S. HRG. 111–720

CONTINUING OVERSIGHT ON INTERNATIONAL COOPERATION TO MODERNIZE FINANCIAL REGULATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITY AND INTERNATIONAL TRADE AND FINANCE

OF THE

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

ONE HUNDRED ELEVENTH CONGRESS

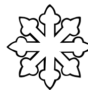
SECOND SESSION

ON

COLLABORATIVE INTERNATIONAL EFFORTS TO PROMOTE FINANCIAL REGULATORY REFORM

JULY 20, 2010

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

62–563 PDF WASHINGTON : 2010

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CONTINUING OVERSIGHT ON INTERNATIONAL COOPERATION TO MODERNIZE FINANCIAL REGULATION

TUESDAY, JULY 20, 2010

U.S. SENATE,
SUBCOMMITTEE ON SECURITY AND INTERNATIONAL TRADE AND FINANCE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:05 a.m., in room SD–538, Dirksen Senate Office Building, Senator Evan Bayh (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN EVAN BAYH

Chairman BAYH. Good morning, everyone. I am pleased to call to order this Subcommittee hearing entitled, "Continuing Oversight on International Cooperation to Modernize Financial Regulation."

I want to thank and welcome my colleague, Senator Corker, and others who may be in attendance shortly. I know the issue of financial regulatory reform is very important to Bob and we have had a lively and productive discussion at our previous hearing on this issue that I look forward to building on today.

To our three witnesses, I want to say welcome and thank you for appearing. I know you are very busy and have a lot of other issues on your plate, so I appreciate your accommodating our Subcommittee today. To some of you, it is welcome back. We appreciate your appearing once again. And I want to thank you for your work that is underway to harmonize international financial regulations.

We have a new addition to our witness list since our last hearing the Honorable Lael Brainard. Lael—I hope I pronounced that correctly—was confirmed as Under Secretary of International Affairs to the Treasury Department. Lael, the way Congress is working these days, getting confirmed to anything is a major accomplishment, so I want to express my thanks for Congress acting in that area. My compliments to you for surviving the gauntlet, so we appreciate you being here today. This is her first hearing in front of this Subcommittee and before the Banking Committee, so I want to welcome her to the Subcommittee and to our continued dialogue. I look forward to her testimony as well as the testimony of our other esteemed witnesses.

Before we turn to the panel, I would like to give some brief remarks and invite my colleagues to do the same if they so choose, and Bob, I think probably the best ground rules will be 5 minutes

with a lot of leeway, of course, and then when we turn to questions, maybe 5 minutes and a second round, if that is in order.

And I would say to our witnesses today, all of your statements will be entered into the record in full, so if we can keep it to about 5 minutes, that will be good and we can get to the questions and answers. But all of your thoughts and your prepared statements will be entered for the record, so please don't worry about that.

Welcome to Senator Warner, as well.

Last September, this Subcommittee met to discuss a critical but often overshadowed component of financial regulatory reform: The international efforts to harmonize and implement financial regulations. As I said then, quote, "We live in an interconnected global economy, and as we have seen, that means interconnected global problems. Vulnerabilities and gaps in financial markets abroad can impact us here at home. The reverse is also true. Any reform or rules we enact here at some level should be matched or harmonized abroad to ensure capital does not gravitate to the lowest common denominator," end quote.

Immediately following the crisis, there was global consensus that regulatory changes were needed to strengthen the foundation of our markets and the global economy, and that those changes should be harmonized to prevent regulatory arbitrage.

At our hearing last September, our leading representatives and experts on international economic and financial affairs outlined their priorities and the work underway to follow through on the commitments made by global leaders at the G-20 meeting. They described their roles on the Financial Stability Board and other international standard setting bodies and how effective those institutions can and will be during this difficult process. We discussed capital requirements, derivatives, accounting standards, and other policy issues.

Nine months have now passed and there are important updates in the area of financial reform. Most notably, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. When President Obama signs the bill into law, we will become the first country to adopt comprehensive financial regulatory reform that meets the principles outlined at the G-20 meetings.

While the bill rightly focuses on reforming our domestic system, it also includes an international provision that requires the Board of Governors and the Administrative Office of the United States Courts to conduct a study on international coordination relating to the resolution of systemic financial companies under the Bankruptcy Code and applicable foreign law.

Continued oversight by this Subcommittee and our progress toward international harmonization will remain very important. In fact, Senator Merkley and I filed an amendment that would make these hearings mandatory. Though our amendment wasn't included in the final bill, I am pleased that all of you have been able to join us today, and as long as we can count on you to continue making the trips up to Capitol Hill on a regular basis, we should be just fine.

Over the last 9 months, we have also seen significant and disruptive international developments. The European debt crisis demonstrated once again the interconnectedness of our global financial

system. The Basel Committee released a draft proposal on capital and liquidity requirements in December and met again last week to continue its work on that critical issue. The EU has been working on legislative proposals on hedge fund and OTC derivatives regulatory reform. And last month, Britain announced that it will abolish its main financial regulator, the FSA, and consolidate its authority into the Bank of England.

The G-20 met again last month in Toronto, and it appears that much of the discussion focused on the global economic recovery and the debate on fiscal austerity *versus* stimulus spending. I am hopeful, however, that our witnesses today will be able to provide some insight on the discussions on financial regulatory reform that took place at the summit.

We meet today to continue our dialogue on these important issues to ensure that we do not lose any momentum or get bogged down in the details as the financial crisis becomes, hopefully, a more distant memory. We have asked the witnesses to provide updates on the key priorities for international alignment and to explore what the consequences may be to the United States and our financial institutions if international coordination is not achieved in those areas.

As President Obama said last year, we need to foster an environment that encourages a global race to the top. Now that the legislative process is complete here domestically and we begin the process of implementing the new reforms, we must ensure that other countries follow our leadership in lifting global financial standards.

I look forward to our witnesses' testimony and to our discussion to come.

I would now turn to my colleagues, starting with Senator Corker, and Bob, once again, it is a pleasure working with you.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Evan, always good to be with you. I thank you for having the hearing and certainly appreciate each of you coming here to talk to us today.

I don't give long opening statements, but I will say that last night, I spent a good deal of time meeting with someone in preparation for this meeting that I think is well respected by all three of you and, I think, all three of us. His number one take-away from what is happening right now is that as he sits down and meets with foreign ministers, one of the things that they are doing is sort of rubbing their hands and licking their chops at the fact that because of what we have done with the Dodd-Frank bill, there are tremendous opportunities in the countries that they represent for out-migration of jobs from our country, and also their ability, even if those jobs don't come there, their ability to actually expand their ability to serve, especially in some of the Asian countries.

So as you testify today, and I am sure we are going to have a lot of questions, I appreciate your insights, number one, on our abilities to sync up as it relates to standards. I mean, the three of you and others involved in these G-20 negotiations have a major responsibility and it really affects all of us. Even in the smaller rural areas of our districts or in States, what you are doing is going to have a huge effect.

And it is not just setting the standards, I think, and trying to cause those to sync up. It is actually applying those. I think all of us realize that there is a pretty big swath, a pretty big difference between the way countries actually apply these standards, and in that process, too, again, our country can become very noncompetitive.

I don't think any of us are going to know the real impact of the Dodd-Frank bill until guys like you, the regulators, which this 2,300-page bill gave tremendous responsibility to, sort of ease through—hopefully not ease through, but work through all the many and various rulemakings that the bill really created.

But I certainly have a lot of questions for you. I thank you for being here and just would say one more time, I know that you know this, but all of us are hoping that you all will do an outstanding job in these meetings because it is going to affect all of us. Thank you.

Chairman BAYH. Thank you, Senator.

Senator Warner.

STATEMENT OF SENATOR MARK R. WARNER

Senator WARNER. Thank you, Mr. Chairman, and I will also try to be brief because I am anxious to hear, as well, from the witnesses.

A lot of the international conversations so far seem to be about what is going on in Basel in terms of the capital standards, terribly important, but the areas where Senator Corker and I worked on this bill in terms of systemic risk, "too big to fail," and resolution, what I hope you will address, as well, is I had the belief, and I think Senator Corker did, as well, that we wanted to have a preferred process for bankruptcy and resolution being only as a remedy of last resort and a remedy that would be clear that if a management team went into it, they would not come out the other end.

The challenge as we kind of, and I am by no means an expert on domestic bankruptcy, let alone international bankruptcy, but the difference between how a bankruptcy fence goes in international countries is something that we clearly need if we are going to have this preference, hopefully preferred preference toward bankruptcy, how we align our bankruptcy provisions on these internationally interconnected firms between American and international bankruptcy provisions, number one. It is something I would love to hear some comments on.

And we did add in this legislation two new tools that I hope are going to be very effective, but I think the jury is going to be out based upon how well they are implemented both domestically and internationally. One is the contingent debt and how contingent debt would convert to equity, what would be the triggers, and again, this is terribly important on internationally interconnected firms so that if there is this conversion process taking place, you don't have trading between balance sheets of domestic *versus* international subsidiaries. This is an area that seems to have gotten some growing interest on the international level.

And then what history may look back and say we were really quite smart in putting into this legislation, or it may go into the category of great ideas that never carried much weight, and that

is the so-called “funeral plans” that are going to have to be blessed by the council. It became evident in meetings with Senator Corker and I during this where there were certain large interconnected organizations that came in during the midst of the crisis and basically said they couldn’t go through bankruptcy because they had so many international operations and, in effect, I think, left the regulators and left the Bush administration with very few choices.

How these funeral plans are going to be blessed, particularly in terms of their international divisions and showing how they can orderly unwind themselves through a bankruptcy process, how that is coordinated with the international colleagues, and then our hopes, at least my personal hope would be that if firms can’t meet that standard, particularly to our friends at the Fed, using this tool in terms of signing off on these funeral plans and making sure there is a real way and a clear path so that it can be used is something I am going to be anxious to hear and press you on in some questions.

So again, thank you, Mr. Chairman, and again, echoing what the others have said, we have got a framework here. How well this framework gets implemented, both domestically but also internationally, I think is going to be one of the real challenges over the next few years and look forward to working with you. Thank you.

Chairman BAYH. Thank you, Senator Warner.

We have a very distinguished panel. I will try and give brief introductions to each. I think we will start right to left—well, from our perspective. That would be left to right from your point of view. So, Lael, I will begin with you and then conclude, Dan, with you.

Lael Brainard was recently confirmed, as I mentioned, as Under Secretary for International Affairs at the Department of Treasury by the U.S. Senate. Brainard advances the Administration’s agenda of strengthening U.S. leadership in a global economy to foster growth, create economic opportunities for Americans, and address transnational economic challenges.

Most recently, Brainard was Vice President and Founding Director of the Global Economy and Development Program at the Brookings Institution, where she held the Bernard L. Schwartz Chair in International Economics and directed the Brookings initiative on competitiveness. Brainard received Master’s and Doctoral degrees in economics from Harvard University. Lael, in our part of the world, we refer to that as the Indiana University of the East——

[Laughter.]

Chairman BAYH. ——where she was a National Science Foundation Fellow. She graduated with highest honors from Wesleyan University. Lael, welcome.

Next, the Honorable Kathleen L. Casey. Ms. Casey is the Commissioner of the Securities and Exchange Commission and is the SEC representative to the Financial Stability Board. Prior to being appointed Commissioner, Ms. Casey spent 13 years on Capitol Hill working for Richard Shelby, our colleague on the Banking Committee. She served as Staff Director and Counsel to the U.S. Banking, Housing, and Urban Affairs Committee for then-Chairman Shelby. So in some ways, Kathleen, this is a welcome home to you. It is nice to see that there is life after Capitol Hill.

[Laughter.]

Chairman BAYH. Ms. Casey was primarily responsible for guiding the Chairman's and Subcommittee's consideration of and action on issues affecting economic and monetary policy, international trade and finance, banking, securities, and insurance regulation, transit and housing policy, money laundering, and terror finance-related issues.

In looking at your background, Ms. Casey, I noted—am I correct—you were born in Libya?

Ms. CASEY. Yes.

Chairman BAYH. That is fascinating, another example of the increased global integration. So welcome back to the Banking Committee.

Finally, the Honorable Daniel K. Tarullo. Mr. Tarullo is a member of the Federal Reserve Board of Governors and he is a frequent guest of this Subcommittee and the full Senate Banking Committee, so we welcome you back once again, Dan.

An expert in international finance and banking supervision, Mr. Tarullo has published a book called, *Banking on Basel.* How far up the Amazon Best Seller List did that make it, Dan? Just joking.

[Laughter.]

Mr. TARULLO. Not high enough.

[Laughter.]

Chairman BAYH. Probably further than my book, I will just say that.

It is subtitled, *The Future of International Financial Regulation.* In that book, he examined international banking regulations and recommended improvements.

Prior to his appointment to the Board, Mr. Tarullo was a Professor of Law at Georgetown University Law Center, where he taught courses in banking law and international financial regulation. Prior to joining the Georgetown Law faculty, Mr. Tarullo held several senior positions in the Clinton administration. From 1993 to 1998, Mr. Tarullo served successfully as Assistant Secretary of State for Economic and Business Affairs, Deputy Assistant to the President for Economic Policy, and Assistant to the President for International Economic Policy. He also served as a principal on both the National Economic Council and the National Security Council. Welcome back again, Mr. Tarullo.

Ms. Brainard, we will begin with you, and again, congratulations on your confirmation and thank you for your courtesy in attending the hearing today.

STATEMENT OF LAEL BRAINARD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Ms. BRAINARD. Well, thank you very much, Chairman Bayh, Ranking Member Corker, and Senator Warner. Thank you for the warm welcome. And the questions that you all posed, I think, are hard questions and questions that we are working very hard on every day.

Tomorrow, President Obama will sign into law the strongest financial reforms this country has seen since the Great Depression. Thanks to the leadership of the President, Secretary Geithner, Chairmen Dodd and Frank, and Members of this Committee, the Dodd-Frank Wall Street Reform and Consumer Protection Act will

lay the foundation for a sounder and more resilient financial system. It will protect America's long-term economic competitiveness. It will help prevent future crises and it will promote stable and sustained economic growth.

The challenge before us now is to ensure that the world standards are every bit as strong as America's. In the wake of the most globally synchronized financial crisis the world has ever seen, we must develop the most globally convergent financial protections the world has ever attempted.

Although global convergence will be critical in areas such as capital and derivatives regulation, our international efforts in other areas may be equally well served by coordinating different approaches across nations reflecting deeply rooted differences in national structures and institutions. In those cases, the mechanism that works best for other countries may not work best for the United States, although we are all seeking to advance common objectives.

Let me speak briefly about the steps we are taking to ensure convergence around the world, focusing on addressing too big to fail, extending the perimeter of regulation, and establishing the right global architecture.

Our international reform agenda is tackling head on the moral hazard problem associated with firms perceived to be too big to fail. A key lesson of the crisis is that more and higher quality capital must be at the core of our reforms and that capital rules must be harmonized internationally to be effective domestically. That is why in Toronto last month, President Obama and other G-20 leaders set the goal of ensuring that financial institutions hold enough common equity to withstand, without Government intervention, stresses of the magnitude seen in the last crisis, and they committed to reach a comprehensive agreement by November.

The Basel Committee on which Dan Tarullo serves is working hard to establish common definitions of capital and risk weights and to determine the necessary amount of capital and appropriate liquidity ratio, along with specifying appropriate transition periods.

A second key component to ending too big to fail is to improve market discipline on major financial players.

Stress tests can help. In the coming days, the Committee on European Banking Supervisors will be releasing bank by bank stress test results for the large cross-border European banking groups as well as many smaller banks. While there is no one-size-fits-all approach to stress testing, with the appropriate assumptions and disclosures, this effort could help to strengthen bank balance sheets in Europe, much as the SCAP did here in the U.S.

Third, the web of bilateral derivatives trades became, as you know, a major source of contagion during the crisis. Our legislation here will reduce this risk by requiring the central clearing exchange trading of standardized OTC derivatives as well as by supervising and regulating all participants in these markets. Because these activities are highly globalized, it is absolutely critical that we work internationally, particularly with the EU, to make certain that critical OTC derivatives market infrastructure is subject to oversight in line with the strong standards adopted here in the

U.S., which were also agreed in the G-20 and the Financial Stability Board.

Let me briefly speak about extending the perimeter of regulation as well as making the system safe for failure. This is, of course, a critical part of ending the moral hazard that afflicted the system and we have a lot of work to do internationally to make sure that other countries have the same strong resolution authority we will have here and to work on cross-border resolution mechanisms, as well as developing credible resolution plans.

