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INTERNATIONAL COOPERATION TO MODERNIZE FINANCIAL REGULATION

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BEFORE THE

SUBCOMMITTEE ON
SECURITY AND INTERNATIONAL TRADE
AND FINANCE

OF THE

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

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FIRST SESSION

ON

COLLABORATIVE INTERNATIONAL EFFORTS TO PROMOTE FINANCIAL REGULATORY REFORM

SEPTEMBER 30, 2009

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INTERNATIONAL COOPERATION TO MODERNIZE FINANCIAL REGULATION

WEDNESDAY, SEPTEMBER 30, 2009

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

The Subcommittee met at 2:39 p.m., in room SD–538, Dirksen Senate Office Building, Senator Evan Bayh, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. I would like to call the Subcommittee to order and thank our witnesses for being with us today. I am well aware of how busy you are, and so in the midst of all the other things you have to deal with, I am very grateful for your insights. I apologize for being a little bit late. I was waylaid by some well-intended members of the fourth estate who, for some reason, wanted to talk about health care. But the matter that we are here today to discuss is very important. We will be turning to that very shortly, and so I am grateful for your presence.

I am pleased to call the Subcommittee to order for our hearing entitled "The International Cooperation to Modernize Financial Regulation." I want to begin by thanking Chairman Dodd of the Banking Committee as a whole and his hard-working staff for their cooperation and assistance in arranging this hearing and for the Chairman's support in looking into these important matters.

I would also like to welcome my friend and colleague, Ranking Member Corker—I am grateful for his leadership on these and other matters—and my other colleagues on the Committee who are with us. Some will be with us later in person. Others will be reading the testimony. I want to thank them for their interest in this matter.

To our three witnesses, I want to welcome you and thank you for appearing before the Subcommittee to give an outline on the efforts underway to harmonize our collective financial regulations. I understand these few weeks have been very busy for all three of you, with the G–20 summit and upcoming meetings abroad. I appreciate your rearranging your schedules and your overseas travel to be with us here today. Once again, thank you for your consideration.

Our panel today consists of our country's leading representatives and experts on international economic and financial affairs, so I look forward to our upcoming dialog. But first I would like to go

over why we are here today and why the international element of our financial regulatory overhaul is critical to our global economic recovery.

One year ago, our country experienced a financial crisis fueled by home foreclosures and institutional failure. The markets dropped drastically and credit began to freeze as banks refused to lend to families, businesses, and even to one another.

It soon became apparent that no one was immune. Our financial crisis quickly became a full-blown economic crisis, complete with a housing decline and our Nation shedding, on average, 700,000 jobs each month. My home State of Indiana was hit particularly hard.

It was clear Congress needed to intervene with massive Government assistance to help stabilize our financial markets and prevent complete economic collapse. As I said at the time, it was a "distasteful but necessary step to protect millions of innocent people."

Now, 1 year later we are on the path to recovery. It will take some time for our financial system to completely heal, but in the meantime, it is our responsibility and the duty of lawmakers to be willing to take the steps necessary toward long-term reform to make sure this situation does not happen again.

The Senate Banking Committee has already held approximately 30 hearings since this January on the issue of financial regulatory modernization. It would be challenging enough to reform our regulatory scheme here in the United States and ignore the efforts internationally. But that would neglect our economic reality. 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 substantially at home. 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. We sometimes refer to that as regulatory arbitrage.

Two weeks ago, in a speech before Wall Street, President Obama reaffirmed his commitment to financial regulatory modernization and the need to close the gaps and harmonize our collective rules. He stressed that the United States needs to play a leadership role in lifting our global regulatory standards to ensure there is a global race to the top. This is necessary to, number one, prevent the regulatory arbitrage I just mentioned that puts our entire financial system at risk; and, number two, make sure we remain competitive with other nations.

In light of that commitment, we are moving forward with today's hearing to show our support for this critical component of regulatory reform. Today we will hear from our three witnesses on the work that is underway to coordinate our regulatory structures.

We have already laid the foundation to begin this process. In an effort to coordinate financial regulatory reforms, world leaders began working together at a series of international meetings to address changes in policy, regulations, oversight, and enforcement. The first was in November of 2008 here in Washington, D.C.

At that meeting, the leaders approved an action plan that included instructing their Finance Ministers to make specific recommendations in a number of areas. Some of the most important included: avoiding regulatory policies that exacerbate ups and

downs of the business cycle, reviewing incentives for risk taking and innovation reflected in executive compensation practices, and strengthening the regulatory scheme for credit derivatives and reducing their systemic risk.

The G–20's next meeting was in April 2009 in London. There the leaders focused on the issues of coordination and oversight of an international financial system with the creation of the Financial Stability Board. The Financial Stability Board is an extension of a previous international organization, the Financial Stability Forum, with an expanded membership to include all G–20 countries, Spain, and the European Commission.

Our three witnesses today are the United States' representatives to the Financial Stability Board, and I look forward to hearing their thoughts on this reinvented organization and how effective it will be in enacting change. Leaders of the London Summit also agreed to work on cross-border cooperation, closer regulation of banks, hedge funds, and credit rating agencies, and a crackdown on tax havens—all important issues.

Last, the United States asserted our leadership in these international economic issues by hosting the Pittsburgh Summit just last week. I am particularly interested in hearing from our witnesses on what was accomplished at the G–20 Summit in Pittsburgh on the international harmonization aspects of regulatory reform. Specifically, we would like to know the U.S. goals of the summit, if the objectives were accomplished, the roles played by the respective governmental witnesses, and the status of any proposals presented by the Financial Stability Board.

The conventional wisdom on international coordination is that at summits countries talk globally but afterwards act only locally. This hearing and the oversight our Subcommittee will conduct on this issue throughout this lengthy process is one way to ensure that the momentum is not lost. However, the work is not completely laid at the feet of the administration and our international standard-setting entities. Congress has some responsibility in this debate as well.

The biggest question for Congress is how much our regulatory modernization should be harmonized with international norms and standards and what we should do when there are conflicts on proposals that may not be consistent with U.S. interests or what Congress prefers. These are difficult questions. But I trust that my colleagues here in the Senate and the witnesses sitting before us today are willing to put in the work to make sure that we make the right decisions and get something done.

Let me close by reiterating how critical these efforts are to our global economic recovery and future success.

Last year, as Congress passed the Emergency Economic Stabilization Act, popularly known as TARP, I said:

> I am not a cynic, but I am a skeptic about the way Washington can work in times like these. Congress will act in a moment of crisis, but once it is abated, the sense of urgency will dissipate. The forces of reform will not have the energy that they have today. All the interests will circle this place like hungry birds looking for carrion in order to prevent us from taking the steps that are necessary. We must not let that happen.

Here we are a year later, and we must remain committed to seeing through long-term reform. We need to bring the same sense of urgency that was so palpable during the crisis.

And now before we hear from our witnesses, I would like to turn to my distinguished colleagues, and I would like to acknowledge the presence of our Ranking Member of the entire Banking Committee, my friend Senator Shelby. Senator, thank you for your presence.

Senator SHELBY. Thank you.

Senator BAYH. And I am not sure what the appropriate protocol is here, gentlemen. Robert, I had intended to turn to you, and it looks as if the Ranking Member agrees with that, so I will turn to my colleague Senator Corker for any opening remarks that he might like to make, although, Bob, I have been informed of something we call the Corker rule, which has to do with your unusual habit for a Senator of being very brief. So I do not know if you intend to invoke the Corker rule today or not, but you are not obligated to.

OPENING STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Listen, Mr. Chairman, I am looking forward to serving with you on this Committee, and I like working with you on numbers of issues. I am not fond of opening statements and not known for them, and I do not plan on changing that today. So thank you for coming as witnesses. We look forward to your testimony, and I do think our distinguished Ranking Member has someone in particular he wants to embellish, but certainly wisdom he wants to share with all of us.

So, Mr. Ranking Member.

OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. I believe I will stay with the Corker rule. By osmosis, you know, we are picking it up day by day.

