application of its standards across jurisdictions, the Basel Committee has initiated a peer review process to monitor, on an ongoing basis, the status of members' adoption of the Basel rules, including the Basel III agreement. Under this process, teams of banking supervisors from different jurisdictions will review the compliance of members' domestic rules or regulations with the international minimum standards and identify differences that could raise prudential or level playing field concerns.

The OCC is participating in this initiative and supports its objectives. Effective implementation of the Basel standards should be a top priority and to that end, the OCC has committed staff and resources necessary to participate in the peer review process to the fullest extent possible.

## **II. Liquidity Requirements**

During the early phase of the financial crisis, many banks, despite adequate capital levels, still experienced difficulties because of inadequate liquidity. Consequently, the Basel Committee and the Dodd-Frank Act, through enhanced supervision and heightened prudential standards, sought to mitigate these concerns by focusing on the importance of effective liquidity management to the proper functioning of financial markets and the banking sector.

Basel III introduces two explicit quantitative minimum liquidity ratios to assist a bank in maintaining sufficient liquidity during periods of financial stress: the Liquidity Coverage Ratio and the Net Stable Funding Ratio. These ratios are designed to achieve two separate but complementary objectives. The Liquidity Coverage Ratio, with a one

month time horizon, addresses short-term resilience by ensuring that a bank has sufficient high quality liquid resources to offset cash outflows under acute short-term stresses. The Net Stable Funding Ratio is targeted toward promoting longer-term resilience by creating additional incentives for a bank to fund its ongoing activities with stable sources of funding. Its goal is to limit over-reliance on short-term wholesale funding during times of robust market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items.

The Basel Committee included a lengthy implementation timeline for both ratios to provide regulators the opportunity to conduct further analysis and to make changes as necessary. The federal banking agencies currently are working together, and with the Basel Committee, to develop and recommend changes to the Liquidity Coverage Ratio to ensure that it will produce appropriate requirements and incentives, especially during economic downturns, and to otherwise limit potential unintended consequences.

As mentioned previously, the Dodd-Frank Act's heightened prudential standards are intended to address risks to the financial stability of the U.S. that may arise from large, interconnected financial institutions and includes the establishment of liquidity requirements to address some of those concerns. Section 165 of the Act requires the Federal Reserve Board to establish prudential liquidity requirements for nonbank financial companies supervised by the Board and bank holding companies with total consolidated assets equal to or greater than \$50 billion. The Federal Reserve Board has issued a proposal that builds on the 2010 Interagency Policy Statement on Funding and Liquidity Risk Management issued by the federal banking agencies and the Conference of State Bank Supervisors and includes, among other things, projected cash flows, stress

testing, and contingency funding plan requirements as well as provisions addressing board of director and senior management responsibilities for overseeing and implementing a company's liquidity program. The proposed standards also would require affected firms to maintain liquidity buffers of highly liquid assets and to establish limits on funding concentrations and maturities – concepts that are broadly consistent with the goals of the Basel III liquidity ratios.

Under the proposal, the liquidity requirements would increase in stringency based on the systemic risk of a covered institution. Thus, a covered company would take into consideration its capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors in implementing the proposed liquidity requirements. Furthermore, the proposal would permit the Federal Reserve Board to subject a covered company to additional or further enhanced liquidity prudential standards where the Board determines that compliance with the proposed rule does not sufficiently mitigate the risks to U.S. financial stability posed by the failure or material financial distress of the covered company.

While the OCC supports the more rigorous liquidity standards that the Basel Committee and the Federal Reserve Board's proposals would establish, we believe it is essential to calibrate these standards appropriately and to harmonize to the fullest extent possible the definitions and data upon which they are based. The OCC has stressed the need to ensure that the Dodd-Frank Act and Basel III liquidity standards being developed reflect empirical analysis and are carried out in a coordinated manner so as to enhance the safety and soundness of the U.S. and global banking systems, while not unduly restricting access to credit.