So with regard to hedge funds, which is the one area I wanted to touch on before I close, the perimeter of regulation must also be extended to ensure strong oversight of these markets. We have worked to ensure international agreement on the U.S. approach, requiring advisors of hedge funds to register and report so that supervisors can assess whether any fund poses a threat to the system. As the EU works to establish similar requirements under their Alternative Investment Fund Managers Directive, we are going to make sure that U.S. managers and funds retain nondiscriminatory access to their market.

Let me just wrap up by saying that to accomplish these goals, we have been working hard to improve the international financial architecture. We have made the financial repair and reform agenda a central pillar of our work in the G-20. The Financial Stability Board in which all three of us participate was established to oversee our collective efforts in the G-20 countries to identify vulnerabilities in the global financial system, to promote financial stability, and to encourage coordinated and comprehensive reforms.

So we appreciate the leadership of this Subcommittee on these key challenges and we look forward to continuing working with you as we engage with our international partners to match the strength and sweep of U.S. reforms. Thank you.

Chairman BAYH. Thank you, Ms. Brainard.

Ms. Casey.

STATEMENT OF KATHLEEN L. CASEY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Ms. CASEY. Chairman Bayh, Ranking Member Corker, and Senator Warner, thank you very much for inviting me to testify on behalf of the SEC about international cooperation to modernize financial regulation.

While Congress has been considering the scope and specifics of regulatory reform in the United States, discussions have been taking place in the G-20, the FSB, IOSCO, and other forums as to what regulatory reforms might be desirable and how best to coordinate such regulatory responses internationally. The G-20 has proven helpful in forging a broad consensus about what major issues should be addressed. Although the G-20 is an excellent vehicle for discussion of the highest level policy objectives for financial regulation, regulatory objectives are just that. Different jurisdictions are likely to use different approaches in pursuit of those objectives.

In this respect, I would note that the relevant provisions of the Dodd-Frank legislation are broadly consistent with the international principles articulated in the key areas of hedge funds, OTC derivatives, and credit rating agencies, and provide the Com-

mission with the requisite authorities to craft regulations consistent with these principles.

Currently, I represent the SEC on the FSB alongside the other U.S. Government participants, including the Federal Reserve and the Treasury Department. While the FSB is useful as a discussion forum to review broad trends affecting the financial system, the real work toward building international regulatory-level consensus and coordination rests with international technical bodies, such as IOSCO, which has the expertise and regulatory authority to establish a coordinated approach to common regulatory problems.

As a securities regulator, the SEC has long been active in IOSCO as a member of both its Technical Committee and Executive Committee. During my recently completed term as Chairman of the Technical Committee, IOSCO took important steps in advancing approaches to regulations in the areas of credit rating agencies, hedge funds, OTC derivatives, securitization, and short selling.

I would like to briefly highlight some areas where there has been some recent work at IOSCO, as well as other multilateral and bilateral work that may be of interest to the Subcommittee.

IOSCO has continued its focus on hedge funds and short selling. With regard to hedge funds, last year, IOSCO published a report setting out six high-level principles for regulation of the hedge fund sector and has sought to provide a coordinated basis for hedge fund oversight by developing a common template to help regulators identify the types of information that could be gathered to assess possible systemic risk.

With regard to short selling, IOSCO has developed four principles for the effective regulation of short selling and aims to identify opportunities for greater convergence in the implementation of and assessment of the effectiveness of these principles. In addition, IOSCO continues to monitor developments in short selling regulation, allowing its members to better understand each others' short selling regulations.

The continued work on credit rating agencies and OTC derivatives provide excellent examples of the interaction of the various levels of cooperation among international organizations and national and regional authorities. With regard to OTC derivatives, in March 2010, IOSCO, the

Committee on Payment and Settlement Systems, and the European Commission formed a working group to further the objective to improve the OTC derivatives markets. And separately, in May, IOSCO and CPSS issued two consultative reports containing proposals aimed at strengthening the OTC derivatives markets on CCPs and trade repositories.

With regard to credit rating agencies, national and regional initiatives have been taken or are underway to strengthen oversight of credit rating agencies. In the U.S., the SEC has adopted or proposed amendments to its rules on NRSROs in order to foster accountability, transparency, and competition in the credit rating industry, as well as to address conflicts of interest. Likewise, many other G-20 countries have also introduced or are planning to introduce new regulatory oversight frameworks for CRAs. As a result, the SEC, the European and Japanese securities regulators are en-

gaged in talks to address significant issues that may arise as a result of differences among their new CRA regulations.

Moreover, in response to the FASB and G-20 recommendations to review the use of ratings in the regulatory and supervisory framework, national and regional authorities, including the SEC, have also taken steps to lessen undue reliance on ratings and rules and regulations.

In addition to our collaborative efforts with our counterparts in IOSCO, the SEC is developing much stronger and more extensive supervisory cooperation arrangements with a number of jurisdictions.

In closing, I would like to briefly describe two additional initiatives, convergence and accounting standards and equity market structure, where regulators and standard setters must bear in mind the international repercussions of their work, but ultimately must take decisions that comply with the demands of their unique mandates.

In the accounting area, the SEC supports efforts of the FASB and the International Accounting Standards Board to reduce disparities in financial reporting standards through their Convergence Agenda, this in support of the broader effort to develop a single set of high quality accounting standards.

In the area of market structure, the Commission has begun an in-depth evaluation of the current structure to ensure that U.S. equity markets remain fair, transparent, and efficient, and to date, the Commission has proposed several rules, a concept release, and held a roundtable. And I would also note that many of our international counterparts are considering similar topics.

In conclusion, increasingly, our success will depend on international consensus on fundamental objectives of securities regulation. As regulators, it is essential that we bear these principles in mind as they will help us support the strength of our own capital markets. Thank you, and I would be happy to take any questions.

Chairman BAYH. Thank you very much, Ms. Casey.

Mr. Tarullo.

STATEMENT OF DANIEL K. TARULLO, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, Ranking Member Corker, and Senator Warner. It is good to be with you again to review international developments in financial regulatory and supervisory cooperation.

Since your last hearing in September on this subject, the inventory of developments, proposals, and work streams has, if anything, increased as the international standard-setting bodies have continued their work and the institutional evolution of the Financial Stability Board has produced some new ideas and initiatives.

In these opening remarks, let me confine myself to making three points.

First, the Basel Committee effort to strengthen capital and liquidity standards has been moving forward since we talked about it last in September, and I think it is on track to be completed this year, though some of the hardest decisions are yet to come. The market risk amendments have been completed and are now await-

ing adoption in the various Basel Committee countries. The Basel Committee put out for comment last December a collection of concrete proposals to strengthen the quality and quantity of capital and to institute quantitative liquidity requirements. In the intervening months, the effort has been to shape these various proposals into a coordinated package of reforms, including assessing their cumulative, quantitative, and macroeconomic effects.

Second, international cooperation on resolution matters has made more progress than I anticipated when I testified last September, though the conceptual and legal hurdles to a comprehensive international resolution system remain high. Right now there are ongoing a number of interconnected and related initiatives in this area. There is an effort to identify common principles and tools for national resolution regimes. There is work in four technical areas to lay the groundwork for more standardized practices on such matters as payment settlement so as to facilitate resolution efforts should they become necessary internationally.

There are initiatives on recovery and resolution plans for specific firms. These track legislation to be signed into law tomorrow here in the United States.

There is an exploration of mechanisms such as so-called "debt bail-in proposals" which would help maintain firms as going concerns without requiring either governmental assistance or a formal resolution process.

Now, much of this work is still in progress, and even if each of these various initiatives proves successful, they will in the aggregate fall short of a comprehensive solution. But I do think that this approach has taken reasonably far down the road the idea of trying to maximize cooperation and planning before a possible insolvency and, thus, to maximize the chances that a distressed firm can be satisfactorily dealt with internationally.

Third, as I suggested at last fall's hearing, we still need to do a good bit of work on the institutional and operational features of the organizations involved in international financial regulatory and supervisory cooperation, in such areas as sorting out which organization or committee does what and how similar efforts in different groups relate to one another, in making the transition from a dominant focus on negotiating rules and standards to their implementation and monitoring, in adjusting to the larger membership of the Basel Committee and the Financial Stability Board while fully incorporating the new members into their activities, and in ensuring that these organizations are helping to advance the shared regulatory missions of their members to supervise internationally active financial firms effectively.

These institutional characteristics and considerations may seem a bit prosaic, but I think that they have the same kind of importance internationally as our implementation and your monitoring of our implementation of the reg reform act has domestically. And without a good set of institutional mechanisms, I think it is going to be difficult for us to achieve the goals which the three of us and all of you share as well.

So thank you for your attention, and I would be pleased to answer any questions you may have.

Chairman BAYH. Thank you very much, Mr. Tarullo.

Senator Warner, before you arrived, I indicated that the first round of questioning we are going to try and keep it to 5 minutes apiece, with some leeway if we need to follow up questions, and then have a second round of questions if appropriate.

Let me just begin by putting to all of you the broader question on the table here today. We have passed a comprehensive regulatory reform bill here domestically in the United States. Do you believe there will be enough convergence in global standards so that we will avoid arbitrage, regulatory forum shopping to avoid a recurrence of the crisis that we have been through? And let me analogize just for a moment to the euro and the problem we are seeing now with Greece.

When the common currency was adopted, there were standards put into place for fiscal policy and supposedly some sort of enforcement mechanism, which obviously was not implemented very well, largely for reasons of solidarity and that sort of thing. So we had an example here where there were common principles and common ideals, but when it came to tough decision making and enforcing them in ways that would really make a difference, that did not happen very much. So will there be enough convergence and will there be a real enforcement mechanism to try and avoid a recurrence of what we have been through? I think that really is the issue on the table here today, so we have acted. Will we get enough cooperation from other countries to achieve the objective? Because if it is only us, that is not going to be enough to avoid a recurrence of this problem?

Ms. Brainard, why don't we start with you if that is OK.

Ms. BRAINARD. Well, I think that is the critical question. In many of these areas—not all, but many—if we are not able to achieve convergence, we will not be able to protect American consumers and businesses and workers the way that this legislation would like to.

The reasons that I think we are going to make more progress than we ever have before are the following:

Firstly, all of the major financial jurisdictions that are engaged in these talks have come through the common crucible of the crisis. So this is a common set of objectives, and that is clear from the discussions we have had at the highest political levels. We have leaders of G-20 countries talking about capital standards for banks. That is pretty unusual, and I think it shows the level of salience and commitment.

Chairman BAYH. Could I interject just for a moment? I am delighted they are talking about the capital standards, but this is going to involve different levels of domestic political pain depending upon the country. Are they willing to actually follow through on those statements even if it is domestically somewhat uncomfortable for them?

Ms. BRAINARD. I think the second——

Chairman BAYH. And that gets to the efficacy of these stress tests that Europe is going through now. That is great they are doing it. It worked well for us. But there are some disturbing reports that maybe they will not be quite as transparent as we might like because of what the results might show.

Ms. BRAINARD. The international architecture that we are developing should go some distance in advancing our convergence agenda. So beneath the level of political commitment, we are elaborating the set of structures importantly among which is the Financial Stability Board, which is helping coordinate the activities of a number of different entities, not just on negotiations, which are the critical first step to make sure that national jurisdictions adopt convergence standards, but also with a follow-on, very important mechanism for implementation, for cooperation, and for peer pressure, if you will.

So with regard to the area of enforcement, one of the best mechanisms for enforcement that we have is transparency and market discipline, and the IMF will participate, as will the FSB and other entities, in making assessments of every jurisdiction's regulatory framework. And we have just gone through this here in the U.S. It is like a very detailed physical check-up, very uncomfortable but very good for the system. And so we will be working with the IMF and the Financial Stability Board to ensure that other countries are not only adopting those standards in rhetoric but are implementing them in reality.

Chairman BAYH. Thank you. And why don't we continue? And I do not want to drag out—I just wondered if each of you would just respond to my question, and I will turn to my colleagues, because this is a longer dialogue. But if peer review is the best we can do and peer pressure and sort of reputational risk, well, I guess that is better than nothing. But a skeptic might say that the IMF has issued reports about countries' fiscal policies and a variety of other practices over the years, and they have been honored primarily in the breach. And you are right, market transparency and market pressure is probably the best discipline, but markets sometimes can wait pretty late. Look at the Greece phenomenon. I mean, markets have reacted to that, but it is only when the imbalance has got to the point where we have got a crisis on our hands, and we are trying to avoid that.

So I guess I would—I am all in favor of peer review, but if we can put a little teeth in the peer review, that would be even better.

Ms. CASEY. Thank you, Chairman Bayh. Just to add on to Lael's comments, as she has noted, there is always going to be arbitrage opportunities given the global nature of our markets and the use of capital flows.

I think that to the degree that you have agreement along regulatory principles or common approaches to regulation at the international level, which is ultimately complemented by increased cooperation and coordination among key regulators and supervisors, you improve the chances of minimizing those arbitrage opportunities.

I think what is also important, and which I think has been reflected in the articulation of some of these common regulatory approaches by the G-20, is that the policy objectives themselves necessarily need to be considerate to the interest of improving market efficiency, stability, and integrity, and that they do not necessarily unduly impede capital formation and growth, and that further in the implementation phase by regulators, which is very critical to whether or not those objectives are achieved, that regulators are

also sensitive to implementing the rules in a manner that they, again, do not unnecessarily create market disincentives to achieving those goals or dampen market growth.

As was just noted, with respect to the focus on enforcement and compliance, that has been one of the lessons, I think, to the crisis you have pointed to, to some of the examples of the effectiveness of previous efforts in the past on the international level. And I think that the efforts of the FSB and existing standard setters, such as IOSCO, have got an intense focus now on implementation and compliance. So what you will see—again, you mentioned peer reviews. There is no question that that does have an element of—a political element as well, but I think that to the degree that you have regulators who by their very nature are voluntarily engaged in these organizations like IOSCO, they bring both the capability to meet those commitments and the consensus that was ultimately achieved in supporting those principles. So you do have that vested interest in seeing that those rules are adopted and that they are adopted consistently across jurisdictions.

So I do think that enforcement is—or assessment and implementation and enforcement of principles is a key focus coming to the crisis. But there is no question that ongoing cooperation and coordination as jurisdictions undertake to implement these new rules and regulations will be critical to whether or not you continue to have significant arbitrage opportunities.

Chairman BAYH. Thank you very much, Ms. Casey.

I was just saying, Mr. Tarullo, I would appreciate your answer, and then I am going to turn to Senator Corker for his round of questioning.

Mr. TARULLO. OK. Just a couple of complementary observations, Mr. Chairman.

One, as I mentioned, there are an awful lot of things going on internationally right now, and we have Federal Reserve staff participating in dozens of working groups in these various international organizations. I do think it is important for the principals and the agencies to zero in on what we think the priorities ought to be, to devote ourselves to trying to get a good set of standards or understandings, and then to do what is necessary to make sure that those standards or understandings are realized.

In that respect, I, as you can tell from my introductory remarks, think that capital standards are among the most important things and among the things most susceptible to effective convergence around the world.

I mentioned in my prepared testimony that along these lines I have long felt—this long predates my arrival at the Federal Reserve—that we need to have a different kind of mechanism for monitoring the implementation of complicated capital standards. Markets are just not in a position to judge whether an internal model has been properly validated and is thus assigning the proper risk weights to particular kinds of exposures. If the markets cannot do it, then we need to make sure that there is some transparency, and my sense is that that is going to need to be provided internationally.

So after we get these capital standards agreed upon, what I am looking forward to is a discussion in international fora of how we

can make sure that everyone has assurance that these standards are being properly implemented.

Chairman BAYH. Very good. I would just only end this round by saying I understand, Ms. Brainard, this is a journey, and we are not going to get this done all at one time. There are a lot of things going on. There are countervailing concerns in addition to the stability we seek in the financial markets. I think you are exactly right, Mr. Tarullo, about the capital standards. So one of the points I am driving at here is I think some of us will look at their willingness to adopt meaningful capital standards, even if they pinch domestically a little bit, look at the stress tests. I understand that may cause some domestic heartburn, but are they transparent, are they meaningful as a test of their seriousness over time in getting us to meaningful standards that really truly have some enforcement mechanism. I am sure that some in Germany, thinking back to the time when they surrendered the Deutsche mark, wish they had focused a little bit more on enforcement of standards and some of these kind of things. Perhaps they did not, and now they are reaping the results of that. So let us learn from some of these lessons. Thank you for your responses, all of you.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you again for being here.

I read an analysis yesterday in the *Financial Times* talking about the bill that was just passed, the Dodd-Frank bill, and the final analysis was so many pages, so little content. And what that means, of course, is over the next 18 months, regulators—the Fed, SEC, Treasury—will be engaged in all kind of rulemakings. We have G-20 happening, we have Basel after that, and so, really, a world of instability as it relates to banking, which no doubt will help continue the malaise that the world is feeling right now as it relates to growing.