But, Mr. Chairman, this is, I think, a very timely hearing and a very needed hearing dealing with international cooperation, dealing with our financial regulation, our accounting system, and everything that goes with it. So I look forward to today's witnesses.

Thank you very much.

Senator BAYH. Thank you, Senator Shelby, very much.

It is now my privilege to introduce our witnesses. Why don't I start moving from the panel's right to the panel's left, and I have very lengthy and detailed synopses of your very distinguished careers. I am going to dispense with that and just give your titles, and I will have the entire introductions entered into the record for those who are interested in the entire resume.

Senator BAYH. First, Mark Sobel. Mark is the Deputy Assistant Secretary for International Monetary and Financial policy in the United States Treasury Department. Mark, thank you for your presence, and we are well aware of how busy things are in the Department these days. And please thank the Secretary for his cooperation in making your presence possible here today.

Second, Commissioner Kathleen Casey. Ms. Casey is an SEC Commissioner and the SEC representative to the Financial Sta-

bility Board. Kathleen, thank you for your good work at the Commission, and I am grateful for your time here today.

Finally, we have the Honorable Daniel Tarullo who has been kind enough to appear before our Subcommittee before. Daniel, it is good to see you once again. He took office as a member of the Board of Governors of the Federal Reserve on January 28, 2009. You have had no lack of things to do since that time as well, Dan, so I am grateful for your insights and your testimony here today.

Thank you and, Mark, let us begin with you, Mr. Sobel. You might want to push the microphone—there you go.

STATEMENT OF MARK SOBEL, ACTING ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. SOBEL. It has been pushed for me. OK. Thank you.

Thank you for this opportunity to testify on international efforts to promote regulatory reform, especially following the Pittsburgh Summit.

Immediately after the start of the crisis, policymakers and regulators worldwide redoubled efforts to repair financial systems and put in place a stronger regulatory and supervisory framework so that a crisis of the magnitude we have witnessed does not occur again.

Good progress is being made, and much was achieved already through the Washington and London G–20 Summits. We strengthened prudential oversight, reached agreement to extend the scope of regulation, strengthened international cooperation, and have taken action to deal with jurisdictions that failed to commit to high-quality standards.

A fundamental objective of the Pittsburgh Summit was to build on these accomplishments. Leaders agreed on four priorities:

Capital. They agreed to develop rules to improve the quantity and quality of capital and to discourage excessive leverage by end 2010. This agreement tracks closely with Secretary Geithner's principles issued earlier this month.

On compensation, leaders endorsed the implementation of standards to help financial institutions and regulators better align compensation with long-term value and risk management. National supervisors will impose corrective measures on firms with unsound practices.

On OTC derivatives, they agreed that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms and cleared through central counterparties by end 2012. Non-centrally cleared contracts will be subject to higher capital requirements.

On cross-border resolution, they agreed to strengthen domestic resolution frameworks and that prudential standards for the largest, most interconnected firms should be commensurate with the costs of their failure.

Leaders also called on international accounting bodies to redouble efforts to achieve a single set of high-quality, global accounting standards.

Firms are now global in scope, as you noted, Mr. Chairman, and we derive benefits from open, interconnected markets. But the cri-

sis highlighted that financial duress can spread quickly across national boundaries. And while the responsibility for sound regulation begins at home, different national standards open the possibility for regulatory arbitrage, gaps in oversight, and a race to the bottom. International cooperation is essential to avoid these pitfalls.

Throughout the crisis, standard setters and other bodies, in addition to the G–20, have helped in this effort. But one body, the Financial Stability Board, has played a critical role in promoting international financial stability. Founded as the Financial Stability Forum in the aftermath of the Asia crisis with strong U.S. support, it brought G–7 officials together with key standard-setting bodies. At the outset of the crisis, the G–7 asked the forum to analyze the causes of the crisis and provide recommendations to increase the resilience of markets and institutions.

Those recommendations have been at the center of the international consensus on how to overhaul the world's financial regulatory system. In April, with strong U.S. backing, the Financial Stability Forum was reconstituted as the Financial Stability Board, with an enhanced mandate and membership now encompassing all G–20 countries.

The FSB has been a key venue to prepare for G–20 leaders summits. I have provided greater detail in my written testimony on the FSB's purposes and functioning.

In the United States, we have set out a proposal for comprehensive regulatory reform, but to promote a global race to the top, we need our G–20 partners to be equally ambitious.

The three institutions we represent have worked closely together in preparing for FSB meetings. In addition, U.S. regulatory officials are heavily involved in setting the agenda for international standard setters. This strong cooperation between U.S. and international officials is reflected in the closely aligned agendas pursued by the FSB in the United States and has allowed us to forge more consistent global standards in line with the U.S. agenda.

As part of our work to help ensure a cohesive national vision at the international level, U.S. officials also coordinate through the President's Working Group on Financial Markets and at a working level conference calls hosted by Treasury with U.S. regulators to discuss implementation of the G–20 leaders and FSB work.

Looking forward, consistent national implementation throughout the G–20 will increasingly be our focus. The FSB will be an important forum to assess progress.

Despite our achievements, much more remains to be done. Some of the flaws in the U.S. financial system and regulatory framework that allowed this crisis to occur are still in place.

In conclusion, the United States has led the effort to create the FSB, shape its agenda, expand its membership, and involve it closely in the G–20's work. In turn, the Financial Stability Board has been a key instrument for policy development. We can be confident knowing that the machinery to strengthen the international financial system is in place and has set forth principles for reform that are consistent with the administration's own plan.

Again, thank you for having me here today.

Senator BAYH. Thank you, Mr. Sobel.

Ms. Casey.

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

Ms. CASEY. Chairman Bayh, Ranking Member Corker, and members of the Committee, thank you for inviting me to testify about the international cooperation to modernize financial regulation.

I am very pleased to have the opportunity to testify on behalf of the Securities and Exchange Commission on this very important topic. International cooperation is critical to the effectiveness of financial regulatory reform efforts. In reaffirming their commitment to strengthening the global financial system, the G–20 Finance Ministers and Bank Governors recently set forth a number of actions to "maintain momentum [and] make the system more resilient."

The G–20 banking statement correctly recognizes that, due to the mobility of capital in today's world of interconnected financial markets, activity can easily shift from one market to another. Only collective regulatory action can be effective in fully addressing cross-border activity in our global financial system.

As an SEC Commissioner and Chairman of the Technical Committee of the International Organization of Securities Commissions, I bring the perspective of both a national securities market regulator and a member of the international organization charged with developing a global response to the challenges posed to securities markets by the financial crisis. I also represent the SEC and IOSCO in the Financial Stability Board, where the U.S. representation is led by the Department of Treasury, with the Securities and Exchange Commission and the Federal Reserve Board both serving as members.

The financial crisis has made it clear that there are regulatory gaps that we must address. The Commission has recently proposed action to this end in a number of different areas, recognizing, however, that some regulatory gaps and market issues cannot be fully addressed without legislative action. The SEC already is working to achieve consistency on the domestic and international levels, including through IOSCO and the FSB, with banking, insurance, futures, and other financial market regulators. The Commission also is working to ensure respect for the integrity of independent accounting and auditing standard-setting processes in the global regulatory environment. This is essential for the benefit and protection of investors.

The Commission has worked actively to achieve consistency in regulatory policy and implementation on an international basis through multilateral, regional, and bilateral mechanisms for many years. The SEC was a founding member of IOSCO and has maintained a leading role in the organization. The Commission's commitment to international cooperation has become increasingly important to its mission in recent years in response to the increasingly global nature of financial markets.

In addition to my chairmanship of IOSCO's Technical Committee, Commission staff leads or is very active in IOSCO's standing committees and task forces, as well as many other multilateral organizations.

While IOSCO represents the primary vehicle for development of common international approaches to securities market regulation,

the Financial Stability Board is another key mechanism for the Commission to engage internationally on broader financial market issues. The Financial Stability Board has a broader scope, with membership comprised of national regulatory and supervisory authorities, standard-setting bodies, and international financial institutions, central bankers, and Finance Ministers. Its mission is to address vulnerabilities and to encourage the development of strong regulatory, supervisory, and other policies in the interest of financial stability.