### III. Cross-Border Resolutions

A key objective of the Dodd-Frank Act is ending the perception that a firm is “too big to fail” by requiring, among other things, more robust resolution planning regimes. The orderly resolution of large, complex financial institutions also is a key objective of the international supervisory community. The international efforts have focused, in large part, on the establishment of cooperative structures, including crisis management groups working alongside supervisory colleges, as a way to provide meaningful planning and timely exchange of information.

Supervisory colleges are international working groups that assist supervisors to develop a better understanding of the risk profile of an international banking group. They are not formal decision-making bodies, but rather provide a forum to discuss broader issues such as the planning of supervisory assessments and the sharing of information and perspectives by home country and host country participants relating to the risk assessment of an international banking group. Colleges facilitate effective crisis management by assisting in planning the crisis management meeting, encouraging the banking group to produce appropriate information for crisis management, and serving as a conduit for information sharing.

In November 2011, the G20 endorsed a new standard (Financial Stability Board’s Key Attributes of Effective Resolution Regimes) as an internationally agreed model for reform of national resolution regimes.<sup>6</sup> Rather than creating a single, global legal framework for the resolution of cross-border financial institutions, the Key Attributes set out the responsibilities, instruments, and powers that all *national* resolution regimes

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<sup>6</sup> Key Attributes of Effective Resolution Regimes for Financial Institutions, Nov. 4, 2011, available at: [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

should have to enable authorities to resolve failing financial firms in an orderly manner. The Key Attributes include requirements for crisis management groups, resolvability assessments, and recovery and resolution planning for global systemically important financial institutions (G-SIFIs), and for the development of institution-specific cross-border cooperation agreements so that home and host authorities of G-SIFIs are better prepared for dealing with crises.

The current U.S. legal framework, as enhanced by Title II of the Dodd-Frank Act, establishes a resolution regime that conforms with the Key Attributes in that it applies in a clear and transparent way to financial institutions whose failure could be systemically significant or critical. It also authorizes U.S. regulatory agencies to require domestically incorporated global systemically important financial companies to develop recovery and resolution plans, including a group resolution plan. U.S. regulatory agencies can require regular resolvability assessments for these companies and enter institution-specific cross-border cooperation agreements. Similarly, certain large insured depository institutions are required to provide plans for their resolution.

The current U.S. legal framework is also consistent with the Key Attributes provisions concerning conditions for cross-border cooperation. U.S. law generally permits U.S. resolution authorities to cooperate with resolution measures by foreign home resolution authorities. Similarly, the Dodd-Frank Act directs the Financial Stability Oversight Council (FSOC), the Federal Reserve Board, and the Secretary of the Treasury to consult with other international regulatory authorities on matters related to systemic risk and supervision of financial institutions. The Dodd-Frank Act also directs the FDIC, as receiver for a systemically important financial company, to coordinate, to the

maximum extent possible, with appropriate foreign financial authorities regarding the orderly liquidation of a systemically important financial company that has assets or operations in a country other than the U.S. The Dodd-Frank Act empowers the FDIC, for purposes of carrying out liquidation and receivership authorities under the Dodd-Frank Act, to request assistance from a foreign financial authority or to assist any foreign financial authority in conducting any investigation, examination, or enforcement action.

Consistent, harmonized implementation is critical to the effectiveness of the model Key Attributes. Legislative changes will be required in many jurisdictions to implement the Key Attributes and to strengthen supervisory mandates and capabilities. Other requirements will demand a high degree of active cooperation among authorities and reviews by firms of their structures and operations. The Cross-Border Crisis Management Working Group (CBCM) of the Financial Stability Board (FSB) is conducting surveys to assess the status of work in the various jurisdictions relating to Crisis Management Groups (CMGs), recovery and resolution planning, and resolvability assessments. In addition, the FSB, with the involvement of the International Monetary Fund, the World Bank, and the standard setters, is also drawing up a methodology to assess implementation of the Key Attributes standards, and the OCC is participating in the development of the methodology. Supervisory colleges and CMGs can also complement these wider peer review processes by promoting a coherent, cross-jurisdictional approach to the consistent and effective implementation of the Key Attributes.