But on those things where there was prescriptive language in the Dodd-Frank bill, Governor Tarullo, what are those things that people are most complaining about as you meet internationally? What are those things that they have most concern about?

Mr. TARULLO. I would say, Senator, the things that I have most heard about are the Volcker Rule and the Lincoln amendment and the degree to which they will apply internationally and to foreign firms in the United States. There is also some concern about the Collins amendment.

I think that in all of those cases, those concerns were communicated directly to members of the conference committee. I heard more about them before the conference committee met than I have since, so I await hearing the degree to which those concerns were allayed in the course of the conference.

Senator CORKER. So, obviously, the Collins amendment had to do with capital. Do you think we ought to have minimum capital requirements internationally?

Mr. TARULLO. I do, Senator. As I said a moment ago, while there are a variety of regulatory mechanisms that are tailored to the legal and financial system characteristics of a particular country, I think capital is a *sine qua non* of a well-functioning, stable financial system. And although, of course, there are going to be some dif-

ferences—tax law and accounting standards make a difference—it is possible to converge around a set of strong capital requirements which try to implement a particular goal, the goal being the one Under Secretary Brainard referred to that was in the G-20 communique and that we at the Fed had articulated in a slightly different way: that these large financial institutions be able to weather a very stressed financial environment and still have sufficient capital at the end of that event to be functioning as successful financial intermediaries. That has been our aim domestically in thinking about capital and has informed the positions that we have been taking along with the FDIC and the OCC internationally on capital.

Senator CORKER. Should goodwill on mortgage servicing count as capital?

Mr. TARULLO. In my view, goodwill should not.

Senator CORKER. What about mortgage servicing?

Mr. TARULLO. Mortgage servicing rights are one of a number of elements of a balance sheet of a firm that do reflect some loss absorption capacity. That is what we want capital to be. We want capital to be loss-absorbing, which is why our focus has been common equity.

The concern, of course, is that if you have something like a minority investment in an affiliate, that investment does not protect the entire financial firm, only the affiliate, and thus it should not be counted the same way as a dollar of common equity at the holding company level.

Mortgage servicing rights, again, are not the same as an asset already on the balance sheet, but they are an expected stream of earning which have performed well in the past. And so our approach has been to say that they should count for something, but——

Senator CORKER. Is that on a multiple?

Mr. TARULLO. Sorry?

Senator CORKER. Is that on a multiple of that?

Mr. TARULLO. On a multiple of the——

Senator CORKER. Servicing.

Mr. TARULLO. No. I think our approach has been that all of these sorts of things, whether they are minority investments or deferred tax assets or mortgage servicing rights, should be applicable but limited. They should only account for a limited portion of your capital needs. And I think we are on the way to achieving that.

Senator CORKER. Internationally?

Mr. TARULLO. Internationally, yes.

Senator CORKER. Let me ask all three of you this: I have doubts, especially when I hear the reaction of people around the world to what we have done, what the country has done with Dodd-Frank, you know, the concerns about the Lincoln amendment, concerns about the Collins amendment, concerns about Volcker—which, by the way, are just so easily gotten around. I mean, let's face it. Somebody in Kansas just picks up the phone and deals with the arm of a non-U.S. bank that is based here, you know, they just transfer them over to somebody in another place, and it seems like it is relatively easy to get around much of this. But let me ask you, if you all found that you had great difficulty in getting other coun-

tries, especially those that we compete so much with, if you found difficulties in getting them to agree to whatever component of the Dodd-Frank bill that, you know, they just would not agree to internationally, would each of you come back asking us to make changes?

Mr. TARULLO. I will start because this has been something that we have been thinking about. We in the United States have had a particular approach to financial regulation going back decades. Our approach was really set in the Depression, building on the National Banking Act when we added Glass-Steagall and the Federal Deposit Insurance Act. We have always had significant activities restrictions on our insured depository institutions to a much greater extent than many banking systems in the rest of the world. And I do not think that has stopped us from having a very healthy banking system in this country for many decades.

Senator CORKER. I know we are going to run out of time, and I really do not want a historic perspective. The question is: If we ended up being out of synch with the rest of the world in areas that made us not competitive that we felt like were not really—you know, let's face it. I mean, politics overcomes substance when these bills hit the floor. Some of these things are passed just for people to make a name for themselves. They do not necessarily have anything to do with stability. If we found some of those that really were not making our country more secure as it relates to our financial system, the question is, without a historic perspective, would you come back and talk with us about those so that we might make changes if it did not have anything to do with the security of our financial system?

Mr. TARULLO. Sure. If we observe that there were provisions that did not seem to be enhancing financial stability and at the same time were creating competitive problems for U.S. industry, of course we would. I just want to make the point that different ways of doing things and different kinds of regulation do not in and of themselves mean that we are going to have the kinds of problems to which you alluded. That is why I was referring to history.

Senator CORKER. Thank you.

Ms. BRAINARD. Senator, could I just respond to that briefly?

First of all, I think it is important to recognize that this is historic legislation that will increase and strengthen the competitiveness of the overall U.S. economy by making it much less prone to excessive investments in areas that are not particularly productive, that other countries are going to want to move in this direction because it will improve the strength and——

Senator CORKER. Well, we do not really know that yet.

Ms. BRAINARD. ——resilience of our financial system.

Senator CORKER. I mean, those are great talking points, but we will know that——

Ms. BRAINARD. Can I just——

Senator CORKER. ——over the next 18 months.

Ms. BRAINARD. ——mention, Senator Corker, so in the G-20 there is actually language welcoming the strong financial regulatory reform bill in the U.S. in the Toronto summit. And many of the countries participating in the G-20 have, in fact, been waiting to see the final outlines of U.S. financial reforms because they want

to move in that direction and emulate the systems that we are putting in place.

As we were saying earlier, there are some areas——

Senator CORKER. But the question is, if they do not emulate, will you come back and talk with us? That is the question.

Ms. BRAINARD. In those areas where we absolutely must have international convergence, we will ensure, like in the area of capital standards, that we come to a global set of high-quality rules. As Dan was suggesting, there are other areas that have to do with our national banking system and its history where we might want to go a different way and where it will create no difficulties for us internationally by continuing to have some of the structures that our consumers have been used to for decades. So in those areas where we must have international rules, we will absolutely pursue them and ensure that the U.S. standard, high standard, is the world standard.

Ms. CASEY. I would say yes, we would absolutely come back and highlight any major divergences that would have a significant adverse impact. I think in particular with respect to areas like OTC derivatives, we continue to engage very closely with our counterparts in Europe, for example, where they continue to give contemplation to achieving the G-20 objectives of mandatory clearing and trade reporting and, where appropriate, exchange trading or platform trading. And I think those key components are going to be really critical, so I know that we do continue to engage reactively now that we have the passage of Dodd-Frank and the expectation of the President's signature soon bringing it into law. But as the law recognizes, international cooperation and consistent implementation in this area will be particularly critical to achieving the broader objectives. So I think that that will be a key area I think we are going to have to work very carefully on, and, of course, to the degree that Congress, which I believe is very important, needs to monitor the implementation, you will be able to identify these issues as we go forward.

Senator CORKER. Thank you.

Chairman BAYH. Thank you very much.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

The first couple questions I want to address to Governor Tarullo and Secretary Brainard, and, Commissioner Casey, I will come back with a couple specific ones for you as well.

We have spoken quite a bit here about capital standards. Another piece—at least in my process of getting educated about the crisis—was the leverage rates. If I have heard once, I have heard dozens of times, you know, Canada made comments about the fact that their lack of problems because of their rates on—their restrictions on leverage. There was a proposal in the House bill to put a restriction on leverage. I believe the blended rate left it—or the conference report left it to you all. Within Basel or elsewhere, are there other discussions about trying to reach some international court on leverage as well?

And then let me also follow up again—this is perhaps more for Dan than others. You know, there is still lots of consternation about the whole question of defensive ring fencing in bankruptcy

and/or resolution. I was just reading again recently some of the Europeans complaining about what happens in the Lehman crisis when Lehman went down and how assets left. And, you know, one of the fears I have going forward with these interconnected international institutions is making sure that we have got, again, preferably through bankruptcy but as last resort resolution some process so that assets are not fleeing quickly from one jurisdiction to the other in the event of an unwind. So leverage and then questions around bankruptcy and/or liquidation.

Mr. TARULLO. With respect to leverage, Senator, there are more than discussions. There are proposals within the Basel Committee right now. The meeting last week addressed the issue of the leverage ratio. I would say at this juncture that there is a reasonable prospect of an agreement upon a leverage ratio. I do not know that that will immediately become a so-called "Pillar 1 requirement," which is to say just an articulated rule; but it may at the beginning be a so-called "Pillar 2" or "supervisory requirement," which would hopefully then migrate into Pillar 1 after there is experience with it.

I share your view that a leverage ratio is an important complement to a risk-based capital ratio. The leverage ratio gives one a clean, unvarnished view of leverage. Of course, its shortcoming is it does not take into account the different risks associated with the assets, but that is why I think they have to be done in tandem.

Senator WARNER. Secretary Brainard, do you want to mention anything on that as well?

Ms. BRAINARD. Just with regard to the leverage, we have, since Pittsburgh, had agreement internationally that the risk-weighted capital framework would be supplemented by a simple leverage ratio which is a sort of supplementary backstop, if you will, to cut through some of the complexity, and as Governor Tarullo was suggesting, it may take some time for that to become a mandatory part of the framework. But there is commitment among the G-20 to migrate it to a mandatory part of the framework, and we are very much supportive of that.

Mr. TARULLO. Did you want to go to——

Senator WARNER. Yes, 1 second, please. Let me just extend the question a little bit, too. There has been some conversation I have heard that there might be agreement on the front end in the event of bankruptcy and/or resolution to, in effect, choose a jurisdiction ahead of time in terms of what rules will apply. I would like you to comment on that. And you used the term "the debt bail-in," which I imagine—I interpreted it as a conversation at the international level about this contingent debt that would convert to equity. I hope, though, it would be preassigned. I would think we would have real problems in our country—I would have real problems if there was going to be kind of an arbitrary taking of debt that would be converting it to equity if investors were not prewarned on that. But you might want to clarify that for me as well.

Mr. TARULLO. Sure. With respect to several of the things that you mentioned in the resolution arena, the idea of a firm being able to choose its locus for insolvency declaration and Administration, I think, is one that is well off on the horizon. It would require the

kind of harmonization of and comfortableness with deference to one another's bankruptcy systems, which in the financial area in particular does not exist right now.

With respect to ring fencing, I think you are exactly right, Senator. It is hard to have a conversation about international insolvency internationally without the term "Lehman" recurring through the conversation. This is the event that, in the case of the U.K., seared itself onto their minds in thinking about the potential for international insolvency.

The difficulties of the kind of lawyer's dream of a comprehensive international system that is completely harmonized in legal terms not being achievable has meant that we are paying more attention to trying to do things in advance which would diminish the need for, and the incentive to, ring fence. So that is why the recovery and resolution plans, the kind of living will exercise that you alluded to, is important because it allows supervisors to see what the sources of liquidity are. It can also entail the rationalization of the corporate structure of these firms. The day Lehman failed, it had 3,000 separate legally incorporated entities. They were not all there for business purposes. And if one can force earlier a business rationalization of the structure of a firm, again, you make it easier to deal with. That is why the payment system obligations are also important to try to standardize.

So a lot of these work groups that we are in right now are actually trying to get to the point where the incipient insolvency of a firm would not raise the prospect of all those assets fleeing immediately and, thus, would result in a somewhat more deliberate response.

On the debt bail-in that I mentioned, I avoided the term "contingent capital" only because that term has now embraced so many different things that it sometimes can be confusing.

The proposal to which I was referring actually has several variants, but the basic idea seems to be that there would be contractual obligations for certain kinds of debt which would act like debt on the balance sheet of the firm in normal times, but which could be converted to equity in order to avoid an insolvency situation and thus could maintain the firm as a going concern.

There are, as I say, several variants which all raise the question of, well, what would the trigger be, what would the amounts be. There are a lot of technical issues that have not been worked out, but I think the concept is one that is appealing enough because of its aim to internalize the potential cost of insolvency that we want to continue working on it even though at this juncture there is not a proposal which specifies the details in a way that we think answers all the questions.

Senator WARNER. Let me make one comment, and I want to get to one question for Commissioner Casey. One is, and I agree with Senator Corker that a lot of this bill was turning over to the regulators to try to figure things out, but they are going to be tough. I mean, if you want to prevent the use of resolution, and only as a last resort, and we want a preferred bankruptcy regime, making sure that the living wills and/or funeral plans are really closely examined, particularly as regards to the international implications,

will be one of the ways that you would prevent, I would think, resolution having to be used. A comment.

Second, I think, whether it is your term debt bail-in or contingent capital, getting that trigger right so it doesn't become a self-fulfilling prophecy that that action means the firm is going down, but if it is some kind of cascading effect rather than a waterfall, in figuring out that trigger early enough on that it is a warning shot but not a death warrant is, sitting up here, the policy goal.

I want to, and again, I know my time is about up, but Commissioner Casey, one of the things that I have been still very concerned about are the events of May 6 when we saw the precipitous drop in the markets and we, to my knowledge, at least, still don't know how much of that was caused by computer error, lack of trip wires, or within this world of high-frequency trading firms using some of these tools to potentially manipulate the market. It seems to me as we move, particularly in your area, to a much more global marketplace of these exchanges, this is an area that desperately needs not just the United States sorting it through, but sorting it through in an international framework, and I wonder if you could, recognizing that we still don't have all the answers to May 6, how we kind of sort through to get an answer, put appropriate trip wires in place. I still have grave concerns about the investments around high-frequency trading, that it is not just all about liquidity, that there are attempts to gain market advantage, how you are looking at that in the international context.

Ms. CASEY. Well, thank you, Senator Warner. As you note with respect to the events of May 6, we don't have particular forensic answers with respect to exactly what happened, but based on the preliminary efforts of the joint SEC–CFTC Advisory Committee, which has been empaneled to actually give consideration to exactly what happened and then report back to the SEC, potentially with recommendations on additional changes that might need to be undertaken, that we do understand that is a confluence of events and we are trying to sort through them to fully appreciate the dynamics of how those events affected that day.

I would say that, with respect—and, of course, we have taken several measures in the near term to address the potential recurrence of such an event. With respect to the international dimension, as you note, there is no question that that is also informing our consideration of these issues. And I would tell you also that we have a great deal of collaboration and consideration with our foreign counterparts on similar concern, because they obviously took note of what happened here and were significantly interested in appreciating what happened and what the implications might be on their markets.

With respect to the role of high-frequency trading, as well, I would note that that also has been a topic of discussion and consideration by the Joint Committee, and I would say more generally the Commission is undertaking a broader review of the role that high-frequency trading plays in our market given the significant volume that it accounts for in terms of trading. And so that more comprehensively, we are giving consideration to and necessarily inform what additional changes, if any, are appropriate in the coming years.

But I would say that the international component is not lost and that it is absolutely well understood, again, the global nature of how our markets operate and the fact that you can have contagion throughout the markets when you have an event like this.

Chairman BAYH. Thank you, Senator Warner.

Let us start our second round here. Mr. Tarullo, I would like to start with you. In your testimony, you note that it is unlikely that our counterparts abroad will follow a universal banking model, or that follow a universal banking model will adopt the kind of restrictions included in the Volcker Rule. To what degree or extent do you anticipate this will leave our financial institutions at a competitive disadvantage, if that turns out to be the case?

Mr. TARULLO. Senator, there are a couple of different questions there. To what degree might some of our regulated financial institutions have some limits on how they can compete in some areas? I think there is little doubt but that that is going to be the case, and I think that, indeed, was contemplated and intended by the Congress, that the protection of insured depository institutions was of sufficient importance and the need to insulate taxpayer funds from having to back up trading losses was a fundamental policy decision that was made.

As I was alluding to earlier, I think that the U.S. financial system has historically moved things around. We developed public capital markets much more quickly and comprehensively than other countries precisely because we didn't allow banks to do a number of things that banks in other countries could do.

So I think it is difficult to say in advance whether the outcome of all of this will be more expertise, development of new approaches, development of new markets within the United States, or whether it will be a case in which some of our large institutions say, they can't compete with what some of the universal banks are doing.

Based on history, I don't think there is any particular reason to believe that they are going to be at a competitive disadvantage since, if you do look at history, the most important characteristic of a financial institution is how safe is it, how sound is it, and do investors and counterparties believe that it is safe and sound. The kind of effort that you have made with this bill, I think, indicates to markets that there won't be public bailouts forthcoming and thus institutions are going to have to stand on their own, and if they have to stand on their own, then they need to operate in a safe and sound fashion, and if they do, they will have advantages in the markets.