In addition to multilateral global engagement, the Commission participates in regional and bilateral mechanisms for discussion and promotion of common approaches to regulation, such as our engagement in a number of Treasury-led regulatory dialogues, including with the European Commission, Japan, China, and India, as well as with Australia and our North American partners, Canada and Mexico.

Securities-regulatory-focused dialogues between the Commission and our counterpart securities regulators in these and other jurisdictions also complement these broader financial sector dialogues. Recently, the Commission and a number of other securities regulators have also entered into bilateral "supervisory" memoranda of understanding that go well beyond sharing information on enforcement investigations. These supervisory MOUs represent groundbreaking efforts by national securities regulators to work together to cooperate in the oversight of financial firms that increasingly operate across borders.

As these efforts suggest, the infrastructure for international cooperation on securities regulatory policy is well developed, and the Commission plays a key role in promoting rising levels of cooperation and building on our successes in raising standards of cross-border enforcement cooperation. Today the SEC has broad authority to share supervisory information as well as to assist foreign securities authorities in their investigations through various tools, including exercising the SEC's compulsory powers to obtain documents and testimony. In order to facilitate international cooperation, the SEC supports legislation providing authority to the Public Company Accounting Oversight Board, which the SEC oversees, to share confidential supervisory information with foreign counterparts. The Commission believes that granting this authority to the PCAOB would enhance auditor oversight, audit quality, and, ultimately, investor protection.

In closing, the Commission looks forward to continuing the ongoing constructive dialogue with our colleagues at the Fed, Treasury, and other agencies, in developing common U.S. position on international cooperation in the future.

While the Commission's particular focus—and that of IOSCO on investor protection and efficient and fair markets has remained constant and somewhat distinct from that of banking supervisors and regulators of other market segments, our recent collaborative work, both at home and internationally, continues to enhance our ability to identify and address systemic risks across the world's financial markets and will be central to efforts to strengthen the global financial regulatory system.

Thank you again for the opportunity to testify, and I look forward to taking your questions.

Senator BAYH. Thank you, 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 Ranking Member Shelby. As Chairman Bayh noted, in less than a year we have had three G–20 leaders meetings at which financial stability was either the sole subject or, as in Pittsburgh last week, one of the most important subjects.

During this period, the Financial Stability Board has emerged as an important forum for identifying, analyzing, and setting in motion coordinated responses to the financial crisis and to regulatory gaps and shortcomings.

There is much promise in what is now a lengthy agenda for the Financial Stability Board and the many other important groups intended to foster international regulatory cooperation. But there is also some risk that progress will get bogged down or that the negotiation of standards or recommendations in a particular area will become an end in itself.

Needless to say, it is essential to ensure that well-devised standards are implemented effectively by all participating countries and that problems revealed during this implementation are cooperatively addressed and changes made.

As we look ahead from Pittsburgh and all the international meetings that preceded it, I would offer a few thoughts on how we should proceed from here.

First, it is important for the U.S. representatives to the FSB and other groups to focus on the topics and initiatives that we believe are most significant for promoting global financial stability and that are also susceptible to practical international cooperative action.

My prepared testimony covers a number of these areas, but I would like to draw particular attention to the emphasis of the G–20 leaders on improvements to capital requirements, which is both an appropriate and critical emphasis.

Second, we will need to work with our counterparts from other countries to rationalize the activities of the many international organizations and groups whose mandates involve financial stability. While overlap among these various institutions can sometimes be useful in fostering alternative ideas and approaches, uncoordinated duplication of effort can be inefficient and sometimes even counterproductive.

A third and related point is that the expansion of both membership and mandate in certain of these international groups will require changes in operating procedures in order to maintain some of the advantages these groups have had.

Fourth, while the financial crisis has understandably, and appropriately, concentrated international energies and attentions on the new standards that will be necessary to protect financial stability, we must guard against these fora being transformed into exclusively negotiating entities. One of the virtues of the original Finan-

cial Stability Forum was that is provided a venue for participating officials to exchange views on current developments and problems in a relatively unstructured fashion that provided at least the potential for new ideas to emerge.

Similarly, a number of the international standard-setting bodies, such as the Basel Committee on Banking Supervision, traditionally provided a venue for senior supervisors to understand the perspectives of their foreign counterparts and at times to develop shared views of common supervisory challenges, quite apart from the negotiation of new international standards.

These other purposes of international financial regulatory groups are, in my view, useful both as ends in themselves and as mechanisms to reinforce the implementations of the standards previously promulgated by these groups.

Thank you, Mr. Chairman. I would be pleased to answer any questions you or your colleagues may have.

Senator BAYH. Thank you, Mr. Tarullo, and thank you to the other panelists. Why don't I work in reverse order and start with you.

On the issue of systemic risk, experts point out that the regulatory reform discussion during the summit meetings has still been fairly vague on critical and complex issues, like systemic risk, cross-border resolution authority, and what to do about derivatives. However, the political hot button issue of executive compensation seems to have been more on a fast track.

My question is: What do you think we can end up doing on the issue of systemic risk, which gets to the heart of the problem that we face? And will we have more than just—and I understand there is a lot going on. It is a full plate. These things take time. But do you think we will end up with something more than unenforceable, you know, vague standards this time? Or can we look forward to something more specific with some real enforceability to it?

Mr. TARULLO. Well, Mr. Chairman, I think the agenda responding to systemic risk is in some sense the biggest part of both the FSB's agenda and much of what the G–20 said. So it is not any one initiative. I would say that the elements of that agenda, internationally as domestically, are mutually reinforcing. So with respect to higher capital standards, for example, I think both higher capital standards applied to existing international agreements and new ideas about how to take steps that contain systemic risk are going to be equally important. The agenda for strengthening capital standards is well underway. There has been some progress already. I think the G–20 Summit is going to catalyze some more progress.

Senator BAYH. Is this difficult for the Europeans, given the condition of several of their financial institutions?

Mr. TARULLO. Well, I think it is going to be a challenge for most countries because we are talking about significant increases in capital over time. I think you probably noted that the G–20 leaders want to move forward with the agreement on tighter, stricter, more robust capital standards now, but the implementation of those standards is presumably going to take place as the financial institutions themselves strengthen.

I think that with respect to some of these newer ideas, one I would draw your attention to is that of contingent capital requirements for large institutions. I think that is an example of where we in the United States have an opportunity to exercise some leadership to produce some good, innovative ideas that will bring market discipline and some protection for taxpayers to each of these very large financial institutions. And so I think that is one of the reasons why we and our colleagues have been promoting those ideas internationally and hope we see some progress on it.

Senator BAYH. Mr. Sobel, or any of the three of you, the topic of derivatives came up several years ago and you mentioned that there have been some general statements in the Pittsburgh gathering about the importance of moving forward on this. The response that we always got previously to this was, well, if you regulate these instruments more closely in the United States, we will just take the business offshore and the risks will be run. It is just that there won't be the employment in the United States. So it is kind of a lose-lose situation. Do you think we will come up with something more specific and enforceable this time to prevent that kind of forum shopping?

Mr. SOBEL. I think one of the main points I wanted to emphasize today is that I think that there is real solid agreement in the G–20, in the FSB, certainly among the main players, certainly in the standard-setting bodies, such as the Committee on Payments and Settlement Systems, to really tackle these issues to make significant progress on them. So I think that the agreements that we have reached, for example, in Pittsburgh, there is a good paragraph there about our agreement on over-the-counter derivatives markets. I think it is a very firmly rooted and earnest agreement. There was no debate about it on the table, and the CPPs are beginning to get up and running. There is business happening on those exchanges.

So I am confident that we are going to push forward. Secretary Geithner has had a personal and strong interest in this area dating back several years to when he was President of the New York Fed to bring transparency and greater data collection to this effort. So I am confident that we are going to push forward in this area.