#### **IV. Derivatives Regulation**

In 2009, G20 leaders committed to reforming over-the-counter (OTC) derivatives markets by year-end 2012, to require clearing of standardized contracts through central counterparties, and to improve transparency of non-cleared derivatives and subject them to additional capital requirements. In Title VII of the Dodd-Frank Act, the U.S. established the legislative infrastructure for these and other reforms in our derivatives markets. As the U.S. makes orderly progress through the implementation of Title VII, we also face questions about the progress of other G20 nations.

Effective restructuring of the derivatives market, in the manner envisioned in Title VII, will be difficult to achieve if traders have the option to conduct their derivative transactions in other, less heavily regulated jurisdictions. If international efforts are successful in implementing robust restrictions in all significant market jurisdictions, we will protect U.S. institutions and markets from exposure to systemic risk in the form of market contagion from under-supervised large traders. Even with such broad harmonization, the goals of Title VII may be affected by smaller differences with other countries.

The G20 leaders have charged the FSB with regularly monitoring the progress of implementation by G20 nations towards the 2009 commitments on OTC derivatives. The FSB, through the OTC Derivatives Working Group, is currently in the process of wrapping up its information-collection activities antecedent to publishing its fourth progress report. While the reports thus far show that the U.S. and some other major market jurisdictions have established the legislative infrastructure necessary to meet the 2012 commitment, many other jurisdictions have not yet undertaken this important step.

On the positive front, international regulators are making important progress in establishing ground rules that will support a global approach to central clearing on a cross-border basis through recognized counterparties. This has the potential to facilitate greater standardization and liquidity in derivatives, increasing the proportion of contracts that can be cleared. In November of 2011, an international working group was established to address this issue and, more broadly, coordinate other international workstreams on OTC derivatives. Other established international supervisory coordinating bodies, such as the Basel Committee, the Committee on Payment and Settlement Systems, and the International Organization of Securities Commissions (IOSCO) are preparing standards, consultative documents, and study papers on international derivatives implementation issues falling within their respective jurisdictions. The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission also have been coordinating with international counterparts in several major jurisdictions to coordinate implementation issues with cross-border impact.

Notwithstanding these preliminary moves, U.S. regulators have been hampered in their work with regulators in other jurisdictions that have not yet established a legislative framework for OTC market restructuring. While it is understandable that these jurisdictions, which currently have smaller levels of OTC market activity, might wish to “wait and see” how the U.S. and European regulators complete their approach before proceeding with their own measures, the “wait and see” approach also creates the risk of regulatory arbitrage, and slows the pace of international coordination.

Important progress also is being made on the implementation of margin requirements backing non-cleared derivatives. The OCC, along with the other U.S. banking, commodities, and securities regulators, are participating in an international supervisors' working group, established in the fall of 2011 under the auspices of the BCBS and IOSCO, to address this topic. U.S. banking and commodities regulators were the first to issue specific proposed margin requirements, in the spring of 2011. The banking agencies' proposal requested public comment on the international application of U.S. margin requirements to non-cleared derivatives executed by foreign branches and subsidiaries of U.S. banks that are swaps dealers or major swap participants. Commenters expressed concerns that U.S. and foreign regulators must coordinate as to the level and effective dates of their respective margin requirements, and anticipated that unilateral U.S. implementation of margin rules would eliminate U.S. banks' ability to continue competing in foreign markets that are behind the U.S. in formulating margin rules for their own dealers. We anticipate the BCBS-IOSCO working group will be in a position to issue a consultative paper on international margin standards by this summer.