Chairman BAYH. Thank you, Mr. Tarullo.

A somewhat similar question for you, Ms. Casey. If our global counterparts adopt significantly different standards for how we treat the end users of derivatives, what will the consequence of that be for our financial markets?

Ms. CASEY. I think that it could have significant implications with respect to the competitiveness of our firms, potentially. I think with that in mind, though, I would note that in the OTC derivatives space, a tremendous amount of cooperation and coordination has been undertaken with respect to how we give consideration to the framework that we hope that most jurisdictions will follow.

I do know that this is, again, with respect to our engagement with Europe, in particular, these issues are currently being contemplated and so our engagement with them as we take the legislative requirements forward through our implementation of the rules, it will be critical to understand how that is going to marry up with what Europe does, as well.

Chairman BAYH. Even if you get a fair amount of convergence? I mean, as long as there is just one significant outlier out there, won't this kind of activity just offload there?

Ms. CASEY. I think that with respect to, again, the significant disadvantages that may come with the cost of financing, depending on how the definition might be interpreted, I think that we just have to be sensitive to what the playing field is with respect to our foreign counterparts and various other jurisdictions. But I would just note that, again, in the OTC space with respect to implementing the legislation, which we will do, it will be critically important that we also closely monitor how other jurisdictions take their rules forward.

Chairman BAYH. Good. One last question for you, Mr. Tarullo, in the area of capital standard setting and particularly the, I think, what is referred as the countercyclical capital standard setting, where as I understand it we would look for a growing gap between the growth of private credit and the growth of GDP to perhaps indicate there was some excessive growth in credit and that then require firms to begin building up their capital during the good times to help get them through the difficult times. It makes sense in theory, but as we discovered here even with our own Fed, as bright and well intended as it was, it is kind of hard to start taking away the punch bowl when the party is in full swing, although in theory that is what needs to be done.

And so my question is, I noted that there was going to be—it was going to be left up to individual nations to decide when this was going to be triggered and implemented. Isn't that a possible significant practical loophole in what is theoretically a pretty sound approach?

Mr. TARULLO. That is a proposal that we have some questions about, the countercyclical buffer. I think we are enthusiastic about the so-called "fixed buffer," which would just be a specific amount of capital that would need to be held, but that falling below that amount would not occasion the same consequences that falling below minimum capital levels would.

The countercyclical buffer, as you suggest, Senator, is one that implicates the issue of variable credit and GDP growth in different countries. So you either have to have a one-size, global-size-fits-all, which has obvious difficulties, or you need to calibrate it to particular countries. And if you calibrate it to particular countries, then you either have to have a fixed calibration at the outset, which is just like a rule, or you have to give discretion.

The problem with a fixed calibration is that the measure you noted that is in the proposal of credit growth to GDP would not have done such a good job at seeing the early stages of the subprime and housing problems. So it doesn't look to us like a particularly efficacious metric.

Whether there are other metrics that would be possible, we are certainly open to them. But this is one of those very good ideas that is conceptually very appealing but whose practical implementation—a little bit like contingent capital that Senator Warner was referring to—has a lot of technical challenges.

Chairman BAYH. The devil is always in the practical details. Thank you, Mr. Tarullo.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. Again, thank you all for being here.

I believe that each of you and the people you work with are going to do the best you can to make sure that we end up internationally in the best place that we should be. I believe that.

I am slightly skeptical about our ability to do that. I watch with interest as the currency issue that is of great concern here in our country with China. I watch the Administration try to deal with Europe on their view of what ought to happen with issues regarding stimulus and they say, absolutely not. We are doing just the opposite. And I would say, I wished we were following their lead in that regard.

But, Madam Secretary, as it relates to that issue, because this would be under your purview, the fact that Europe is taking a markedly different position as it relates to austerity and balancing budgets and those kinds of things than we are, what kind of discussions is that generating inside Treasury today?

Ms. BRAINARD. So I think that in Toronto, there was actually a lot of agreement around the table about steering a path forward, given where we are in the recovery, still at a rather nascent stage, still needing to provide public support for the hand-off to the private sector. There was broad agreement around the table that there is still a need to support the economy, to support recovery, to follow through on the stimulus plans that all members of the G-20 have undertaken.

At the same time that we all, and this has been very important to President Obama, articulate a medium-term path of fiscal consolidation that will put public finances on a very sound footing, in fact, those two things are very carefully intertwined, that the more confidence there is in the longer term fiscal consolidation path, the more able we are to support recovery now. The better we support recovery now, the better our growth prospects will be contributing in turn to fiscal soundness.

So there was a lot of agreement around the table, and in fact, the U.S. plans going forward are fiscal consolidation plans are among the steepest and most rapid of the G-20 economies, in fact, of the G-7 economies. Germany is actually bringing its stimulus down at a slightly slower pace than the U.S. is starting in 2011. So we, I think, got to a good place with our partners in the G-20 in terms of working together to make sure that this recovery really gets onto sounder footing, and then working together to make sure that we move forward to put our fiscal finances here in the U.S. more broadly on a sound footing while ensuring that there is a broader plan for rebalancing of growth so that other countries stimulate the global economy through their demand to a greater extent

than we saw in previous years and we grow through exports and through our competitiveness.

Senator CORKER. Thank you.

Commissioner, you know, we typically have—you were here for a long time and you know, candidly, more about the inner workings here than I do, I am sure. We typically have a hearing like this—my friend Evan Bayh is leaving us soon, which I regret, but we will have a hearing and then——

Chairman BAYH. Absence always makes the heart grow fonder. [Laughter.]

Senator CORKER. We have a hearing and then there is really, you know, it kind of goes away. We don't focus on it. As a matter of fact, I would say that not only did the regulators miss a lot of things during this last crisis, candidly, we didn't do our work in this body properly as it relates to oversight.

So as it relates to the things that each of you are working on with G-20, with Basel, what is it we should do here to ensure that the work is being carried out in a way that we can say grace over and that we keep ourselves fully informed?

Ms. CASEY. Well, as you note, these hearings serve an important function of giving us an opportunity to bring you up to date on some of the work that we are engaged in and the progress that is being made in some of the key areas that we are working on.

I think, also, another mechanism that works, and again is completely a function of the interest of the committee or particular members, are informal briefings, which I think do occur quite regularly, and I would anticipate, given the sheer amount of implementation rulemakings the Commission would be engaged in that we would also be spending a tremendous amount of time being responsive to the Congress in understanding how those rules are going forward. So I do think informal mechanisms, in terms of briefings at the staff level, can also be very effective in monitoring what we do.

And I think, also, that will be complemented by the fact that with respect to the rules that we are going to be required to adopt under the law, it is going to be a very transparent process with respect to putting forward our rules in a notice and comment period and, again, being very clear about the direction that the Commission is going in implementing them.

With respect to, again, the international components, I think to the degree that we can help the Subcommittee understand how that is consistent or inconsistent with other efforts that are being taken internationally, we can put that in a context as we proceed in implementing the new law.

Senator CORKER. Thank you.

Mr. TARULLO. Senator?

Senator CORKER. Yes, sir?

Mr. TARULLO. Can I just add one thing on that point, because I know exactly what you mean about the phenomenon of a hearing and then you wonder sometimes what happens thereafter. But I can think of a couple of important instances in which this Subcommittee's oversight actually had an impact.

In 2005 and then again in 2006, Senators Sarbanes and Shelby, who reversed chair and ranking roles during that period but were

together on the issue, held oversight hearings on capital standards and on Basel II. And although those hearings came at the end of that process, when the basic framework had been agreed on, my own observation as someone who testified at both of those hearings as an academic and then observed from outside was that those hearings and the fact that Senators Sarbanes and Shelby were clearly together in their concerns had an impact on the implementation of Basel II here in the United States, specifically in some of the safeguards that were included in the regulations.

So although sometimes it may not be so obvious sitting on that side of the dais, I think there is enormous utility to a Congressional committee focusing on a particular ongoing issue and just forcing us to come up and explain why we have made the decisions that we have and where the implementation is.

Senator CORKER. Thank you for that.

Let me ask you, and I will stop with this last question, I think, some mention has been made in this hearing and I know a big part of the debate as we passed, as this legislation was passed, dealt with resolution. I think Senator Warner made a very good contribution to that. I know a lot of people worked on it. From my perspective, judicial checks that should have been in place didn't end up making it in place and I think Senator Warner would agree with that.

But the big, glaring, huge issue that wasn't dealt with was really causing the Bankruptcy Code to work more fully for highly complex bank holding companies, and there was just a tremendous resistance toward that occurring. It also was in a different committee of jurisdiction, and around here, it is unfortunate for the American people. You know, it is the same reason the SEC and the CFTC exist. It is shame. They shouldn't both exist. We all know that. There is not a person in this room that believes they should both exist, and yet they exist because of committee jurisdictions, and that is a flaw that has to do with all of us as politicians, if you will. And so I will throw that back on us.

But back to the issue of bankruptcy, I don't think—I think what we have done with the Dodd-Frank bill is we have added a tool to the tool kit that could be abused. There could be some crony capitalism. I don't think there are enough checks. I mean, I look at Treasury, and Madam Secretary, I mean, Treasury and the Feds come out a winner, obviously, but the Treasury has got tremendous powers now, powers that I think all of us, I mean, the country has resisted giving Treasury. It now has those, and I am sure with people like you and others, it will be handled responsibly.

But a lot of things occurred in this bill except really dealing with this bankruptcy issue, and as we met with sophisticated folks who deal in international problems like this, it just became more and more glaring as an omission. So I would just ask, what is it we needed? I don't think—and we have added a tool to the tool kit. I don't think we by any means have come close to dealing with the too big to fail issue because of the international relationships that exist. What is it, and that is hard work. That is maybe more difficult than much of what you all will be working on over the next year and a half. What is it, though, we need to begin doing to try to create a regiment that will work internationally?

Mr. TARULLO. As I said earlier, Senator, and I think is implicit in your question, we are not any time in the foreseeable future going to converge around a single legal mechanism which is operative and effective across jurisdictions. We are not going to have the equivalent of an international treaty that says everybody is going to now change their bankruptcy law to conform in precisely these particulars and here are the debtor and creditor rights.

So in that world, I think what we have to try to do is to ease in advance the kinds of concerns that arise, as Senator Warner was saying earlier, when people see that there may be a problem and thus they have the instinct to ring fence.

So I actually do think that the so-called "living wills" have a lot of efficacy as supervisory tools domestically, just forcing firms to plan and think well about their ongoing operations, including liquidity, but also internationally, because they force us all, meaning U.S. banking agencies and our counterparts abroad, to think through what the impact of the highly stressed and potentially insolvent status of an internationally active institution would be, and then in a very practical way, allow us to start trying to tackle those problems.

That is where those four work streams that I alluded to earlier came from on things like payment systems. It is people actually thinking practically, what would be the impact of a high degree of stress on this kind of firm. Ah, here is where it is. Let us see if we can relieve some of that stress.

So I think if we continue to do that, and if other countries begin to implement resolution mechanisms that have some of the same features as we do, then over time we may be able to converge around a set of practices which are sufficiently common that we could handle an international insolvency.

But I would not disagree with you for a moment. I think we have a good ways to go before we get there.

Senator CORKER. So if I hear you, though, you would advocate that other countries adopt a similar resolution mechanism, not necessarily that we all develop more sophisticated Bankruptcy Code to work for highly complex entities like that.

Mr. TARULLO. I think the domestic choice that a country makes as to whether it is going to have a special part of its bankruptcy law devoted to financial institutions or whether it is going to have something that it calls a resolution mechanism is less important than the resolution mechanism or the special bankruptcy chapter having the kinds of provisions that are being elaborated right now in the Basel Committee work, or FSB work, to say these are the kinds of things that we need to be able to do. These are the kinds of decisions that we need to be able to make, things like bridge banks, in order to contemplate a successful resolution.

And the last thing I would say, Senator, is the FDIC is going to work with the law that has been passed and the resolution mechanism that they have and try to implement that in the best way possible. One of the elements of that best way possible is to try to get some compatibility, not harmonization necessarily but compatibility with what other major financial centers are doing.

Senator CORKER. Can I ask another question or do you need to go? I am going to just ask one more. As you look at the Dodd-Frank

bill and you are out dealing with your international counterparts, is there anything that each of you wish was in the bill that is not?

[Laughter.]

Chairman BAYH. We should have given the witnesses—we should have put some sodium pentothal in the water, Bob, before asking that question.

Senator CORKER. And forget even the international component, just from where you sit. I personally thought that, looking at any bill this size, there are going to be some good things in it, and there are some good things in this bill. I also thought, on the other hand, there was a lot of overreach in areas that have nothing whatsoever to do with financial regulation and the country will figure that out over time. But it also was a tremendous missed opportunity to address some of the core issues that, as a country, we needed to address.

That was my own view, and it obviously is on public record now. I felt that, overall, the bill was a net negative because of that, OK. And I guess it was so close to it, I just knew what it could have been as a bill and it wasn't and that was disappointing. But over time, we are going to have some opportunities to correct unintended consequences and we will be dealing with this and I look forward to dealing with people on both sides of the aisle to do that.

But from your perspective, what are some of the things that you wish were in the bill but are not?

Mr. TARULLO. Senator, by and large, my sense is that, as you and the Chairman have both indicated, there is a lot of open textured language and authority in the bill in the Systemic Risk Council and in the constituent agencies of it. So if we think that there is something lacking, there is often an avenue for trying to develop the necessary authority.

I think one problem, and I am not saying the bill doesn't have the ability to address this, but the way I have looked at the financial crisis and our financial system is that we have had three kinds of problems. We have had domino-effect type problems, counterparty problems, where the failure of one firm could induce the failure of another.

We have correlation problems, whereby a big negative effect on assets affects everybody's balance sheet and leads to distress sales that drive down asset prices further and get the negative spiral going. And we have had contagion problems, where the problems in one institution, because of information asymmetries, lead to runs on other institutions.

I think that there is an enormous amount in the bill that addresses the first problem of domino or counterparty effects, and it is going to be up to us to elaborate capital, liquidity, and other kinds of regulations that will successfully address the second and third issues.

And I would also say that we have two kinds of phenomena out there. We have the too big to fail phenomena, which we just needed to address and we need to continue to address. But we also have what I think of as the parallel strategies problem. So let us hypothesize. You have 30 or 35 midsize financial institutions who are all engaged in the same kind of activity, all relying on the same sources for their liquidity, and a problem arises in that market.

You are going to have a systemic issue just as surely as if you had a challenge to one of the two or three largest firms in the country. And I don't think we have really come to grips with that kind of issue yet.

We are not extending capital and liquidity requirements to all big financial firms, only to those that own banks and/or those that are regarded as in and of themselves systemically important. So the Council is going to have to do a good bit of monitoring to see whether activities and parallel strategies migrate into the unregulated sector because I think that is at least a possibility going forward.

Ms. CASEY. Just briefly, you touched on one of the primary reforms I had hoped for, which was sort of structural, which would have been a merger of the CFTC and the SEC, which, again, I think would have resulted in enhanced efficiencies, I mean, I think despite our best efforts to work very collaboratively together, which we are doing and will do. But there is a lot in the bill for the SEC and our mission, so I think I guess that is the one I would highlight that would have been more fundamental to reforming our oversight of the markets.

Ms. BRAINARD. Senator, I think Members of this Committee just should feel enormously proud of this legislation. I think that it will put in place protections that address every component that contributed to the financial crisis, and I think it does what good legislation does. It creates a full and very clear framework of high quality standards for U.S. financial markets, but leaves a lot of work to regulators, supervisors, in terms of implementation going forward. It ends too big to fail. It will end taxpayer-funded bailouts. It will provide the greatest set of consumer protections that this Nation has seen. It gives regulators and supervisors the tools they need to constrain the kind of reckless risk taking that went into the crisis. And it is going to create a safer, more transparent derivatives market.

So I think if you look at this bill against the principles that have been agreed internationally in the G-20 and the Financial Stability Board, this bill hits every single one of those core priority objectives and really does set the standard internationally. And now I think we all have our work cut out for us to make sure that other financial jurisdictions come to the same standards.

You asked earlier what Members of this Committee could do. We engage a great deal, not just multilaterally but also bilaterally, especially with the Europeans, and I know Members of this Committee have engaged with European Parliamentarians, but as they work through in the critical areas of hedge funds, where we need to make sure our firms have nondiscriminatory access as they work through end user exemptions in OTC markets, I think engagement with the European Parliament is another avenue for continuing our joint efforts to bring those standards up.