Senator BAYH. Well, I am confident of the Secretary's interest in this issue, as well, and his good faith efforts. I am a little more concerned about some of the other global players and would ask you, particularly in the area of derivatives, is there an enforcement mechanism for the standards that are going to be hopefully a consensus formed around? What will the role of the IMF be? The IMF is a wonderful institution. I have great respect for them. But historically, in some areas, they don't really have much of a way to enforce some of their authorities.

Mr. SOBEL. The way I see the answer to that question, Mr. Chairman, we are going to work together really hard with——

Senator BAYH. And I had currency manipulation in mind, not—when they have loaned money to countries, they do have leverage there. But in some other areas—and they can make pronouncements, but moral suasion doesn't seem to be enough in some cases.

Mr. SOBEL. In terms of making progress on OTC and this enforcement question that you have raised, the way I see the answer

to that question—and it is not just the OTC area, it pertains to other areas—is that we are going to work together really hard. We are going to work through the standards-setting bodies. We are going to work through the FSB to raise standards, to seek agreements. And then taking the standards, it is a question for national supervisors to implement while continuing the cooperative efforts that we are building.

So ultimately, I see enforcement as having to happen at the national level, but we need to use the FSB to make sure that everybody is on the same page and that we are marching forward together.

Senator BAYH. We will have multilateral standards but national enforcement. That may be the best we can come up with, but that does raise the prospect of different jurisdictions taking different levels of zeal in enforcing these things, which gets us back to the problem of forum shopping and regulatory arbitrage and all that kind of thing. Is this just a dilemma that we can only hope to limit but never completely eradicate?

Mr. SOBEL. In my view, we live in a world in which regulation is a national-based activity, but we do have global markets, as you were outlining in your opening statements. I think the question is, how do we bring these forces together?

My answer is, one, I think the United States, and the Secretary in particular, are exercising a great deal of leadership. The FSB agenda, I think, is aligned very much with our principles for regulatory reform. You see that very clearly in the agreements reached in Pittsburgh on capital.

Second, I have talked about the effort to raise standards. Again, I think this is a strong international commitment. I think leadership committed to it. I think that is going to put extra backbone to the effort. This is definitely the case with respect to the systemically significant firms, to make sure that they operate under a tougher regime.

You know, one area where we are always—the subject of gaps comes up relates to, for example, the non-cooperative jurisdictions. And here, I think the Secretary in March, just after assuming office, put forward a three-pronged approach to basically raise standards in the prudential tax information exchange and anti-money laundering effort, and this was a major aspect of the April summit. Since then, you have seen substantial progress. You have seen many tax information exchanges signed around the world.

We have put in place a process through a global forum, an OECD body, to develop carrots and sticks, which will be announced in March 2010. And similarly, we are working through the FATF processes and a new FSB process to raise adherence to standard by all jurisdictions. So I think that when you raise this question about gaps and arbitrage, you are putting your finger on a definite issue, a totally legitimate issue, and as you said, it is not an easy one to deal with, but we are bound and determined to do our best and we have our eye on the ball.

Senator BAYH. Thank you. I am going to turn to my colleagues now. They have been most patient. I just observe, I very much appreciate the focus of the Secretary, the hard work that is being done in the Department. I know this is a very difficult diplomatic

issue. We have made some progress here and in some other tangentially related areas. The Swiss are beginning to perhaps change some of their practices with regard to tax avoidance and that sort of thing, but it is a challenge we face when nation states enforce the rules but the consequences of their lack of diligence and enforcement go way beyond the border of those nation states. And given the experience we have just come through, heaven help us if we permit a repetition. But I understand it is a very difficult issue.

Senator Corker?

Senator CORKER. Mr. Chairman, thank you, and thank you for your testimony. I think it is great that the G–20 is working together on so many of these issues. I think it will be interesting to see whether, as time moves on, this solidifies or sort of fragments, which I think could be a challenge as you move ahead.

One of the issues that has been mentioned is just the whole procyclical nature of the way that we deal with our financial markets. I think it is interesting, Mr. Sobel, that you shared that as one of the issues that you all are working on, obviously, at the G–20. Here in our country, I think as history records what is happening right now, it will say, as it has in the past, that the herd mentality took over and that our regulators helped create, in many ways, a self-fulfilling prophecy. I think that is happening right now as really insane things are being asked at the local markets by regulators because of their concern about various types of credits. Obviously, when the market is rising, everybody levers up against appreciating assets.

What is it that is being looked at—I would say the first thing we need to do is look at home. I think the OCC is in many ways creating far greater problems in our country than would otherwise exist. I don't think it, I would bet on that in major ways. But what are we doing at the G–20 level to focus on the whole procyclical nature of the way regulators work? They exacerbate bubbles and exacerbate problems.

Mr. SOBEL. Let me lead off, and if any of my colleagues, on the basis of their work, would like to amplify, I will turn the floor to them.

I would say in the G–20 context, the main area of discussion relates to capital, the capital area. So, in essence, there is a feeling, obviously, that we didn't have enough capital in the system, but there is also a belief that banks should have more capital, that they should be able to draw down their capital in bad times. So there is a lot of work that is being now undertaken in the Basel Committee which has been referenced in the Pittsburgh Summit communique about establishing countercyclical buffers of capital.

There are obviously broader macroeconomic questions you raise that lie more in the domain of other institutions than the Treasury. But again, the main focus has been on the countercyclical cushions. I don't know if any of my colleagues would like to——

Senator CORKER. So as the markets are rising, more capital is required, and as the markets are declining, less capital——

Mr. SOBEL. Yes, sir.

Senator CORKER.——the opposite of what we are doing right now in our country.

Mr. SOBEL. Yes, sir.

Senator CORKER. Well, let me ask you this, just out of curiosity. Why would we talk about this theory to save the world and yet not put it in practice today in our country? I am just curious. And maybe others might want to jump in.

Mr. TARULLO. Senator, a couple of things. First, I think your identification of procyclicality is right on target. In my observation, problems of procyclicality pervade the financial regulatory system, and indeed they pervade financial practice. At some level, Senator, financial regulatory capital requirements of any sort are themselves procyclical, because when you think about it, if you have a capital requirement and a bank is taking losses because of a downturn in the economy, then all of a sudden, their capacity to lend has been reduced.

I think what we saw in the run-up to the financial crisis was excessive procyclicality in financial regulation more generally. As Mr. Sobel has said, we definitely saw it in capital requirements. And one of the concerns that I had long before I arrived at the Federal Reserve was that some of the new kinds of capital requirements that were being thought about would increase procyclicality.

Second, and Commissioner Casey may want to address this, accounting standards can be procyclical, and that is why her committee and the activities of the FSB on accounting have focused on that, as well.

Third, even things as widely accepted and necessary as deposit insurance premium structures can be procyclical. If you are allowing lesser or no payments during good times, that puts you in a situation in which in bad times, the FDIC is in a very difficult position as the deposit insurance fund declines. So I think this is something we have got to think about across the board.

Now, to your question of, well, if it is such a good idea, how come we are not already doing it? Let me give a two-part answer to that. First, it is a really attractive concept. In good times, banks have to buildup more capital, and as times aren't so good, they have to draw it down. But as you know, there is often a considerable distance between a really attractive concept and something which is technically feasible and which we know is not going to produce unintended consequences.

So a lot of the activity right now, both in the Basel Committee and among the bank regulatory agencies here at home, has been an effort to come up with the right kind of calibration so that we do have the effects that we want to have in countering the traditional procyclicality while not doing more harm along the way. And this is really an integrated effort at this point because I think we would want to see major financial institutions in other countries do it at the same time that our institutions do.

Ms. CASEY. To just follow up on Dan and Mark's points with respect to the procyclicality focus of the G–20 and the FSB, as Dan mentioned, there is no question that, I think, accounting standards have been a key focus of concern with respect to how they might contribute to procyclical effects on the system, and I think that much of the work that was done in the FSB was largely focused on valuation and leverage questions, as well as looking at existing

accounting standards and practices with respect to loan loss provisioning.