To summarize, in the key aspects of OTC derivatives market restructuring, the G20 leaders have committed to core changes, channels of communication between supervisors have been established, and the parties are working toward convergence, though the final outcome remains to be seen. Given our commitment to convergence with international standards, our primary concern with the ongoing efforts to reform OTC derivatives markets is one of timing. If the U.S. is unable to implement market reforms in a coordinated and contemporaneous fashion with all significant derivatives market jurisdictions, we face the risk that trades will move to an unregulated market. This would

thwart the intended result of Title VII reforms, and negatively affect the ability of U.S. financial institutions to compete for international market share.

In addition, there is one particular aspect of Title VII for which there appears to be no equivalent policy among our foreign counterparts: the “push out” provisions of section 716, which dictates where in a U.S. bank holding company certain aspects of derivatives dealing business can be conducted. The language of the section is ambiguous in important respects, but the U.S. appears to be alone in espousing the basic approach in section 716 of limiting the flexibility of holding companies to conduct some aspects of their derivatives dealing business within depository institutions.

## **V. Volcker Rule**

The Dodd-Frank Act contains certain provisions, like section 619 (the “Volcker Rule”), that have no foreign equivalent and, unlike capital and liquidity requirements, currently are not the subject of international harmonization efforts. Section 619 generally prohibits a banking entity, which includes a U.S. banking entity and a foreign bank with certain U.S. operations,<sup>7</sup> from engaging in proprietary trading and from making investments in, and having certain relationships with, a hedge fund or private equity fund. The statute excepts from these prohibitions certain activities, including market-making related activities, underwriting, risk-mitigating hedging, trading in U.S. government obligations, and activities conducted by qualifying foreign banking entities “solely outside of the United States.”

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<sup>7</sup> Section 619 applies to any foreign bank that “is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978” and its affiliates worldwide.

On November 7, the federal banking agencies and the SEC issued a notice of proposed rulemaking to implement the Volcker Rule (the Proposal).<sup>8</sup> The public comment period on the Proposal closed on February 13, and the agencies are now considering the over 16,000 comment letters received. These include comment letters from both U.S. and foreign banking entities, trade associations, and governmental authorities, including the governments of Canada, the European Union, France, Germany, Mexico, Japan, and the United Kingdom.

It is clear from these comment letters and meetings with our foreign counterparts that the U.S. restrictions on banking entities' high-risk trading and investment activities are unique. As our foreign counterparts have pointed out, the G-20 did not endorse regulation of proprietary trading and hedge and private equity fund investments as an area of the financial system requiring reform and, to our knowledge, other countries have not adopted such measures.

Instead, other countries have chosen different measures to guard against the financial and operational risks banking entities may face from businesses perceived as high risk. Most countries are relying primarily on enhanced capital and liquidity requirements and new resolution frameworks for globally systemic banks to address such risks. The United Kingdom has proposed additional measures (known as the "Vickers Proposal") to restructure its banks: its so-called "retail ring-fencing" measures would require banks to conduct retail and investment banking services in separate subsidiaries, thereby limiting capital and liquidity transfers from the retail arm of the banking group to the wholesale side of the business. The Vickers Proposal, in contrast to the Volcker Rule,

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<sup>8</sup> The CFTC published a notice of proposed rulemaking implementing section 619 on February 14, 2012. The CFTC proposal, which adopts the same rule text as the Proposal, is open for comment through April 16, 2012.

would not prohibit proprietary trading in a banking organization, but rather require that it be conducted outside of the retail bank.