Senator CORKER. Madam Secretary, I might disagree with a few of the points you just made, but I would say you are as well coached, well prepped, well talking pointed as any person that has ever come before this Subcommittee.

I wish you all well, and as you move ahead, I look forward to working with all three of you——

Chairman BAYH. Any person who is not a Supreme Court nominee? Bob, is that what you meant to say?

Senator CORKER. There you go. I thank you all for your service and certainly for coming here today. Thank you.

Chairman BAYH. Thank you, Bob.

I just have—you have been very patient. I just have a couple quick questions, and you don't need to go on at great length.

I note that estimates show that $5 trillion in bank debt may be coming due in 2012. At least that is the figure that has been supplied to me. That seems like a lot for the system to adjust in any one period of time. Does this present a possible systemic risk, Mr. Tarullo, and if so, what are we doing to prepare for that? Most of it is European, but a big slug of it is here in the United States, as well.

Mr. TARULLO. So——

Chairman BAYH. Trying to digest that much debt in the banking sector, what is that going to mean to credit availability elsewhere and that kind of thing?

Mr. TARULLO. Senator, the capital position of our large firms in the United States, I think, has been substantially enhanced over the last year as a result of the stress tests and the capital increases that we required. And I think right now, the funding capacities of those large institutions are actually quite strong. Obviously, the European situation created some stresses, but at this juncture, I don't think we have any reason to believe that our institutions will not be able to access capital markets very successfully.

Chairman BAYH. Let me ask you this. What about some of the European institutions? Obviously, our markets react here when they have adverse developments there. They have got some sovereign debt problems they are trying to work their way through and it seems to me this may be a potential problem for us. Is this the sort of thing we are collaborating with our counterparts in Europe on?

It leads me to my second question. These stress tests are coming up in a matter of days.

Mr. TARULLO. Right.

Chairman BAYH. Do you think they should be made public in their entirety, and if that is not what the Europeans decide to do, what does that tell us about their seriousness in really making some difficult decisions to get to the root causes of this problem over the longer term?

Mr. TARULLO. Well, my understanding is that the intention of the Committee of European Banking Supervisors is to post the results of the stress tests in both aggregate and individual bank form on Friday. They have a rather elaborate timing sequence that they actually laid out in a press release. I don't know, Senator, the degree of detail that will accompany those releases, but I do think that the European authorities understand the importance of transparency in conducting a successful set of stress tests.

Chairman BAYH. Good. Hopefully, they will keep ambiguity to a minimum.

Just two more quick questions, one on behalf of Chairman Dodd, who could not be with us today. My final question on my behalf to all of you is, as you know, some of the Europeans are moving for-

ward with bank assessments, taxes, whatever we want to call it. It doesn't look like at least in the immediate term we are going to be doing that in our country. This is sort of the reverse of a couple of questions you were being asked earlier. If the Europeans move forward with that tax, we don't, what is that going to do to the competitive balance of the financial institutions here and there? Does anybody want to take that on?

Ms. BRAINARD. So I think there have been a lot of conversations, as you know, within the G-20 about whether to adopt a consistent financial fee across the jurisdictions and the agreement that we reached in Toronto, I think, was a good one and it is that all of the members of the G-20 essentially agreed that taxpayers should never bear the burden of any extraordinary interventions into the financial system, that financial institutions should. And that, of course, is reflected in the Dodd-Frank legislation. And that is, I think, a basis for creating a level playing field.

And so to the extent that different jurisdictions have different burdens to compensate in terms of extraordinary Government interventions, there may be different levels of need for assessments on financial institutions, but our general conclusion from those discussions is that as long as the general principle was recognized and that those fees are imposed in a way that respects a level playing field, that different jurisdictions were going to have different needs to impose those levies at different times.

Chairman BAYH. Thank you very much, Ms. Brainard.

On behalf of Chairman Dodd, who could not be with us here today, let me ask you the following question. Governor Tarullo and Commissioner Casey stressed the importance of strong Congressional oversight. Secretary Brainard, will Treasury be responsive to this Subcommittee's request for testimony from Secretary Geithner to explain the recent International Economic and Exchange Rate Policy Report? I think we are talking about the China currency issue here. So far, Treasury has not been responsive. That is channeling Chairman Dodd.

Ms. BRAINARD. Treasury is always very responsive to this Subcommittee and will continue to be.

Chairman BAYH. Do you care to put a time line on that?

Ms. BRAINARD. I don't actually know discussions about dates, but will be very happy to get back to you or to Chairman Dodd on that request.

Chairman BAYH. Very good. Thank you.

My final observation, I hope your take-away from this when you go to the international forums in which you work with our counterparts is that you can tell them that the Congress is serious about convergence. We think that is important over time to avoiding a repetition of what we have been through, and that we are also serious about enforcement mechanisms. At the beginning, understandably, we will rely upon sort of soft enforcement, but over time, you need to have real teeth if we are going to truly take our aspirations and translate them into better financial stability reality. I think that is the point of the hearing today, and I am very grateful to each of you in your capacities for promoting that objective. It really is doing our country a great service, and I know that sometimes progress is not as fast as we would like in international forums,

but it is essential and I just want to express my appreciation for your work in that regard and also for your courtesy and your time here today.

Thank you all very much. This hearing is adjourned.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF LAEL BRAINARD

UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS,
DEPARTMENT OF THE TREASURY

JULY 20, 2010

Chairman Bayh, Ranking Member Corker, and Members of the Subcommittee, thank you for the opportunity to discuss our international financial reform agenda.

The historic passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act lays the foundations for a sounder and more resilient financial system. Thanks to the leadership of President Obama, Secretary Geithner, and Chairmen Dodd and Frank, and to the hard work of this Subcommittee, this legislation enacts the most far-reaching reforms of our financial system that this country has seen since the Great Depression.

The challenge before us now is to ensure that the world's standards are every bit as strong as America's. In the wake of the most globally synchronized financial crisis the world has ever seen, we must develop the most globally convergent financial protections the world has ever attempted. It is critical to level the playing field up—while protecting against future financial crises and promoting economic growth.

While implementation will take some time, we are determined to move quickly to provide clarity and certainty about the basic rules. We will do so with great care recognizing the complexity of the challenges, but with a sense of urgency commensurate with the critical importance of achieving international convergence and consistency.

Today, I will discuss our international regulatory reform agenda, focusing on the importance of achieving international convergence to high-quality standards that address too big to fail and extend the perimeter of regulation, and establishing a global architecture that will prevent future crises.

Setting High-Quality Standards

You have now acted with legislation to address the fundamental weaknesses in the U.S. financial system. The Dodd-Frank bill does just what good legislation should do: it creates a clear, full framework of high-quality standards for U.S. financial markets. Now that we have achieved this goal at home, why do international standards matter for U.S. households, workers, and firms?

Financial firms, markets, and transactions are more interconnected than ever before, and the breadth and depth of these linkages require us to coordinate across borders if we are to protect America's economic and financial well-being. Without internationally consistent standards, large financial firms will tend to move their activities to jurisdictions where standards are looser and expectations of Government support are stronger. This can create a race to the bottom and intensify systemic risk throughout the entire global financial system.

As the crisis demonstrated, significant market disruptions in one market can have a significant impact on other markets. Therefore, our financial reform agenda will not be complete until we achieve a level playing field with high-quality standards across the world's major financial centers covering the most globally mobile activities.

But while global convergence will be critical in areas such as capital and derivatives regulation, our international efforts in other areas may be equally well served by coordinating different approaches across nations, reflecting deeply rooted differences in national structures and institutions. In these cases, while we share common objectives globally, the mechanism that works best for other countries may not work best for the United States in seeking to advance our common objectives.

Addressing Too Big To Fail

The recent financial crisis demonstrated clearly that some financial firms are so large and interconnected that their failure could pose a threat to overall financial stability. The crisis also made clear that the existing framework for constraining the risk of large, interconnected financial firms and our Government toolkit for managing their failure were profoundly inadequate. That is why our reform efforts are tackling head on the moral hazard problem associated with firms perceived to be "too big to fail," by increasing the incentives of these firms and their shareholders, creditors, and counterparties to manage and discipline their risk-taking and by reducing the threat they pose to the system. Internationally, our efforts are focused on the largest and most consequential economies in order to reinforce our domestic reform efforts.

Constraining Risk-Taking by Major Financial Firms

In the lead-up to the recent crisis, major financial institutions around the world held too little loss-absorbing capital relative to risky assets; used excessive leverage to finance their operations; and relied too much on unstable, short-term funding. The resulting distress, failures, and Government intervention imposed steep and unacceptable costs on households, workers, and businesses that are still felt today.

The lesson is clear: more and higher quality capital must be at the core of our efforts to ensure a more resilient financial system less prone to failure.

It is equally clear that we must focus our regulation of these firms on protecting the stability of the financial system as a whole—not just the solvency of individual firms—and that the new standards on capital must be global in reach. For the past two decades, there has been broad recognition that the high mobility of bank risk-taking in response to small differences in regulatory capital requirements demands convergence of capital rules for globally active firms across major financial centers. And that is truer than ever today when considerations of safety and soundness are paramount.

That is why, in Toronto last month, the G-20 Leaders agreed on the need to increase the quality, quantity, and international consistency of banks' capital with the goal of ensuring that financial institutions hold enough common equity to withstand without Government intervention stresses of the magnitude seen in the last crisis. President Obama and other G-20 leaders set the goal of reaching a comprehensive agreement by the time of their next summit, in Seoul in November.

The Basel Committee on Banking Supervision (BCBS)—which is responsible for setting capital standards—is working hard to meet this deadline. Efforts are underway to establish common definitions of capital and risk weights and to determine the necessary amount of capital and an appropriate liquidity ratio for a more resilient system, along with specifying appropriate transition periods. The U.S. banking regulatory agencies have been key players in advancing this work in the BCBS.

Improving Market Discipline Through Enhanced Disclosures

Improving market discipline on major financial firms is an important complement to prudential supervision and regulation by governments. This in turn requires increasing the quantity and quality of information available to market participants about major financial firms.

Stress tests are one important source of information that can help to identify sources of significant risk and assess the resilience of individual financial institutions in adverse scenarios. While controversial at the time, the decision to subject large U.S. financial institutions to stress tests through the Supervisory Capital Assessment Program (SCAP) and to fully disclose the results at the aggregate and bank levels marked a turning point in global financial markets by reducing uncertainty and restoring confidence in our financial institutions. Since that time, U.S. banks have raised more than $150 billion in high-quality capital.

In the coming days, the Committee of European Banking Supervisors will release bank-by-bank stress test results for the large cross-border European banking groups as well as a number of smaller banks. While there is no one-size-fits all approach to stress testing, this European effort—with the appropriate assumptions and disclosures—could play a helpful role in dispelling uncertainty about the financial conditions of individual financial institutions in Europe and in strengthening transparency and bank balance sheets, as SCAP did in the United States.

Strengthening Shock Absorbers and Market Infrastructure To Reduce the Risk of Contagion

In the years leading up to the crisis, a parallel banking system emerged, populated by highly leveraged nonbank financial firms that relied on short-term borrowing to finance the purchase of long-term assets. This parallel banking system had none of the Government-provided shock absorbers that protect the banking system—deposit insurance, a lender of last resort, and guaranteed payment systems.

In turn, the traditional banking system had important exposures to this parallel banking system with its risks of asset bubbles, runs, and collapse. Banks provided credit to, and engaged in large amounts of over-the-counter (OTC) derivative transactions with, the major securities firms and other nonbank financial institutions. Banks also provided payment, clearing, and settlement services to the parallel banking system. In significant part because of these exposures, the collapse of the nonbank financial sector during the crisis threatened the safety and soundness of the banking system itself.

In particular, the build-up of risk in OTC derivatives markets became a major source of contagion during the crisis. To reduce risk from the web of bilateral derivatives trades between the major financial firms, U.S. financial reforms require

clearing of standardized OTC derivatives through well-regulated central counterparties; exchange trading of standardized derivatives to promote transparency, price discovery, and liquidity; and supervision and regulation of all derivatives dealers and major market participants, including conservative capital and initial margin requirements on all non-centrally cleared derivatives. Moreover, trade repositories will provide regulators with information about standardized and customized transactions so that they can assess the potential for derivatives trades to transmit shocks through the financial system.

In light of the globalization of these transactions, we are now working internationally to make sure others take comparable steps. In this regard, we are working especially closely with the EU to make certain that critical OTC derivative market infrastructure is subject to oversight in line with the standards adopted by the G-20 and FSB, and that appropriate cooperative oversight frameworks are established to address the information needs of supervisors and regulators.

Providing Better Tools To Resolve Major Financial Firms While Safeguarding the System

Another key element of our approach to constrain risk-taking and tackle moral hazard consists of making the system safe for failure. The Dodd-Frank legislation helps to achieve this objective by providing for a special resolution authority for the Federal Government to use in times of distress when the failure of a major financial firm could pose a threat to the broader system. Modeled on the FDIC process, this resolution authority closes a gap that severely limited the Federal Government's options during the crisis.

We have worked within the G-20 to secure a commitment to robust resolution authority consistent with the recommendations of the BCBS, which has identified improvement of national resolution systems, better cross-border crisis management mechanisms, and convergence of national laws as key priorities.

In addition, G-20 Leaders have agreed that major financial firms should be required to prepare and regularly update credible plans for their rapid resolution in the event of severe financial distress—so that governments and stakeholders are better prepared to accomplish an orderly unwinding of the firm in the event that crisis strikes. Regulators in the United States and the other G-20 countries are working through the FSB and the BCBS to implement this requirement in an internationally coordinated fashion.

Finally, it remains vital that the financial sector, not taxpayers, bear the burden of risks imposed on the system as a whole. In Toronto, G-20 Leaders agreed on the principles that financial institutions—not taxpayers—should bear the burden of extraordinary support provided in crisis to the financial sector, that any fees be based on risk imposed on the system, and that such fees be undertaken in a manner that allows for broad international adoption. This is a significant achievement.

Tying Compensation to Long-Term Value Creation

We recognize that excessive compensation in the financial sector both reflected and encouraged excessive risk-taking. Our response has been decisive. Last year, G-20 Leaders endorsed the Financial Stability Board's (FSB's) Principles for Sound Compensation Practices, which aim to align compensation with long-term value creation, deter excessive risk-taking, and create a level international playing field. The FSB has since reviewed implementation of these important principles, found that substantial progress had been made but that more work remains to be done, and indicated that it will follow up with a further review next year.

Our work domestically supports these principles. The Dodd-Frank legislation gives shareholders a say in the compensation of senior executives at the companies they own, and it requires independence of the compensation committees of corporate boards. The Federal Reserve has conducted a review of incentive compensation practices at large banks and, along with other U.S. banking regulators, issued supervisory guidance on sound incentive compensation policies. These efforts are in addition to the SEC's recent enhancement to rules on compensation disclosure and Treasury's appointment of a Special Master to ensure that the pay packages of executives at firms that received exceptional Government assistance promote long-term value creation and avoid incentives for excessive risk.

Extending the Perimeter of Regulation

Of course, effective restraint of risk-taking in the financial system depends in the first instance on Government having the authority to subject firms that present outsized risks to the stability of our financial system to a common framework of supervision and regulation. All firms, products, and institutions that could pose significant risks to the system should be regulated—thereby extending the perimeter of regulation.

A well-functioning financial sector also depends on supervision addressing risks to the stability of the system as a whole, not just the risks arising from individual institutions. Prudential supervision has historically focused on the safety and soundness of individual firms, an approach that can fail to detect emerging threats to financial stability that may cut across many institutions. The new Financial Stability Oversight Council of financial regulators will help fill gaps and supplement existing approaches to supervision with assessments of the potential impact of the activities and risk exposures of major firms across financial institutions, critical markets, and the broader financial system.

While supervisory and regulatory institutions vary across jurisdictions, there is broad recognition within the G-20 of the need for supervision to be consolidated and to address risks to the system. European policymakers are now creating a macro-prudential supervisory function—the European Systemic Risk Board—to assess systemic risks and vulnerability, as well as issue risk warnings.

We are also working with our partners in the G-20 to address other areas that require broader international consistency, including credit rating agencies and hedge funds. The Securities and Exchange Commission is leading work with our international partners in the G-20 and the Financial Stability Board to develop stronger oversight of the credit rating agencies in order to eliminate conflicts of interest, reduce reliance on ratings, and improve disclosure.

The perimeter must also be extended to ensure stronger oversight of hedge funds—an area where international consistency is at a premium. We have worked to ensure international agreement on the same approach that the United States has adopted: requiring all advisers to hedge funds (above a threshold) to register and report appropriate information so that regulators can assess whether any fund poses a threat to overall financial stability by virtue of its size, leverage, or interconnectedness and to impose heightened supervisory and prudential standards on entities that do.