And just as a more fundamental matter, if I could just step back with respect to accounting, I think from a securities market regulator perspective, one of the key issues that has been raised in this debate about procyclicality is also appreciating the role of accounting standard setting and the purpose of financial reporting, and I think that what we have found is that while there may be legitimate concerns about what the intersection is between accounting standards and capital, capital adequacy issues, at the same time, it is quite important from an independent standard-setting perspective, and again, the purpose and focus of financial reporting remain focused on the interest of investors. So that has been a key interest that we have brought to the table.

But that being said, I would say that with respect to our work on provisioning, myself and John Dugan, the head of the—the Comptroller of the Currency, headed up a working group within the Financial Stability Board aimed at looking at existing provisioning practices and standards, which currently rely on an incurred loss model, to give consideration to whether or not—what impact they do have on procyclicality, whether or not within existing standards there are ways to mitigate that, and then, alternatively, whether or not more forward-looking or alternative models might address procyclicality while also ensuring that an investor interest in terms of getting timely, relevant, decision-useful information could be met.

And what we found through our work was that you actually had an interest of both investors as well as prudential regulators in perhaps looking at alternative models that were more forward-looking in terms of identifying credit losses more early in the cycle. And so some of the recommendations that came out of that work stream was intended to encourage the standard setters to look at a variety of different models that would be more forward-looking, including expected loss, dynamic provisioning, and fair value, and that is part of the effort that the standard setters are currently engaged in.

But again, just to reinforce, I think that that is an instance perhaps where you have an intersection of interests, where both investors and the interested prudential regulators and broader interested financial stability could potentially be met.

Senator CORKER. Thank you.

Mr. TARULLO. Senator, excuse me. I think the Commissioner is excessively modest here. Her role in trying to move some of these questions forward——

Senator BAYH. That is unusual in Washington, D.C.

[Laughter.]

Mr. TARULLO. Her role in trying to move some of these questions forward productively in the FSB, I think has really been critical to getting more of a convergence around some of the very troublesome problems in accounting.

Senator CORKER. Thank you.

Senator BAYH. Senator Shelby?

Senator SHELBY. Thank you, Mr. Chairman.

Commissioner Casey, the Commission has proposed what you call the road map for the potential use of financial statements that were prepared in accordance with the International Financial Reporting Standards as issued by the IASB, the standard-setting body that you well know exists in London. Given the tremendous impact of accounting standards in our financial system, are you or any of your Commissioners at the SEC concerned that IASB's independence and objectivity could be compromised? Has that been discussed?

Ms. CASEY. Thank you, Senator. Sort of to step back to one of the key objectives or goals of G–20 leaders is convergence of accounting standards and the development of a single set of high-quality international accounting standards, and as part of that effort to achieve that goal, you have efforts by both the IASB, the International Accounting Standards Board, and the FASB to try to reconcile where it would improve the standard, reconcile differences between U.S. GAAP and IFRS, and where either standard is lacking, trying to come up with a better converge standard.

They have been engaged in this effort for the past several years and I think that much progress has been made. I think over the course of the past year, however, there has been a tremendous amount of pressure placed on standard setters with respect to certainly issues of the appropriate use of fair value, mark-to-market concerns, and I think that what we found as a result of that is that it has placed some question about political pressure brought to bear on these standard setters.

That being said, I think that despite that, I think both standard setters remain committed to their best efforts to achieve convergence on key projects, such as the Financial Instruments Project, and I think that as part of that effort, there is no question that the credibility of that process is going to be vital, and I think particularly for here in the United States, where the United States is giving consideration to whether or not we should allow U.S. issuers to use IFRS. And I think central to that will again be confidence in the independence and the credibility of the standard setting process.

Again, I think that from the SEC's perspective, we remain committed to supporting both standard setting bodies in their efforts. We remain committed to achieving a single set of high-quality international accounting standards. And I expect in the coming months that the Commission will speak more clearly about the next steps for contemplating potential user adoption of IFRS in the United States for U.S. issuers.

Senator SHELBY. Has the SEC staff considered, to your knowledge, or seen a particular financial statement prepared under the rules of the international standards as opposed to FASB, and how do they work? You are looking for equivalence, aren't you?

Ms. CASEY. You know——

Senator SHELBY. How do they work together?

Ms. CASEY. There have been a couple of mechanisms we have to take confidence in the application of IFRS and the rigor with which IFRS is being adopted. Certainly, our staff looks at filings of foreign private issuers who currently are allowed to file in IFRS, and

so that gives us a very good sense of the quality of their reporting in IFRS.

We also have an important workstream underway with the European securities regulators which was undertaken—I think it is actually one of the good examples of bilateral cooperation that we have had, where both the SEC and the CESR have undertaken to look at both the quality and the application of both U.S. GAAP as well as IFRS for large financial institutions that are registered with the SEC and also file in IFRS. And I think that those efforts are going to give us the opportunity to take greater confidence with respect to the state of IFRS and its application in a very company-specific way, and I think, ultimately, that will also assist us in taking judgment as we look to roadmap questions about implementation of IFRS more generally.

Senator SHELBY. Governor Tarullo, you noted that the Basel Committee, and this was referenced already in a sense, has been working on recommendations to improve the resolution of international banking organizations. As banking becomes increasingly global, the U.S. financial regulatory structure, I believe, needs to make sure it can adequately handle the failure of banks operating globally.

What are some of the problems with resolving large international banking organizations? And other than the Obama administration's proposal for a new resolution authority, what changes should be made to make it easier for the United States and other countries to resolve large international bank failures, for example?

Mr. TARULLO. Thank you, Senator. Let me reemphasize the premise of your question, which is that resolution is very much of a challenge. Let me step back for a second and suggest why it is such a challenge, even more than a lot of the other areas we are talking about.

If we want to make changes in capital standards and the FSB gets together and we converge around a set of changes, we all have ample domestic legal authority under our own constitutional structures to go back and make those changes. In the area of resolution, of course, we are talking about bankruptcy law. We are talking about bank insolvency law under the FDI Act, things that the Congress and parliaments around the world have put into legislation. So here, each country has its own set of legal rights and priorities for creditors. We have our own set of laws on what constitutes a fraudulent conveyance, for example. We have our own set of practices as to what kinds of creditor adjustments can be made during a bankruptcy or resolution procedure.

So, from some people's point of view, the first best or at least the cleanest solution would be one that would have to harmonize the bankruptcy and resolution mechanisms and laws all around the world——

Senator SHELBY. And that is no easy task.

Mr. TARULLO. I think even to state it, Senator, suggests the difficulty, and when I talked in my opening statement about practical, this is one of the things I had in mind. Let us be practical when we are trying to move resolution forward.

So here is what I think we can do. First, I think it is important that each country that has major financial institutions have at

least a legal structure that creates the possibility for cooperative action for a failed or failing large financial institution. So here at home, that would mean a resolution mechanism for non-bank large financial institutions. And obviously, you are already thinking about that.

Second, there are some things that can be done short of a binding international treaty or harmonization of insolvency regimes to get us closer to the point where we can handle these things better, at least, than they have been in the past, and here are the three things that I think have been the most promising.

First, the contingency plans. Now, some people have referred to these as living wills or death plans for the company. You know, the basic idea is that each of the big firms would have to spell out how it could be wound down in the event of a crisis.

Senator BAYH. I think we need to ensure that the record shows, Governor, that the death plans have nothing to do with the health care debate.

[Laughter.]

Mr. TARULLO. I am not going there, Senator.

Senator BAYH. Thank you.

Mr. TARULLO. That is a different committee——

Senator BAYH. I just wanted to be clear.

Mr. TARULLO. That is right.

Senator SHELBY. Not yet, anyway.

[Laughter.]

Mr. TARULLO. I prefer to think of them somewhat more broadly. I think that a contingency plan required of each major financial institution can do three things: One, it can be a very good supervisory tool, because when Lehman Brothers failed, Senator, it had almost 3,000 legal entities under it. So when people thought about resolution, the challenges were enormous to even figure out where are the vulnerabilities——

Senator SHELBY. Were they too big to regulate?