These comment letters also raise significant issues relating to the international implications of the Proposal by addressing the potential impact of the Proposal on competitiveness and on the extraterritorial reach of U.S. laws. Some of these issues flow from the provisions of the statute, while others are the result of how the agencies have proposed to implement the statute. For example, U.S. banking entities have expressed concern that they will be at a competitive disadvantage internationally when they conform their worldwide operations to the requirements of the Proposal because foreign banking entities not covered by the Volcker Rule would be permitted to engage in proprietary trading and make hedge fund and private equity investments, subject only to applicable foreign laws. In addition, foreign banking entities covered by the Volcker Rule may engage in proprietary trading and make hedge fund and private equity investments “solely outside of the United States” by the terms of the statute. U.S. banking entities have pointed out that this difference in treatment could result in regulatory arbitrage, regulatory uncertainty, and unfair competition and could affect the competitiveness of all U.S. companies that depend on U.S. markets for liquidity and capital formation. They have noted that reduced liquidity, on a macroeconomic level, could restrain economic development, job creation, and the international competitiveness of U.S. businesses. Many of these complaints are about the basic policy contained in the statute, but we are carefully considering these concerns to determine the extent to which they are exacerbated by the Proposal.

Foreign governments and foreign banking entities have expressed concern about the extraterritorial impact of the Proposal, including the agencies' approach to implementing the statutory exception which permits qualifying foreign banking entities to engage in prohibited trading and covered fund activities "solely outside of the United States." Commenters have asserted that the Proposal construes this exception too narrowly, and, as a result, foreign banking entities will need to rely on other exceptions in the Proposal in order to engage in activities outside of the U.S. Commenters have maintained that these exceptions impose U.S. legal requirements on foreign banking entities operating outside of the U.S., which may conflict with applicable foreign laws and may be inconsistent with the regulatory approach adopted by foreign regulators.

Commenters also have criticized the application of the statutory backstops and the proposed compliance and reporting requirements to operations of foreign banking entities outside of the U.S. The backstops provide that a banking entity may not engage in any permitted activity that would involve or result in a material conflict of interest or a material exposure to a high-risk asset or trading strategy or threaten the safety and soundness of the banking entity or the financial stability of the U.S. Section 619 requires the agencies to issue rules regarding internal controls and recordkeeping to ensure compliance with the statute. The Proposal imposes the statutory backstops, a detailed compliance program, and extensive reporting requirements on all banking entities subject to section 619, including foreign banking entities. Commenters have urged the agencies to limit the scope of these requirements to foreign banking entities' U.S. operations.

Finally, commenters have objected to the preferential treatment afforded to U.S. government obligations as compared to obligations issued by foreign governments. They

have urged the agencies to treat foreign sovereign bonds like U.S. government obligations by creating an exception for trading in foreign sovereign debt. Commenters have argued that foreign sovereigns are used as collateral and for asset liability management purposes and that disrupting their trading will jeopardize banking entities' safety and soundness. In addition, they have noted that making sovereign debt harder to trade, especially by primary dealers, will make the market for that debt less liquid. This could hinder central monetary operations and thereby decrease financial stability. Moreover, the commenters have suggested that providing preferential treatment to U.S. sovereign debt may result in retaliatory efforts by other countries.

We plan to carefully consider all comments received in implementing the regulation. In particular, we plan to consider both the extraterritorial reach of the Proposal and the potential for regulatory overlaps and inconsistencies the Proposal may create for banking entities' worldwide operations.

## **Conclusion**

The OCC is committed to effective implementation of international financial regulatory agreements and the Dodd-Frank Act. As we move forward with Dodd-Frank Act implementation and toward convergence with international standards, we must be mindful of the need to strike an appropriate balance between enhanced regulation, better supervision, and market restrictions.

Achieving a level playing field for internationally active institutions is an important objective, but it is never fully achieved, and sometimes national policy choices, like a number of those I have noted in the Dodd-Frank Act, place other national

objectives above competitive equity. Still, it is important to appropriately reconcile the enhanced U.S. requirements with the enhanced international standards wherever possible, or run the risk of placing U.S. banks at a competitive disadvantage that may drive important elements of financial services and financial intermediation out of the banking system or out of the U.S.

Thank you for the opportunity to discuss the international implications of the Dodd-Frank Act and to update the Committee on the efforts currently underway to harmonize U.S. regulatory requirements with international standards and frameworks. I am happy to answer your questions.