As the EU works to establish similar requirements under their Alternative Investment Fund Managers Directive, we are working to ensure that the EU provides U.S. managers and funds with nondiscriminatory access to the EU market on par with that of EU-based managers—in the same way that U.S. rules treat all advisors and funds operating in the U.S. equally regardless of their origin.

Strengthening the International Architecture for Financial Cooperation

Building a resilient financial system at home will require strong financial reforms around the world. For that reason, we have been working to strengthen and extend the global architecture for financial cooperation—fostering high-level political commitment to implement key reforms where global consistency and cooperation is most critical; extending international regulatory, supervisory, and standard-setting cooperation to include key emerging markets; and working intensively through strengthened bilateral channels.

Building Stronger Global Cooperation

Owing in large part to President Obama's leadership, the G-20 has become the premier forum for global economic cooperation. By working with our partners in the G-20, which represents 85 percent of global economic output, we have pursued global economic stability and growth, and built high-level political commitment to the core tenets of our financial reform and repair agenda.

To help coordinate the formulation and execution of strong and consistent rules across key financial jurisdictions, last spring, G-20 Leaders agreed to reestablish the FSB with a strengthened mandate and expanded membership. The FSB is a critical part of our collective efforts to identify vulnerabilities in the global financial system, promote financial stability, and encourage coordinated and comprehensive regulatory standards through peer review. The FSB brings together representatives from 25 major jurisdictions, including all major global financial centers, along with international regulatory, supervisory, and standard-setting bodies. The FSB is working closely with the BCBS to coordinate international efforts to strengthen bank capital and liquidity standards, and to devise policy recommendations for winding down large, interconnected financial institutions. Currently, the FSB and BCBS are preparing recommendations on this set of issues for the next G-20 Leaders Summit in November.

To promote effective and timely implementation of national regulation and supervision in activities where international consistency is at a premium, and to provide safeguards against jurisdictions with lax standards, we are also working to build effective systems of surveillance and peer review.

The International Monetary Fund (IMF) is central to this effort, and it has expanded its multilateral and bilateral surveillance analysis to identify emerging mac-

roeconomic and financial risks, and to recommend actions needed to address those risks. It also has contributed work on financial risk fees, alternative approaches to cross-border resolution, and supervisory effectiveness. The IMF's Financial Sector Assessment Program (FSAP) is a voluntary, comprehensive, and in-depth analysis of a country's financial sector, and has been strengthened to reflect lessons learned from the crisis, including regular coverage of systemically important countries and more candid and transparent assessments.

Peer reviews will be increasingly integral to collective efforts to raise international standards in the areas of prudential supervision, antimoney laundering and counterterrorism financing, and tax information exchange. The three responsible international bodies—respectively, the Financial Stability Board, the Financial Action Task Force, and the Global Forum on Transparency and Exchange of Information for Tax Purposes—have each launched a rigorous process for peer review of compliance in their relative areas.

Building Stronger Bilateral Cooperation

Finally, we are also building stronger bilateral mechanisms for regulatory and supervisory cooperation and coordination with major and emerging financial jurisdictions. We have recently elevated our Financial Market Regulatory Dialogue with the EU to ensure greater consistency and nondiscriminatory approaches as rules are being rewritten on both sides of the Atlantic on key areas such as derivatives and hedge funds. Treasury, in cooperation with U.S. regulators and supervisors, is also strengthening financial policy dialogues with China, Japan, India, Mexico, Canada, and Australia, recognizing that cross-border coordination is more important than ever to ensure the integrity and resilience of our financial system.

Looking Ahead

In conclusion, as we prepare for historic financial regulatory reform to be enacted into law in the United States, we must work to level up the playing field across all major and emerging financial centers internationally. By pursuing and implementing high-quality standards, addressing the moral hazard associated with too big to fail, extending the perimeter of regulation, and establishing a stronger international architecture to prevent future crises, we will enhance the soundness and resilience of our own financial system to better serve America's households, workers, entrepreneurs, and corporations for generations to come.

We appreciate the leadership of this Committee on these key challenges, and we look forward to working with Congress as we engage with our international partners, challenging them to match the strength and sweep of American reforms.

Thank you.

PREPARED STATEMENT OF KATHLEEN L. CASEY

COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

JULY 20, 2010

Chairman Bayh, Ranking Member Corker, and distinguished Members of the Subcommittee, thank you for inviting me to testify about international cooperation to modernize financial regulation.

International Cooperation: From Policy to Principle to Standard

I am pleased to have the opportunity to testify before you on behalf of the Securities and Exchange Commission on this very important topic. As I stated in my testimony before the Subcommittee last September, international cooperation is critical for the effectiveness of financial regulatory reform.[1] At that time, I described the existing mechanisms for international cooperation in securities market regulation and key securities regulatory reform issues being pursued through such mechanisms. The various mechanisms I described in September all remain active and relevant today. I therefore would like to use this opportunity to comment on some of the entities and venues in which we cooperate, and update the Subcommittee on progress in certain key areas.

At the same time that Congress has been considering the scope and specifics of regulatory reform in the United States, discussions have been taking place in the G-20, the Financial Stability Board (FSB), International Organization of Securities Commissions (IOSCO), and other forums as to the nature of regulatory reforms that might be desirable in the wake of the crisis and how best to coordinate such regulatory responses internationally. Effective international coordination begins with a

[1] *See, http://www.sec.gov/news/testimony/2009/ts093009klc.htm.*

coherent articulation of and commitment to policies designed to address the weaknesses identified in the crisis. Those policies, in turn, must be reflected in sound principles developed to guide national regulatory authorities' regulation, such that national authorities can move forward in a coordinated fashion to consider and implement those principles in their own standards and regulations.

Articulating International Policy

The G-20 has proven helpful in forging a broad consensus about what major issues should be addressed by the individual G-20 members in seeking to avoid and to mitigate at least some of the risks the global financial system may continue to face.

In addressing such broadly identified risks, not all jurisdictions will follow the same or even similar approaches. While the G-20 is an excellent vehicle for discussion of the highest-level policy objectives for financial regulation, regulatory objectives are just that—objectives. Different jurisdictions are likely to use different approaches in pursuit of those objectives, depending on their own legal and market structures. In this respect, I would note that the relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act are broadly consistent with the international principles articulated in the key areas of hedge funds, OTC derivatives and credit rating agencies, and provide the Commission with the requisite authorities to craft regulations consistent with these principles.

In addition, because not all jurisdictions are members of the G-20, and even in those jurisdictions that are, not all important actors are represented—legislatures, for example—national deviations from the G-20 consensus are possible. On issues relating to regulatory arbitrage or market competitiveness, it is unlikely, however, that a significant divergence from the G-20 consensus would go unnoticed.

At the G-20 Summit in Toronto, the Leaders pledged to act together to achieve the commitments to reform the financial sector made at the Washington, London, and Pittsburgh Summits. This reform agenda rests on four pillars, consisting of a strong regulatory framework, effective supervision, resolution of financial institutions in crisis and addressing systemic institutions, and transparent international assessment and peer review. The G-20 has tasked the FSB and other organizations with certain responsibilities in these areas, supported their ongoing work, and set forth timelines for completion of some of this work.

Currently, I represent the Commission in the FSB alongside the other U.S. Government participants, including the Federal Reserve Board and the Department of the Treasury. Although the SEC is a independent Federal agency, the Commission places a high priority on coordinating the U.S. position with its fellow agencies and presenting a strong and unified position in policy discussions at the FSB level. This has been highly effective and is accomplished through extensive and informal communication between the staffs of our agencies as well as the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, and the Federal Reserve Bank of New York.

The Commission continues to support the efforts of the FSB, which includes officials from across the spectrum of financial regulation. It is useful as a discussion forum to review broad trends affecting the financial systems. Through FSB discussions, some gaps in regulation can be more readily identified and remedial action prioritized. The G-20's focus on these results also is helpful in ensuring that the pace of reform is maintained and that a clear and coherent international framework emerges.

While the FSB is useful in discussing and coordinating these efforts, the real work associated with building international regulatory-level consensus and coordination rests with international technical bodies such as IOSCO. The members of these organizations have both the expertise and regulatory authority to establish a coordinated approach to common regulatory problems. For these reasons, we cannot underestimate the importance of efforts at the level of international bodies like IOSCO, where policies, including many of those agreed to by the G-20 and the FSB, can be forged into principles to guide securities regulation.

IOSCO

As a securities regulator, the SEC has long been active in IOSCO as member of the Technical Committee and Executive Committee. As mentioned, I recently completed a 2-year term begun by former SEC Chairman Chris Cox as Chair of the Technical Committee. During this period, IOSCO has taken important steps in advancing approaches to regulation in the areas of credit rating agencies (CRAs), hedge funds, over-the-counter derivatives, securitization and short selling. IOSCO recently agreed to reorganize its internal structure as part of an ongoing strategic review, as well as to strengthen the organization's role in forging an international

consensus on issues where the potential for regulatory arbitrage or conflicts are real concerns.[2]

IOSCO is the leading forum for securities regulators to discuss regulatory issues and concerns and to move these issues from broader agreement on policy to an articulation of particular principles that should guide regulation across global capital markets. The crisis has highlighted the need for enhanced cooperation in international regulation, and IOSCO has continued to focus on raising standards for international cooperation and coordination among securities regulators. This past year's focus on cooperation relates to enforcement as well as in supervisory oversight of market participants whose operations cross borders in the globalized market place.

Principles of Securities Regulation

The IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles) have, since their adoption by the organization in 1998, served as the key international benchmark for the regulation of securities markets. They are recognized by the international community as one of "Twelve Key Standards" for a sound financial system.[3]

In the wake of the recent financial crisis, IOSCO's Executive Committee charged its Implementation Task Force to revise the IOSCO Principles to take into account the emerging consensus regarding regulatory concerns raised by the recent crisis. At the annual meeting last month in Montreal, the Presidents' Committee approved revised IOSCO Principles, which include eight new principles as well as a number of revisions to existing principles.

The new principles address concerns regarding systemic risk in markets, recognizing the vital importance of this concept, and emphasize the need to review the perimeter of regulation to address other market practices highlighted during the global financial crisis.

Enforcement Cooperation

In May 2002, IOSCO developed the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU), a nonbinding multilateral enforcement information-sharing and cooperation arrangement that describes the terms under which any signatory can request information or cooperation from any other signatory as part of an investigation of violations of securities laws or regulations in the requestor's jurisdiction. The MMoU serves as an international benchmark for securities regulators interested in acquiring the powers necessary to cooperate fully in the fight against securities fraud and financial crime. The MMoU has also greatly expanded the number of securities regulators who have the ability to gather information and share information with the SEC for enforcement investigations and proceedings.

IOSCO completed a milestone this past January when 96 percent of the eligible membership of 115 securities regulatory authorities met the requirements needed to become signatories to the MMoU, or have made the necessary commitment to seeking national legislative changes to allow them to do so in the near future. This represents a virtually complete commitment on the part of the international regulatory community to meet the minimum standards expected of regulators with respect to cooperation in the enforcement of securities laws. In order to pursue full implementation of the IOSCO MMoU, the IOSCO President's Committee passed a new resolution in June of this year requiring all IOSCO members with primary responsibility for securities regulation in their jurisdictions to become full (Appendix A) signatories by January 1, 2013.

Supervisory Cooperation

Recognizing the increasing need to collaborate in the oversight of firms and markets that are increasingly global, the Technical Committee, in June 2009, established a new Task Force on Supervisory Cooperation. This Task Force, led by the SEC and the French Autorité des marchés financiers, was tasked to develop prin-

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[2] During its 35th Annual Conference, held in June this year, IOSCO reformulated its strategic mission and goals for the next 5 years, in order to take into account IOSCO's increased role in: maintaining and improving the international regulatory framework for securities markets by setting international standards; identifying and addressing systemic risks; and advancing implementation of the IOSCO Principles

[3] The objective of the IOSCO Principles is to encourage jurisdictions to improve the quality of their securities regulation. They are used not just by developing markets interested in creating a regulatory structure for an emerging financial market, but also by the World Bank, the International Monetary Fund, and other international financial institutions in conducting their financial sector assessment programs and similar regulatory assessment exercises.

ciples on cooperation in the supervision of markets and market participants whose operations cross international borders. This effort is particularly relevant to IOSCO's ongoing work related to broker-dealers and exchanges as well as hedge funds, credit ratings agencies and other elements of the securities markets infrastructure. In May 2010, IOSCO published *Principles Regarding Cross-Border Supervisory Cooperation,* which included a report and sample Supervisory Memorandum of Understanding to assist securities regulators in building and maintaining cross-border cooperative relationships with one another.

Hedge Funds

In June 2009, IOSCO's Technical Committee published a report, "Hedge Funds Oversight," which sets out six high-level principles for regulation of the hedge fund sector.[4] A task force under the direction of the Technical Committee has since expanded its efforts to provide a coordinated basis for hedge fund oversight by developing a common template to help regulators identify the types of information that could be gathered to assess possible systemic risk arising from the hedge fund sector. This template contains a list of broad proposed categories of information (with examples of potential data points) that regulators could collect for general supervisory purposes and potentially to help in the assessment of systemic risk (including, for example, product exposure and asset class concentration, geographic exposure, liquidity information, extent of borrowing, credit counterparty exposure, risk issues).

Short Selling

In the last few years, many jurisdictions, including the U.S. and EU member states, have been considering the implementation of regulatory controls to govern the short selling practices of market participants.[5] The SEC participates in the IOSCO Short Selling Task Force formed during the depths of the financial crisis to effect coordination among member states with respect to short selling regulations. Pursuant to its mandate, the task force developed four principles for the effective regulation of short selling[6] and aims to identify opportunities for greater conver-

[4] The Final Report is available at: *http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf.*

[5] For example, the SEC has adopted several rules and regulations relating to the short selling of securities by regulated entities. On June 23, 2004, the Commission adopted Regulation SHO, which was designed primarily to address concerns regarding potentially abusive "naked" short selling and persistent fails to deliver securities. As adopted, Regulation SHO included a close-out requirement that required broker-dealers to purchase securities to close out fail to deliver positions in certain securities with large and persistent fails to deliver. The Commission subsequently amended the close-out requirement in the fall of 2008 such that fails to deliver in all equity securities must be closed out immediately after they occur. This amendment, among other actions taken by the Commission, has significantly reduced the number of fails to deliver securities. In addition, the Commission also adopted a "naked" short selling antifraud rule in October 2009 which, among other things, makes it unlawful for individuals to submit an order to sell an equity security if they deceive others about their intention or ability to deliver the security, and such person fails to deliver the security on or before the settlement date. In February 2010, the SEC adopted an alternative uptick rule (Rule 201) which imposes restrictions on short selling if a security has triggered a circuit breaker by experiencing a price decline of at least 10 percent in one day. At that point, short selling would be permitted if the price of the security is above the current national best bid. The implementation date for this short sale price test is November 10, 2010.

With respect to the European Union, on June 14, 2010, the European Commission published a consultation paper on short selling addressing the scope of securities covered under a short selling regime, increased transparency of short positions, restrictions on "naked" short selling and credit default swap transactions, possible short selling exemptions and emergency powers relating to short selling. A formal European Commission proposal is scheduled for adoption in September 2010. In addition, on March 2, 2010, the Committee of European Securities Regulators (CESR) submitted a proposal to the European Institutions recommending the introduction of a pan-European two-tier disclosure regime for net short positions. Further, in October 2009, the United Kingdom's Financial Services Authority (FSA) published a feedback report detailing the responses it received on a February 2009 discussion paper regarding short position disclosure. In the report, which made no changes to its current short position disclosure regime that has been in effect since 2008, the FSA advocated for the adoption of the CESR proposed disclosure regime and indicated it is awaiting the outcome of the CESR proposal before amending the current FSA short position disclosure policies.

[6] These principles state that (1) short selling should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of financial markets; (2) short selling should be subject to a reporting regime that provides timely information to the market or to market authorities; (3) short selling should be subject to an effective compliance and enforcement system; and (4) short selling should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

gence in the implementation of, and assessment of the effectiveness of, these principles. As IOSCO member jurisdictions are still in the process of implementing and/ or conducting consultations with respect to new short selling measures, including transparency measures,[7] the task force chair is organizing a workshop for members to continue monitoring developments in short selling regulation through an exchange of experiences, allowing members to better understand each other's short selling regulations and policies.

Examples of the Layers of International Coordination

Credit rating agencies and over-the-counter (OTC) derivatives provide illustrative examples of the interaction of the various levels of cooperation—involving the G-20, FSB, IOSCO, and national and regional authorities.