Mr. TARULLO. Well, I do not know. If they had been subject to mandatory prudential regulation, one hopes that this would have been brought into mind.

Senator SHELBY. OK.

Mr. TARULLO. So one thing you can do, you try to use their planning to get a rational, well-understood relationship among their subsidiaries and, indeed, make sure that you have legal entities aligned with business lines.

Second, I think that the plan itself can be one that helps save the firm. If they know where their vulnerabilities and exposures lie and where the cross exposures lie, then as things begin to deteriorate, they are in a better position to act. And one thing we all learned during the crisis was that many firms really did not have a good handle on their own exposures, their own vulnerabilities.

Third, if ultimately the firm is not able to survive, the planning may indeed have the salutary effect of helping the supervisors do a more rational job of resolving.

Very quickly, the other couple of things I think are probably worth doing internationally are, first, expanding the scope of the so-called supervisory colleges to do some planning for bad things

happening, the kind of information flows that different countries would need to know where the capital problems may lie.

And, finally, I do think it would be worth the effort to try to get some standardization of a lot of the big contracts that go back and forth internationally. So, for example, termination clauses in various forms of financial contracts, if they were standardized so that each country was looking at the same contractual terms, it would be easier for officials in one nation to think about how they are going to deal with those problems.

So I will not for a moment promise you that that solves the problem, but I think it is a practical agenda for moving us forward.

Senator SHELBY. Chairman, could I ask one more question?

Senator BAYH. Of course.

Senator SHELBY. Credit rating agencies. Commissioner Casey, you mentioned in your testimony—is IOSCO how you say it? Is that right? IOSCO has refined its code of conduct with respect to credit rating agencies in response to the financial crisis. You have been a strong advocate for removing the Government's stamp of approval from the NRSRO ratings.

My question is: Do you believe that if the SEC took meaningful steps to address reliance on ratings in its rules, this would help other countries to seriously consider doing the same thing? Because we are talking in an international context.

Ms. CASEY. Thank you, Senator. I believe that there is no question that many other jurisdictions, including the United States—and I would even note that the administration's plan notes regulators should look to reduce reliance on ratings wherever possible. But other jurisdictions as well have highlighted this as something that deserves particular attention in light of what we saw through the crisis that came from an undue reliance on the part of investors and markets on ratings. And I think for the SEC in particular, it is an opportunity for us to—and the Commission is currently considering removing—in fact, we have just removed several references in our last rulemaking, recognizing that we still have some daunting challenges with the tough ones, particularly with respect to money funds and then capital references.

With that being said, I think that there is no question that I think for the markets and for investors, if we are going to promote the kind of necessary credit analysis that does not necessarily rely on ratings judgments, that I think removing the regulatory imprimatur would be an important step in that respect.

I think also that as a result of the ratings references that we have had in our rules, we have played an important role in creating essentially the oligopolistic structure that has dominated and exacerbated the weaknesses and——

Senator SHELBY. In other words, no competition.

Ms. CASEY. No competition. And so I think that what you see is that with the removal of references, it removes that imprimatur and that franchise. It encourages hopefully the right incentives in the market. And I think it complements any kind of regulatory oversight that certainly the SEC has already undertaken pursuant to the law that was drafted in this Committee and passed by the Congress. And I think that there is a recognition that if we were to take those formative steps, longer term we would have prob-

ably—we would have much better quality and integrity in ratings than if we were to continue to rely on the regulatory uses that we see in our rules right now.

Senator SHELBY. Thank you, Mr. Chairman.

Senator BAYH. Thank you, Senator Shelby.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. You are most generous today.

Before the G–20 summit, Chairman Bernanke came out with a principles-based compensation process where, instead of looking at firm caps, nominal numbers like French and other governments were doing, he did that, I think, because you all are in a political sphere as it relates to this G–20, and you each need to influence each other. But, Mr. Tarullo, was he successful in sort of getting that mantra going, a principles-based focus? Or as you all left Pittsburgh the other day, were there still countries looking at an actual amount, a nominal cap on compensation?

Mr. TARULLO. Senator, a little bit of history here may be useful. In the spring, the Financial Stability Board came out with its set of principles on incentive compensation, and we, meaning the United States, but specifically the staff from the Federal Reserve, have been very closely involved in the articulation of those principles.

At that time, we began internally our process of thinking about how we would want to give guidance to the institutions we supervise to implement those principles. And the press reports which people saw a couple of weeks ago reflected, more or less accurately, the direction in which we are headed. The Board has not actually voted on the guidance yet, but it reflected accurately the direction in which we are headed. And that direction is one which, as you say, emphasizes that there is not a single formula that is sensible for all kinds of employees who have the capacity to assume a lot of risk for their enterprises in a variety of different companies.

So our approach, I think, has been to want a rigorous internal process in firms in which the onus is on them to develop the right kinds of compensation contracts and provisions, taking into account their particular business and the kinds of responsibilities their employees have, but that those specific policies and practices need to be consistent with the overall goals of risk-appropriate incentive-based compensation.

We worked on that and continue to work on it, but we worked on it through the spring and the summer, knowing what kinds of discussions were going on internationally as well. I think that our view has been that the direction in which we are going is completely consistent with the FSB principles of last spring, and I think if you look at the final FSB report which was referenced by the leaders this fall, that there was not a mandating of particular formulas applicable to all employees. It is, once again, an emphasis on the goals to be served, and I think you will see that our guidance, when it does come out, will be consistent with those principles.

Senator CORKER. The resolution mechanism—I know that our distinguished Ranking Member brought it up a minute ago—many of us—and, thankfully, Paul Volcker has been vocal lately and

talked about the "too big to fail" category just should not exist. And I know that, you know, there have been discussions about whether there was or was not a mechanism in place when we started all of the things with did with TARP because maybe there was not an orderly way to resolve a highly complex bank holding company.

So I know the administration has put forth a proposal that I think is exactly the wrong direction to go, but the fact is there is gaining momentum, I think, around actually having a resolution mechanism that says when an institution fails, it actually fails, and there is a process through which they go. They are not conserved and new life breathed into them with taxpayer money.

If that type of solution prevails—and I hope that it does—what does that do as it relates to the international systems and the fact that there are different laws in different countries? You know, we may have a large entity here that obviously has subsidiaries all around the world. Talk to us about some of the complexities that might exist if that type of mechanism were put in place.

Mr. TARULLO. Senator, I think that you will have complexities with or without the mechanism, but they will be of a somewhat different sort, and my instinct would be that the complexities with the mechanism in place here will be more manageable than under the status quo.

Senator CORKER. Where they actually go out of business?

Mr. TARULLO. No, it is not that so much. It is just that the way I have thought about this is we really need a third alternative, somewhere between bailout and bankruptcy—or an uncontrolled bankruptcy, I should put it, a "disorderly bankruptcy," as it is called. And that, it seems to me, should be the starting point for thinking about a resolution mechanism.

Now, with respect to the complexities, for the reasons I indicated earlier, there is not going to be—and Senator Shelby's intermediate question I think emphasized that—an international treaty that says everybody has the same resolution mechanism, certainly not anytime in the foreseeable future. So there will be some potential discontinuities between the systems in each country.

But I think a resolution mechanism can provide tools to each national government that could allow a more orderly or less disorderly resolution of a failed institution. For example, it may permit the creation of a bridge bank. It may create the possibility for dividing into a good bank or a bad bank, where right now you do not really have the legal capacity to do that.

In your words, there will be complications and complexities because the rules may still be somewhat different elsewhere, and there may be assets located in other countries that you are not sure can be subject to the same legal treatment. But I think it gets you at least a step down the road.

And, again, keeping in mind that the domestic or overarching purpose, this ought to be as an element of a broad-based response to the problems of moral hazard and too big to fail. So we need multiple instruments, I think, to contain moral hazard, and that means that a resolution mechanism should be moving us toward more market discipline, not less market discipline.

Senator CORKER. Any comments by the other witnesses?

[No response.]

