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Opening Statement by Governor Daniel K. Tarullo

Thank you, Madam Chair.

The proposal before us today lies at the intersection of two important principles of post-crisis regulatory reform: one is that strong capital requirements are central to ensuring a safe and sound financial system. The second is the relatively new principle that the stringency of prudential standards should be proportional to the systemic importance of regulated firms.

The proposed system of graduated capital surcharges would be another step toward implementation of section 165 of the Dodd-Frank Act. It builds on the framework for capital surcharges agreed upon in the Basel Committee on Banking Supervision for application to banks of global systemic importance. The Federal Reserve, along with a few like-minded central banks, was an early advocate for the capital surcharges, and we should be pleased that we were eventually able to reach international agreement on this important innovation in international capital standards.

The proposed regulation differs from the international framework in two significant respects: the calibration of surcharges would generally be higher than those applicable to the eight covered U.S. banks under the international standard, and the formula by which we calculate applicable surcharges would directly take into account the reliance of each firm on short-term wholesale funding. Let me briefly note the reasons for both these differences.

First, with respect to calibration, surcharge levels for most of these eight banks would be higher under the proposal than those required by the Basel standard, and likely meaningfully higher for some of the firms. The approach to calibration we developed in cooperation with other Basel Committee members was to determine the additional capital necessary to equalize the probable systemic impact from the failure of a systemically important bank as compared to the probable systemic impact from the failure of a large, but not systemically important, bank holding company.[1] However, the surcharge levels ultimately agreed to by the Basel Committee were toward the low end of the range suggested by this analysis. The levels included in the proposed rule are more in the middle of that range, and, as suggested in an economic impact analysis undertaken by Basel Committee members, should provide substantial net economic benefits by reducing the risks of destabilizing failures of very large banking organizations.

The applicable surcharge would be increased as a bank's systemic importance grows, and reduced as a bank reduces its size, interconnectedness, reliance on short-term funding, or other characteristics that determine its systemic significance. Moreover, the surcharges apply only to systemically important banking organizations. Thus, other banks may have capacity to act as substitute providers of credit in response to any reduction in at least some forms of lending by larger banks. Finally, I note that several other countries have also decided to enhance financial stability by applying capital standards above Basel surcharge levels for their systemically important banks.[2]

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[1] For example, if the probable systemic impact from the failure of a global systemically important bank (GSIB) would be five times that resulting from the failure of a nearly-systemic bank holding company, the GSIB should hold capital sufficient to make the probability of its failure one-fifth that of the nearly-systemic firm.

[2] Switzerland, Sweden, and the Netherlands each require a capital surcharge of 3 percent of risk-weighted assets in common equity tier 1 capital for their largest banks. Sweden is increasing the requirements for its G-SIBs to 5 percent by 2015.

With respect to the difference in the proposal's formula from the Basel formula, inclusion of a short-term wholesale funding factor reflects the fact that reliance on short-term wholesale funding can leave a firm vulnerable to creditor runs that force the firm to rapidly liquidate its own positions or call in short-term loans to clients. Both of these responses can lead to fire sales that create a vicious cycle of mark-to-market losses, margin calls, forced deleveraging, and further losses. Thus, reliance on short-term wholesale funding is among the more important determinants of the potential impact of the distress or failure of a systemically important financial firm on the broader financial system. Unfortunately, the surcharge formula developed by the Basel Committee does not directly take into account reliance on short-term wholesale funding.

Inclusion of reliance on short-term wholesale funding as one of five factors in the systemic significance formula is intended principally as a means for assuring the resilience of large firms that are in fact dependent on such funding. It is not a substitute for liquidity regulations such as the Liquidity Coverage Ratio that we recently adopted, or the Net Stable Funding Ratio that we will be considering next year.

In conclusion, the proposed rule would strengthen the Basel standard as applied in the United States both by raising the surcharges to levels that would yield greater net economic benefits and by explicitly incorporating a factor for determining those surcharges that lay at the heart of the recent financial crisis. The proposed *Federal Register* notice includes a number of questions designed to elicit views on these and other features of this important regulatory advance, and I look forward to seeing public comments in the coming months.

Let me now turn to Mike Gibson for a full presentation of the proposed rulemaking.