OTC Derivatives

In March 2010, IOSCO, the Committee on Payment and Settlement Systems (CPSS) and the European Commission formed a working group to analyze and suggest policy options to further the objectives agreed upon at the September 2009 G-20 Leaders' Summit in Pittsburgh to improve the OTC derivatives markets.[8]

Separately, IOSCO and CPSS issued in May 2010 two consultative reports containing proposals aimed at strengthening the OTC derivatives market.[9] One report presents guidance for central counterparties that clear OTC derivatives products, and the other presents a set of considerations for trade repositories in OTC derivatives markets and for relevant authorities over trade repositories. These are examples of how experts from IOSCO, the Basel-based committees, and national authorities are collaborating to ensure a coordinated approach as regulatory reforms in our respective jurisdictions evolve, in a manner responsive to the objectives laid out in policies developed by the G-20.[10]

Credit Rating Agencies

At the London Summit, G-20 Leaders agreed that regulatory oversight regimes of credit rating agencies (CRAs) should be established by the end of 2009. The G-20 Leaders took as a starting point the IOSCO CRA *Code of Conduct Fundamentals* (Code Fundamentals) first adopted in 2004. Following this commitment, national and regional initiatives have been taken or are underway to strengthen oversight of CRAs. In the U.S., the SEC has adopted or proposed amendments to its rules on nationally recognized statistical rating organizations (NRSROs) in order to foster accountability, transparency, and competition in the credit rating industry as well as to address conflicts of interest at NRSROs, including through enhancements to their disclosure requirements. The recent regulatory reform legislation also seeks to further strengthen oversight, ensure greater transparency and address conflicts of interest at NRSROs.

Many other G-20 countries have also introduced or are on the way to introducing new regulatory oversight framework for CRAs. In the European Union regulation introducing oversight and supervision of CRAs entered into force in December 2009; and the Committee of European Securities Regulators (CESR) issued guidance in June 2010 on various topics including the registration process and supervisory practices for CRAs. In Japan, the final version of a cabinet order and cabinet office ordinances were published in December 2009, following the June 2009 law that introduced a new regulatory framework for CRAs. The new regulations became effective in April 2010.

While these national developments build on the IOSCO Code Fundamentals, attention is needed to ensure international coordination. The SEC, Financial Services

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[7] The Commission has also worked with several Self Regulatory Organizations ("SROs") to improve public disclosure regarding short sales. Specifically, the SROs have made the following short sale information publicly available to all investors: the aggregate short selling volume in each individual equity security for that day; and, information regarding individual short sale transactions (without identifying the parties to the transaction) in exchange-listed equity securities. In addition, the Commission increased the frequency of its publication of data regarding fails to deliver for all equity securities.

[8] The Pittsburgh Leaders' Statement states, "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Noncentrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."

[9] *See, http://www.iosco.org/news/pdf/IOSCONEWS182.pdf.*

[10] From the U.S., representatives of the Commission, the Federal Reserve System and the Commodities Futures Trading Commission participate on the working group.

Agency of Japan and CESR-members have been engaged in ongoing discussions to address issues relating to cross-border transferability of credit ratings and any other significant inconsistencies or frictions that may arise as a result of differences among their new CRA regulations.

These discussions have been facilitated by the work of Standing Committee 6 of IOSCO's Technical Committee (which is chaired by SEC staff). In May 2010, IOSCO issued for public consultation a report reviewing CRA supervisory initiatives in several of its member jurisdictions in order to evaluate whether, and if so how, these regulatory programs implement the four principles set forth in the 2003 IOSCO paper *Statement of Principles Regarding the Activities of Credit Rating Agencies.*

In response to the FSB and G-20 recommendations to review the use of ratings in the regulatory and supervisory framework, steps are being taken to reduce official sector use of ratings. The Basel Committee, for instance, is working to address a number of inappropriate incentives arising from the use of external ratings in the regulatory capital framework. National and regional authorities, including the SEC, have also taken steps to lessen undue reliance on ratings in rules and regulations or are considering ways to do so. As guidance to assist this work, the FSB has collected information on the measures taken both at international and national levels, and is discussing the development of high-level principles for use by authorities in reducing their reliance on ratings.

Bilateral Cooperative Arrangements

In addition to our collaborative efforts with our counterparts in IOSCO, the Commission is pushing ahead in developing much stronger and more extensive supervisory cooperation arrangements with a number of jurisdictions. These types of arrangements improve our abilities to share information at the operational level, to essentially "compare notes" with our counterparts abroad and share information about the entities we regulate. This combined emphasis—engagement with and strengthening of the international standard-setting bodies, and forging closer bilateral ties with our counterpart regulators overseas—is necessary for the high-level objectives of the G-20 to be implemented in any meaningful fashion, and in ways that do not lead to regulatory arbitrage.

On June 14, 2010, the SEC, Quebec Autorité des marchés financiers (AMF) and Ontario Securities Commission (OSC) announced a comprehensive arrangement to facilitate their supervision of regulated entities that operate across the U.S.-Canadian border. The arrangement, in the form of a memorandum of understanding, provides a clear mechanism for consultation, cooperation, and exchange of information among the SEC, AMF, and OSC in the context of supervision. The memorandum of understanding sets forth the terms and conditions for the sharing of information about regulated entities, such as broker-dealers and investment advisers, which operate in the U.S., Quebec, and Ontario.

I anticipate that there will be additional arrangements of this sort in the future. Certain provisions of the Dodd-Frank bill will facilitate supervisory cooperation between U.S. authorities and our foreign counterparts by further enabling and protecting information sharing with foreign authorities. [11]

Initiatives in Other Areas of International Interest

Ultimately, while bodies such as the G-20 and FSB play an important role in the international policy dialogue, it is critical that regulatory bodies such as the Commission have control over their own agendas and the ultimate outcomes of their regulatory and standard-setting work consistent with their national authorities and mandates. Regulators and supervisors have specific goals for regulation—which may differ from sector to sector—but are all important. For example, a key goal of securities regulators is investor protection; this goal is not the focus of bank or insurance supervisors, who have other priorities. Only by allowing the primary regulators,

[11] Section 929K, "Sharing Privileged Information With Other Authorities", indicates that the Commission shall not be deemed to have waived any privilege applicable to any information by transferring that information to, among others, any foreign securities authorities or foreign law enforcement authorities. This extra protection for shared information can be expected to strengthen the volume and types of information that the SEC can comfortably share with our foreign counterparts, for the benefit of investors. Section 981, Authority to Share Certain Information with Foreign Authorities, allows the Public Company Accounting Oversight Board (PCAOB) to share information with its foreign counterparts without the information losing its status as privileged and confidential in the hands of the Board. To receive information from the PCAOB, a foreign counterpart will need to provide assurances of confidentiality, a description of its applicable information systems and controls and of its relevant laws and regulations. The PCAOB will have the discretion to determine the appropriateness of sharing. This information sharing will enhance the PCAOB's ability to effectively oversee firms that audit multinational public companies.

where the technical expertise resides, to develop regulatory approaches in their areas of concern, can we ensure that all regulatory goals are being met. Moreover, implementation and enforcement depend on legal mechanisms and processes that vary jurisdiction by jurisdiction, and sector by sector.

I would like to briefly describe initiatives in two areas where regulators and standard setters must bear in mind the international repercussions of their work, but ultimately must make decisions that comply with the demands of their unique mandates.

Convergence in Accounting Standards

Continuing a policy established over three decades ago, the Commission unequivocally supports efforts of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) to reduce disparities in financial reporting standards through their convergence agenda. The Boards formalized their efforts to remove differences in key areas of their respective accounting standards in a 2006 memorandum of understanding.

In the Leaders Statement issued at the September 2009 Summit in Pittsburgh, the G-20 "call[ed] on our international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011." In the wake of the G-20 Statement, the IASB and FASB have been working aggressively toward completion of their eight remaining joint projects.[12] To provide greater visibility into and accountability for their processes, in November 2009, the Boards issued a joint statement that set forth milestones for each remaining major convergence project. The Boards will issue quarterly reports on progress on those projects until they are completed. Two such quarterly reports have been issued to date.

The Boards' most recent progress report, issued on June 24, provided the details behind a modified approach to its work plan, announced in general terms on June 2. The modification reflects a prioritization of the major projects in the memorandum of understanding to permit a sharper focus on the issues and projects for which the Boards believe the need for improvement in their respective standards is the most urgent. For these projects, the modified strategy retains the target completion date of June 2011 or earlier. Included among these is the financial instruments project, the importance of which was accentuated during the financial crisis.

Another revision to the project plan will result in phased publication of exposure drafts and related consultation on standards under development. Many stakeholders expressed concern that they may not be able to provide high quality input to each project, given the large number of major exposure drafts previously planned for publication in the second quarter of this year, in order to finalize standards by mid-2011. A more rationalized pace of proposed standards for comment is expected to increase the input provided to the Board, which in turn should contribute to the development of sustainable final standards.

The Boards' modified strategy has the full support of the Monitoring Board of capital market authorities, which oversees the IASB's trustee body. SEC Chairman Mary Schapiro issued a statement upon announcement of the modified plan, expressing support for the adjustment. Both Boards are obligated to develop high quality accounting standards that improve the transparency and usefulness of financial reporting in the interest of investors. At their most recent summit in Toronto last month, the G-20 Leaders' statement urged the Boards to complete their convergence project by the end of 2011.

The Commission staff continues to develop its analysis of the appropriate role of the accounting standards set by the IASB, International Financial Reporting Standards (IFRS), in financial reporting for U.S. issuers, as directed by the Commission in a February 2010 Statement in Support of Convergence and Global Accounting Standards. The staff's work is designed to position the Commission in 2011 to make a determination regarding incorporating IFRS into the U.S. financial reporting system for U.S. issuers.

Equity Market Structure

Last year, the Commission began an in-depth evaluation of the U.S. equity market structure. The Commission embarked on this review to ensure that the U.S. equity markets remain fair, transparent and efficient in light of new technology and trading strategies. To date, the Commission has proposed several rules related to the equity market structure that would:

[12] In addition, the Boards are collaborating on a number of other projects.

- Establish a consolidated audit trail system to help regulators keep pace with new technology and trading patterns in the markets.[13]
- Generally require that information about an investor's interest in buying or selling a stock be made available to the public, instead of just to a select group operating with a dark pool.[14]
- Effectively prohibit broker-dealers from providing their customers with unfiltered access to exchanges and alternative trading systems and ensure that broker-dealers implement appropriate risk controls.[15]
- Create a large trader reporting system to enhance the Commission's ability to identify large market participants, collect information on their trades, and analyze their trading activity.[16]

Each of these proposals is currently pending before the Commission, and the Commission has received helpful comment from the public on these proposals.

In addition, to help generate thought and provide the Commission with insight on the current landscape of the U.S. equity markets, the Commission issued a concept release in January of this year.[17] The Commission followed on this Concept Release this past June by holding a Roundtable on Equity Market Structure.[18] The Concept Release covers three broad categories. First, it asks about the performance of the U.S. market structure in recent years, particularly from the standpoint of long-term investors. Second, it seeks comments on the strategies and tools used by high frequency traders, such as colocation services. Finally, it asks about dark liquidity in all of its forms, including dark pools, alternative trading systems (ATSs), over-the-counter market makers, and undisplayed order types on exchanges and ECNs.

While the Concept Release is focused on analyzing the changes of the U.S. equity market structure, the Commission did request comment on the impact of globalization on U.S. equity markets. Specifically, the Commission asked the following questions:

1. How does global competition for trading activity impact the U.S. market structure?
2. Should global competition affect the approach to regulation in the U.S.?
3. Will trading activity and capital tend to move either to the U.S. or overseas in response to different regulation in the U.S.?
4. How should the Commission consider these globalization issues in its review of market structure?

The SEC is not alone in its interest in evaluating equity market structure. These topics are currently being evaluated in other jurisdictions. For example, the EU is currently in the process of reviewing the Market in Financial Instruments Directive (MiFID) in light of new technology.[19] In May of this year, the U.K. Financial Services Authority issued its regulatory agenda for the U.K. markets, which highlights many of the market structure issues that the Commission is considering, such as dark pools of liquidity and new trading platforms.[20] In addition, IOSCO is evaluating certain market structure issues, such as dark pools and direct market access.

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[13] SEC Release No. 34-62174 (May 26, 2010), available at *http://www.sec.gov/rules/proposed/2010/34-62174.pdf.*

[14] SEC Release No 34-60997 (November 13, 2009), available at *http://www.sec.gov/rules/proposed/2009/34-60997.pdf.*

[15] SEC Release No 34-61379 (January 19, 2010), available at *http://www.sec.gov/rules/proposed/2010/34-61379.pdf.*

[16] SEC Release no 34-61908 (April 14, 2010), available at *http://www.sec.gov/rules/proposed/2010/34-61908.pdf.*

[17] Concept Release on Equity Market Structure, SEC Release No. 34-61358 (January 14, 2010), available at *http://www.sec.gov/rules/concept/2010/34-61358.pdf.*

[18] See the SEC Press Release announcing the agenda and panelists for the Market Structure Roundtable, available at *http://www.sec.gov/news/press/2010/2010-92.htm.*

[19] *See, e.g.,* "CESR Call for Evidence, Micro-Structural Issues in the European Equity Market", CESR Ref No. 10-142 (April 1, 2010), available at *http://www.cesr.eu/index.php?page=consultation__details&id=158. See also,* "CESR Technical Advice to the European Commission in the Context of the MiFID Review—Equity Markets", CESR Ref No. 10-394 (April 2010), available at *http://www.cesr.eu/index.php?page=consultation__details&id=16.* In its call for evidence, CESR requested comment on issues related to high frequency trading; sponsored access; colocation services; fee structures; tick size regimes; and indications of interest.

[20] *See,* "The FSA's Markets Regulatory Agenda", (May 2010), available at *http://www.fsa.gov.uk/pubs/other/markets.pdf.*

Conclusion

Beyond the formal bilateral regulatory dialogues and international financial and regulatory bodies in which the Commission and its staff participate, we have a long-standing commitment to assist in the development and strengthening of capital markets globally. Securities commissions and stock exchanges are increasingly requesting the expertise and experience of SEC staff in dealing with insider trading, market manipulation, pyramid schemes, corporate governance, inspections and compliance, antimoney laundering, and a host of other market development and enforcement issues. Utilizing a faculty of senior SEC and industry officials, and seasoned practitioners, the technical assistance program has provided training to nearly 2,000 regulatory and law enforcement officials from over 100 countries. Such technical assistance helps build good relationships with our regulatory counterparts abroad. We often need the assistance of our counterparts abroad in cross-border enforcement matters and, increasingly, in cross-border supervisory matters. Increasingly, we find that they are pursuing the same wrongdoers that we are, so sharing our best regulatory and enforcement practices redounds directly to our benefit.

Through its flagship International Institutes, bilateral dialogues, and regional training programs, we seek to improve market development and enforcement capacity around the world. This past April, we held our 20th annual International Institute for Market Development. The International Enforcement Institute is held each fall. Earlier this month, the Commission hosted its second annual Institute on Inspection and Examination of Market Intermediaries.

As is described above, the Commission is continuing its pursuit of efforts to improve securities market regulation in the wake of the financial crisis. Increasingly, our success will depend on international consensus on fundamental objectives of securities regulation—investor protection; the promotion of fair, efficient and transparent markets; and the reduction of systemic risk. As regulators, it is essential that we bear these principles in mind, as they will help us support the strength of our own capital markets. Our markets are made better not simply by international consensus on principles, but also on our implementation and enforcement at the national level of common objectives agreed upon at the international level.

PREPARED STATEMENT OF DANIEL K. TARULLO

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JULY 20, 2010

Chairman Bayh, Ranking Member Corker, and other Members of the Subcommittee, I appreciate the opportunity to testify today on developments in international regulatory reform and U.S. Government priorities for international regulatory cooperation.

When you held a hearing on this topic in the fall, I gave an overview of the Federal Reserve's role in international cooperative activities and reviewed some pertinent recent developments. In my testimony today, I will begin by enumerating the goals that should inform U.S. participation in international regulatory and supervisory activities. Then I will turn to some of the issues you identified in your invitation letter as being of interest to the Subcommittee in this hearing: the Federal Reserve's role in the international financial reform efforts—including our work on the Basel III reforms, cross-border crisis management and resolution, and incentive compensation—and a preliminary assessment of the likely effect of the Dodd-Frank Act of 2010 on international financial reform. Finally, I will close with a few thoughts on the future role of the Financial Stability Board (FSB) and other international regulatory bodies as we move from the design of financial regulatory reforms to implementation of the new framework.