Senator CORKER. A very complete answer. I will say—and I know this is the end of my time here. I can tell by the body language of our Chairman.

Senator BAYH. Take your time.

Senator CORKER. But the procyclical issue, it sounded to me that the answers, which I very much appreciate were thoughtful, really do not come to a conclusion; that as you try to avoid, you know, an unnecessary steaming up of the economy, there are issues there as to what is happening right now. I mean, I think we are unnecessarily driving it into the ground. We talk about Main Street all the time. I do not even like that kind of terminology, and I cannot believe I let it come out of my mouth, where you separate the two because it is all intertwined. But the fact is that at local levels around our country today, there is no question that banks are doing things that are not in their best interest, and they are being driven there by regulators and a herd mentality. I mean, they are doing things that happen every time these cycles occur. There are absolutely ignorant things that are being done. They are hurting shareholder value. They are hurting their communities. And it is being driven by regulators who—you know, it is kind of like you yell "Fire" and everybody leaves. You yell "commercial real estate" or you yell some kind of—and everybody—it is the same exact thing that happens in every cycle. And yet I have not heard a response—I am not criticizing you. I have not heard a response as to how to deal with that other than maybe the regulators acting sensibly. But I do not know how you put that in a formula, if you will, and then try to cause that to occur.

And that is just one example. There are all kinds of procyclical issues, I understand. But I think that is going to be maybe the most important thing that occurs. I mean, the whole issue is to keep us from having a systemic failure, and so you have to sort of work on those procyclical things, which are tough to do when times are good.

But, anyway, I have taken too long. I thank each of you for your testimony. And when you figure that out, if you would send us a memo, we would appreciate it.

Senator BAYH. Thank you very much, Senator Corker.

Senator Shelby.

Senator SHELBY. I would like to ask the Governor a question, picking up on what Senator Corker is talking about, and that is, resolution authority. We have got this "too big to fail" mentality, and maybe it is more than that, which a lot of people disagree with, and the majority of the American people definitely disagree with. But we have got it in Europe, too, and so forth.

But there has to be an end to something sooner or later, and if we do not have some type of legislation with something definite for the regulators, whoever the systemic regulator comes up to be, where if something does get so bad you need to close it up, you need to sell it off, that you do it.

What is bothering me is Citicorp has had all this money pumped into it. We have 36 percent of the stock, more or less, I guess. There is no resolution to that a year later.

AIG, I do not know if we are getting our arms around—I hear we are getting our arms around them. There are going to have to

be some long arms, some big arms to get your arms around that. But what is going to be the ultimate resolution of that? How long is it going to take, too, all of these things? Because as I look at a regulator that is going to wind down something, I think—and oftentimes, FDIC, you have got to give them credit for one thing. They can wind down an institution, sometimes faster than a lot of people would want. But they can wind it down. But can the Fed wind them down? Questionable.

Mr. TARULLO. Well, Senator, the Federal Reserve is certainly not interested in being a receiver or conservator of any institutions. Let me say a couple of things.

One, the complexity of the larger institutions is going to be a challenge, and I think we all just have to acknowledge that. The FDIC does a terrific job of winding down institutions, but if we look at the profile of those institutions, they are overwhelmingly fairly straightforward banking institutions.

Second, I think that as we approach the resolution issue, as I said to Senator Corker a moment ago, we do have to make sure that we are increasing market discipline, and usually what that means is—forgive me for the vernacular—but guys are going to take some losses. And unless that is pretty clear, then you are going to lose the advantages of market discipline along the way.

But the third thing I will say is—and I have said this before in this hearing and other hearings—I am not sanguine that any one tool is going to be adequate to contain systemic risk and, more importantly, in a direct regulatory sense to deal with the moral hazard and too big to fail problems. That is why I think that we should regard a resolution mechanism as one element, necessarily imperfect but I hope positive, along that road.

Senator SHELBY. We are always going to have in a market system winners and losers, failures and success, and that is the genius of the market in a sense. And you are going to have failures in banks ahead down the road. But do you believe as a regulator that you would have some responsibility to make sure that these banks are well capitalized and that are not into something that you—in other words, you do not let the banks run ahead of you and jeopardize themselves and ultimately the taxpayers in some way?

Mr. TARULLO. Absolutely, Senator. I think capital is one of the key instruments to which I was referring earlier.

Senator SHELBY. OK. Thank you, Mr. Chairman.

Senator BAYH. Thank you, Senator Shelby.

I just had two quick questions, Governor Tarullo, for you, following up on my colleagues' very good questions. You outlined a number of sensible steps—you referred to them as "practical steps"—that could be taken with regard to the whole resolution issue. Are any of those being pursued by the FSB or by other entities or in other forums? What is the prospect of some of those actually being implemented?

Mr. TARULLO. A couple of things, Senator. This is one of those areas where there are a couple of different committees internationally at work on these issues. The Basel Committee on Banking Supervision, I think yesterday, but certainly very recently, released a set of recommendations on cross-border resolution which included some recommendations I would say are congruent with what I just

stated a moment ago, and now there is going to be a follow-up process to see if we can move internationally along that path.

I am quite certain that with respect to the supervisory colleges and information issue that I mentioned, I think that will move forward. With respect to the contingency planning, I think that will move forward, too.

The issue of an appropriate resolution mechanism is something—by the way we operate in democracies—our congresses and parliaments are ultimately going to decide.

The standardization of contracts——

Senator BAYH. If I could interrupt for just a second, Governor, so these recommendations were made to whom?

Mr. TARULLO. To members of the Basel Committee——

Senator BAYH. These are just best practices basically made to the different countries that comprise the——

Mr. TARULLO. And that really launches the process by which people then go home and say, OK, now how are we going to——

Senator BAYH. So now it is up to all of us, basically, to act on these recommendations.

Mr. TARULLO. Correct, Senator. Correct.

Senator BAYH. Very good. My last question is for you, Mr. Sobel, and Ms. Casey, I hope you are not insulted I didn't have a question for you today. I found your testimony to be quite excellent, however.

I briefly mentioned, then we got off into a different aspect of a question earlier, the role of the IMF, Mr. Sobel. What is the status of thinking on that, the FSB or——

Mr. SOBEL. The role of the IMF with the FSB?

Senator BAYH. Well, what role they might play ultimately in overseeing the recommendations that are—the FSB and the other recommendations that are made.

Mr. SOBEL. So the——

Senator BAYH. I know they were searching for a mission. With the recent crisis, they have been resuscitated. God willing, that is a temporary state of affairs. So I am just wondering what role they might play in all this at the end of the day.

Mr. SOBEL. Well, I think the IMF has a very important role to play in promoting global financial stability. The FSB brings together national regulators, supervisors, Treasury officials with standard setters. The IMF attends the meetings. Sometimes the way I think about it is a bit simplistic, but there is kind of a micro focus on what are you doing in any given institution.

But I think one of the things we have learned from the crisis is we need a macro focus to understand what are the macroeconomic phenomena and dimensions that interact with the performance of the institutions. If you just look at one individual firm, but you don't see what is happening across firms, you can miss some——

Senator BAYH. Well, that is a role the IMF could——

Mr. SOBEL. Yes, and that is where I see—I think the Fund can play an important role in providing kind of a macro approach to vulnerabilities and building up in the system early warning, perhaps. The Global Financial Stability Report is, I think, a high-quality product. It provides a lot of insights into what is happening in financial markets. And, of course, the IMF also works with coun-

tries, first of all, through the Financial Sector Assessment Programs, but also through technical assistance to strengthen banking systems.

Senator BAYH. Very well. Well, again, thank you all for your time. A lot of good progress has been made. A lot of good work has been done, but this is still very much a work in progress. And so perhaps a year from now, I think it might be appropriate to reconvene and to see how much of a consensus has actually been achieved, what continuing disparities exist with regard to individual countries following up on that consensus, and where any opportunities for—where any leaks in the system might continue.

So again, I want to thank all of you. I realize how busy you are. I really appreciate it. Keep up the good work. Thank you.