Goals for International Cooperation in Financial Regulation and Supervision

Before discussing some of the very important initiatives that are under way, I think it important to specify what I believe should be the U.S. goals for international cooperative efforts.

First, to increase the stability of our financial system through adoption of strong, common regulatory standards for large financial firms and important financial markets. As events of the past few years have shown, financial stresses can quickly spread across national borders. Global financial stability is a critical shared goal.

Second, to prevent major competitive imbalances between U.S. and foreign financial institutions. A core set of good common standards will reduce opportunities for cross-border regulatory arbitrage, even as it promotes financial stability. This goal

is particularly noteworthy as the United States tightens its domestic prudential standards.

Third, to make supervision of internationally active financial institutions more effective through a clear understanding of home and host country responsibilities and adequate flows of information and analysis.

Fourth, beyond the supervision of individual institutions, to exchange information and analysis in an effort to identify potential sources of financial instability and to take action to help mitigate the buildup of risks in international financial markets, particularly those potentially posing systemic risks.

Embracing these goals does not, of course, answer the often complex questions raised in specific initiatives, such as the degree to which rules should be standardized and the degree to which national variation or discretion is warranted in pursuing shared regulatory ends. But I do think it is useful to keep all of these goals in mind as we pursue our international agenda. Our task as U.S. regulators is to work to ensure that, together, the various international financial organizations produce reforms and practices that are consistent with U.S. interests and legal requirements.

The Federal Reserve's Role in International Financial Reform Efforts

As a central bank with significant supervisory responsibilities, the Federal Reserve actively participates in both (1) central-bank-focused groups that monitor developments in global financial markets and promote sound and efficient payment systems and (2) supervisory forums, such as the Basel Committee on Banking Supervision (Basel Committee), which promotes high global standards for banking supervision and regulation. We also actively participate in the FSB, which is coordinating many of the initiatives undertaken in response to the financial crisis and is directly communicating with the Group of Twenty (G-20).

Our contributions to these groups take advantage of the synergies between our central banking functions and our supervisory responsibilities. Our contributions combine our economic research, knowledge of financial markets, and regulatory policy experience. Interestingly, in the wake of the financial crisis, we see some other countries, notably the United Kingdom, moving back toward a more significant involvement of the central bank in supervision, presumably for these same reasons.

Basel III

The Basel Committee is working toward new global standards for minimum bank capital levels and a new liquidity requirement—a project that has become known as Basel III. This undertaking is central to the first and second goals for international cooperation that I noted earlier. The Basel Committee aims to complete this task by the November G-20 leaders meeting in Seoul. The Federal Reserve has devoted considerable resources to this important global initiative, and we note that international bank supervisors continued to make progress at the Basel Committee meeting last week.

We agree with the yardstick set forth last month by the G-20 leaders in Toronto—that minimum capital requirements should "enable banks to withstand—without extraordinary Government support—stresses of a magnitude associated with the recent financial crisis." [1] Our view is that large institutions should be sufficiently capitalized so that they could sustain the losses associated with a systemic problem and remain sufficiently capitalized to continue functioning effectively as financial intermediaries. Meeting this standard will require a considerable strengthening of existing requirements, both with respect to the amount of capital held and to the quality of that capital. As to the former, it is particularly important that the risk weightings associated with traded instruments be substantially increased. As to the latter, the crisis confirmed what many of us have long believed—that common equity is by far the best measure of a firm's loss absorption capacity. During the crisis, regulators, counterparties, and market analysts all looked to levels of common equity as the key measure of a firm's durability in the face of extraordinary financial stress. We have conducted extensive analysis to inform our judgments on the specific rules needed to implement this standard. In this respect, the stress tests we conducted last year as part of the Supervisory Capital Assessment Program have been very useful in assessing the amount of capital needed to survive a financial crisis without unusual Government support.

Since the Basel Committee published its proposals in a number of consultative documents, the Federal Reserve and the other U.S. Federal banking agencies have

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[1] G-20 (2010), "The G-20 Toronto Summit Declaration", Financial Sector Reform, item 18, G-20 Toronto Summit held June 26-27 in Toronto, Canada, *http://g20.gc.ca/toronto-summit/summit-documents/the-g-20-toronto-summit-declaration.*

been working together for a Basel III framework that produces a strong set of globally consistent capital and liquidity requirements that will promote financial stability and a level playing field for internationally active banks. We have assessed how various proposals would, or would not, achieve that aim. We have also considered carefully how to structure the transition to the new requirements so as to minimize their effect on the economy as a whole and to allow adequate time for firms to adjust their capital accounts.

Although adopting a robust, common set of capital and liquidity rules for internationally active banks is critical, it is neither practical nor desirable to negotiate all details of financial regulation internationally. It is important that the United States preserves the flexibility to adopt prudential regulations that work best within the U.S. financial and legal systems. Within a common set of agreed-upon global standards, each jurisdiction will want to tailor some of its rules and supervisory practice to national conditions and preferences. Along these lines, there have been recent discussions within the FSB on the possibility of formalizing consultations among member countries to examine how each member is using its own mix of instruments to achieve particular safety and soundness ends.

The Basel Committee has a number of initiatives and work programs related to capital requirements that go beyond the package of measures that we expect to be completed by the fall. These efforts include, among others, ideas for countercyclical capital buffers, contingent capital, and development of a metric for capital charges tied to systemic risk. Each of these ideas has considerable conceptual appeal, but some of the difficulties encountered in translating the ideas into practical rules mean that work on them is likely to continue into next year.

Cross-Border Crisis Management and Resolution

Like stronger capital and liquidity requirements, improved resolution regimes for both banks and systemically important nonbank financial companies are a critical element of the domestic and international agenda to contain systemic risk. Internationally, the FSB is seeking to enhance cross-border cooperation both in making advanced preparations for handling severe stress at specific firms and in dealing with financial crises when they occur.

The FSB is developing concrete policy recommendations for the G-20 Summit in November. Specifically, the FSB is working to identify common principles and key attributes for effective national resolution regimes, including a menu of resolution tools for authorities to draw upon in light of the varying circumstances that may be associated with distress at a particular firm. Among these are restructuring and wind-down measures for firms that will be closed down, such as arrangements for providing temporary funding or the ability to establish a bridge bank to take over essential functions. There is also considerable interest at the FSB in developing a resolution tool that could facilitate a restructuring of a firm's own capital and liquidity that would allow it to continue operating as a going concern. Specifically, the FSB is exploring whether there could be a viable mechanism for converting debt into equity through terms set out in the debt instruments.

Another aspect of the FSB's work focuses on four technical areas that may affect cross-border recovery or resolution: (1) practices for booking trades in one legal entity and then transferring the market or credit risk of the trade to a different location or legal entity; (2) the use of intragroup guarantees and related cross-border implications; (3) the critical nature of global payments operations, such as cash payments or securities settlement; and (4) the adequacy of a firm's management information systems and service level agreements. The FSB is exploring ways to mitigate challenges related to these four areas.

Firm-specific crisis management working groups composed of home and host supervisory authorities are working to identify specific issues and barriers to coordinated action that may arise in handling severe stress at identified firms. This process should culminate in recovery plans—developed by the individual firms—that outline options for an institution to recover from a severe distress without extraordinary official sector actions, and resolution plans—developed by the official sector—intended to identify options that would result in an orderly wind-down.

Domestically, we have formed crisis management groups to cover the key internationally active U.S. banking organizations. In addition to the Federal Reserve, the groups include representatives from the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and relevant foreign supervisors and central banks. The firms are each internally identifying and assessing their options and strategies to lower risk in the event of stress, including selling portfolios or business lines, restructuring liabilities and implementing contingency funding plans. The objective is to ensure that each firm has a concrete and viable plan to reduce riskiness, ensure the continuity of critical fi-

nancial services, preserve liquidity, and make up cash flow shortages under severely adverse conditions. They are individually working with their own crisis management group to isolate key impediments to recovery and are focusing on work that should be undertaken in the near term to enhance recovery options. These plans will have to be dynamic to ensure they remain relevant and appropriate in light of changing business and economic conditions.

Despite the progress that is being made through the FSB work and domestic efforts, comprehensive solutions to cross-border crisis management difficulties will not be easy to achieve. Enhancing cross-jurisdictional synchronization of resolution options and recovery processes would be a meaningful step in the right direction. At least for the foreseeable future, a focus on regulatory coordination and supervisory cooperation and planning before a large firm's failure becomes a real possibility is likely to yield the greatest benefit.

Incentive Compensation

In the last 2 years, compensation has been a regular topic of discussion at meetings of international regulatory groups, culminating in the FSB's agreement last year on principles to guide incentive compensation.[2] The principles specify that compensation practices at major financial institutions should properly account for risk, that boards of directors and risk managers at such firms should ensure they do so, that supervisors should provide effective oversight, and that firms' disclosures should be sufficient to inform stakeholders about compensation and risk.

In addition to these principles, a number of specific projects are in progress or have recently been completed by international regulatory working groups. The FSB conducted a peer review of G-20 nations' progress toward implementing the principles, which found that progress is being made but more work is needed. Other projects include work by the Basel Committee, expected by end-2010, on practices that would improve the soundness of risk-taking incentives, and a proposal for disclosure of compensation information under Pillar 3 of Basel 2.

While the views of national supervisory authorities have in many respects converged on such matters as the sources and effects of incentive problems and some methods for better aligning the risk-taking incentives of employees at major financial institutions with the interests of shareholders and the financial system, different nations have taken different approaches in implementing the FSB principles.

We have adopted an approach that requires large financial organizations to establish and maintain internal governance and management systems to implement principles for assuring that incentive compensation arrangements are risk-appropriate. These principles, and the process by which we proposed that they be implemented, were issued by the Federal Reserve for public comment in October. The final supervisory guidance, which was jointly issued with the other banking agencies, was released last month.[3] We chose a principles-based approach because of the substantial variation in the actual incentives and risks associated with the thousands of executives and other employees within and among banking organizations. Our view continues to be that a uniform or formulaic approach to all such employees would be neither efficient in motivating and compensating employees nor effective in preventing excessively risky activity, particularly among nonexecutives such as traders.

In contrast, this month the European Parliament approved a directive that has the potential to lead to a number of formula-based restrictions on employee compensation at financial services firms operating in the European Union (EU).[4] This approach is consonant with views expressed by some EU members to the effect that formula setting—for example, putting a floor on the portion of an employee's salary that must be deferred—is the surest way to produce changes in bank practice. However, many of the details are left to be set by the European Commission, the Committee of European Bank Supervisors, and other entities.

While both approaches have merit, we believe the option we have chosen is likely to be more successful in promoting risk-appropriate compensation practices. As already noted, we fear that a formula-based approach applicable to all covered employees may spawn efforts to circumvent the rules through creative new compensation practices, whereas our requirement that the banks internalize sound principles

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[2] *See,* Financial Stability Board (2009), FSB Principles for Sound Compensation Practices (Basel, Switzerland: FSB, September), *www.financialstabilityboard.org/publications/r_0904b.pdf*

[3] *See,* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2010), "Federal Reserve, OCC, OTS, FDIC Issue Final Guidance on Incentive Compensation", joint press release, June 21, *www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm.*

[4] More information on this directive is available on the European Parliament Web site at *www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2010-0274&language=EN.*

for incentive compensation and apply them to all such arrangements places a continuing responsibility on the firms themselves. Of course, considerable oversight is needed to ensure that a principles-based approach is implemented rigorously. We have already conducted an extensive horizontal review of compensation practices at 25 large U.S. financial holding companies and have sent detailed assessments to each firm commenting on their proposals for implementing the principles.

It may well be that over time the two approaches will converge somewhat. For example, we may determine on the basis of experience with many firms that there are certain best practices that should at least presumptively be applicable to certain classes of employees. Similarly, the EU may find that more attention to internalization of the principles and customization of appropriate practices is necessary, particularly as applied to nonexecutive employees. We intend to continue information sharing and discussions through the FSB and the Basel Committee. For now, though, there is indeed a difference in approach, one that illustrates the point I made earlier that there need not be complete harmonization in all prudential regulation and supervision, even where there is agreement on basic goals.

Effect of the Dodd-Frank Act

Of course, concurrent with the efforts of the Federal Reserve and other U.S. agencies to advance the goals of international regulatory reform, the U.S. Congress has debated and passed the Dodd-Frank Act, creating a comprehensive package of domestic financial reforms.

Many elements of the Dodd-Frank Act align closely with the efforts of the G-20 leaders, the FSB, and the Basel Committee. For example, the act provides the Federal Government with the authority to subject all financial firms that present outsized systemic risks—regardless of whether they own an insured depository institution—to a common framework of supervision and regulation by the Federal Reserve. In addition, the act creates a special resolution regime that gives the Government the capacity to unwind or break apart major nonbank financial firms in an orderly fashion with less collateral damage to the system. Moreover, the act strengthens the resiliency of the financial market infrastructure by mandating increased central clearing and transparency for over-the-counter derivative transactions and stronger prudential regulation of bank and nonbank derivatives dealers. The act also provides for the registration of advisers to hedge funds and other private investment funds, improved regulation of credit rating agencies, and more-consistent oversight of systemically important financial market utilities.

At the same time, there are aspects of the Dodd-Frank Act that are unlikely to become part of the international financial regulatory framework. For example, the act generally prohibits U.S. banking firms (and the U.S. operations of foreign banking firms) from engaging in proprietary trading and from investing in or sponsoring private investment funds. The act also prohibits U.S. depository institutions from entering into certain types of derivatives transactions. In the United States, activity restrictions have long been a part of the bank regulatory regime, serving to constrain risk-taking by banking firms, prevent the spread of the market distortions caused by the Federal bank safety net to other parts of the economy, and mitigate potential conflicts of interest generated by the combination of banking and certain other businesses within a single firm. Many other countries follow a universal banking model and are unlikely to adopt the sorts of activity restrictions contained in the act.

Similarly, the Dodd-Frank Act expands the existing 10 percent deposit cap in U.S. law by preventing the Federal Reserve from approving a material acquisition by a financial firm if the resulting firm would have liabilities that exceed 10 percent of the total liabilities of the broader U.S. banking system. Other countries with more concentrated banking systems are unlikely to impose this type of concentration limit on financial firms in their jurisdiction.

Again, not all elements of financial reform can be designed on a national level in a way that is perfectly consistent across countries. The characteristics of each country's financial system differ, sometimes significantly. Our challenge is to strike the right balance between achieving global consistency on the core reforms necessary to protect financial stability and provide a workably level playing field, and at the same time providing the flexibility necessary to supplement the common standards with elements tailored to national financial systems, legal structures, and policy preferences.

Current and Future Focus of International Regulatory Groups

As my testimony makes clear, the international regulatory groups remain focused on responding to the crisis. The FSB is pursuing financial reform and working with the relevant standard-setting bodies to ensure that detailed proposals are developed

in a timely manner. In some cases, the importance of the issues and the drive to respond quickly to the crisis have led to a proliferation of international working groups whose mandates may overlap. While this reaction is natural in the wake of a crisis, we will need to rationalize the activities of these groups as our focus shifts from policy development to implementation. So, too, we will need to ensure that the relatively new members of these groups are fully and effectively integrated into their activities, including in leadership positions.

It is also important that we not lose sight of the third and fourth goals I suggested for our international cooperative efforts. While much of the effort in the international groups has recently been focused on negotiating rules and principles to reform financial regulation, it would be unfortunate going forward if negotiations were to become the dominant mode of international financial cooperation. We would not want to crowd out the other valuable aspects of international regulatory cooperation, including sharing supervisory perspectives on internationally active financial institutions and analyzing latent risks to financial stability.

The FSB itself has a valuable role to play by bringing together the international standard-setting bodies and key national authorities responsible for financial stability in the G-20 member jurisdictions. Its role might usefully be conceived as roughly paralleling the role to be played by the Financial Stability Oversight Council in the United States under the Dodd-Frank Act. The FSB can facilitate discussion and analysis of emerging risks to financial stability that cut across sectors or across the jurisdiction of more than one regulator. Because it consists of senior officials from finance ministries, regulatory agencies, and central banks, it is well positioned not only to identify cross-cutting risks or regulatory gaps, but also to take action to address those risks.

Finally, I believe that it will be important for standard-setting bodies such as the Basel Committee to enhance monitoring of the implementation of the sometimes complex agreements reached internationally. Where it is difficult for market analysts and other outside observers to determine if, for example, Basel III capital rules are being vigorously implemented and enforced, the international standard setters must themselves develop appropriate monitoring mechanisms. These mechanisms must go beyond examining whether international standards have been duly incorporated into domestic law to consider whether financial institutions are complying with those standards.

Thank you for again giving me the opportunity to share our thoughts on the evolving issues in international financial cooperation. I would be pleased to answer any questions you may have.