The Subcommittee hearing is adjourned.

[Whereupon, at 4 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions follow:]

PREPARED STATEMENT OF MARK SOBEL

ACTING ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY

SEPTEMBER 30, 2009

Chairman Bayh, Ranking Member Corker, members of the Senate Subcommittee on Security and International Trade and Finance, thank you for this opportunity to testify on the subject of international efforts to promote regulatory reform. I commend the Subcommittee for bringing greater public attention to this critical issue and for choosing such a propitious time, coming on the heels of the G–20 Pittsburgh Summit, to hold this hearing. It is also a personal privilege to testify alongside Dan Tarullo and Kathy Casey.

G–20 Cooperation and Progress Made

The Pittsburgh Summit marks another milestone in the effort to promote a more integrated approach between national and international regulation and supervision. In the wake of the onset of the crisis, and particularly over the last year, policymakers and regulators from across the globe have redoubled their efforts to repair financial systems and put in place a stronger regulatory and supervisory framework to help ensure that a crisis of the magnitude we have witnessed does not occur again, to strengthen our financial systems so they are more robust in the face of duress, and to create a culture of greater integrity and responsibility in financial markets that guards against reckless behavior and excessive risk-taking.

Good progress is being made. Last year's Washington G–20 Summit produced a 47-point Action Plan to strengthen regulation. The London Summit in April advanced that work. Already, before we went to Pittsburgh, the international community working through the G–20 had achieved much. For example:

- Prudential oversight has been strengthened. Capital requirements had been increased for risky trading activities, some off-balance sheet items, and securitized products. Principles had been developed for sound compensation practices to better align compensation with long-term performance. Banks were acting to put in place strengthened liquidity risk management principles.
- Agreement had been reached to extend the scope of regulation to all systemically significant institutions, markets and products. Non-bank financial institutions, credit rating agencies, and hedge funds are being subjected to greater scrutiny, while the transparency and oversight of securitization and credit default swap (CDS) markets are being improved.
- International cooperation is being reinforced. More than thirty colleges of supervisors have met to discuss supervision of large, globally active firms. The Financial Stability Board (FSB, previously the Financial Stability Forum—FSF) has been strengthened, including by expanding its membership to include all G–20 countries, promoting financial policy coordination and regulatory cooperation throughout the world.
- Market integrity has been strengthened. The G–20 has acted to improve adherence to international standards in the areas of prudential supervision, anti-money laundering and counter financing of terrorism, and tax information exchange as part of a U.S. initiative to deal with jurisdictions that fail to commit to high-quality standards in these areas.
- Core Principles for Effective Deposit Insurance Systems have been developed to protect depositors around the world in a more consistent fashion. On a personal note, I would commend Martin Gruenberg, a former staff member of this Committee and now Vice-Chair at the FDIC and chair of the International Association of Deposit Insurers, for his leadership on this front.

Pittsburgh Summit

A fundamental objective of the Pittsburgh Summit was to build on these accomplishments and the critical work underway and to identify and gain agreement on the necessary financial supervisory and regulatory reforms to prepare financial institutions to better withstand shocks in the future. G–20 Leaders agreed on timetables to take action in four key priority areas: capital, compensation, over-the-counter (OTC) derivatives and cross-border resolution.

- ***Capital.*** The crisis demonstrated that capital and liquidity requirements were simply too low and that firms were not required to hold increased capital during good times to prepare for bad. Thus, G–20 Leaders agreed to develop rules to improve the quantity and quality of bank capital and to discourage excessive leverage by end-2010. The Leaders' agreement recognizes that strengthening

capital standards is at the core of the reform effort and it tracks closely with the Principles for Reforming the United States and International Regulatory Capital Framework for Banking Firms, which Secretary Geithner set forth just before the G–20 Ministerial meeting in London earlier this month.

- ***Compensation.*** Compensation practices at some firms created a misalignment of incentives that amplified a culture of risk-taking. Building on the principles developed by the FSB earlier this year, G–20 Leaders endorsed the implementation of standards to help significant financial institutions and regulators better align compensation with long-term value and risk management. National supervisors will review firms' policies and structures and impose corrective measures on those that fail to implement sound practices.
- ***Cross-border banking resolution.*** The global financial system is more interconnected than it has ever been and the crisis affected financial firms without regard to their legal structure, domicile or location of customers. G–20 Leaders agreed to establish crisis management groups for the major cross-border firms and to strengthen their domestic frameworks for resolution of financial firms. Further, it was agreed that prudential standards for the largest, most interconnected firms should be commensurate with the costs of their failure.
- ***Over-the-counter (OTC) derivatives.*** The OTC derivatives markets, which were mainly used to disperse risk to those most able to bear it, also allowed hidden concentrations of risk to buildup. G–20 Leaders built on the work already undertaken in this area, agreeing that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms and cleared through central counterparties by end-2012. Further, they affirmed that non-centrally cleared contracts should be subject to higher capital requirements.

In addition, the Leaders called on international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards. Leaders also reaffirmed their commitment to maintain the momentum to raise standards to deal with tax havens, money laundering, and terrorist finance.

These are important achievements. But by no means can we be complacent. Not only must the international community act to make sure that all G–20 commitments are put in place at the international level, each G–20 country must now intensify its effort to help ensure that these commitments are implemented at the national level.

The National and International Spheres

The financial crisis has highlighted the global sweep of financial markets. As Secretary Geithner has said, we may not all be in the same boat, but we are in the same storm.

Firms and markets are now global in scope. We derive benefits from open, interconnected capital markets. However, traditionally, the scope of financial regulation was nationally oriented, stopping at the water's edge. Further, different national standards open the possibility for regulatory arbitrage, gaps in oversight, and a race to the bottom.

These pitfalls must be avoided. The recent crisis also highlighted that financial duress can spread quickly across national boundaries.

Thus while financial regulation continues to be essentially a national activity—grounded in domestic laws, cultures, and history—and the responsibility for sound regulation begins at home, we must seek to improve international cooperation in the regulatory and supervisory sphere. In particular, the major international financial centers must work together to make national laws and practices more consistent and convergent with high quality regulation.

The Machinery for International Supervisory and Regulatory Cooperation

Throughout the crisis, a number of bodies, in addition to the G–20, have helped the international community advance its work in strengthening the international financial system.

Let me be clear—international cooperation is not new. For many years, independent standard setting bodies—such as the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors—have brought together regulators from key countries with the aim of fostering cooperation and forging more consistent global standards.

But one body, the Financial Stability Board (FSB), has played a critical role and I would like to highlight it as its history provides meaningful insights into why it is such a useful tool for us today. It was founded in 1999 as the Financial Stability Forum (FSF), in the aftermath of the Asia financial crisis, by the G–7 Finance Min-

isters and Central Bank Governors. Secretary Geithner, then the Under Secretary of the Treasury for International Affairs, played a seminal role in its establishment. It was charged to promote international financial stability through enhanced information exchange and international cooperation in financial market supervision and surveillance. The unique feature of the FSF was that it brought together G–7 central bank, finance and regulatory officials, plus officials from a number of other financial centers, with the heads of the key standard setting bodies. The focus was not so much on the global macroeconomic situation but on financial sector developments and vulnerabilities as well the work of the standard setting bodies.

At the outset of the crisis in September 2007, the G–7 Finance Ministers and Central Bank Governors asked the FSF to analyze the causes and weaknesses producing the crisis and provide recommendations to increase the resilience of markets and institutions. The FSF issued its first report in April 2008 and an update in October of that year. The report set forth recommendations on: strengthened prudential oversight of capital, liquidity and risk management; enhancing transparency and valuation; changes in the role and uses of credit ratings; strengthening the authorities' responsiveness to risks; and robust arrangements for dealing with stress in the financial system.

These recommendations have been at the center of the international consensus on the necessary steps to overhaul the global financial regulatory system and tackle the root causes of the crisis and were reflected in the November 2008 and April 2009 G–20 Leaders Declarations.

Reconstituted as the Financial Stability Board in April 2009, with an enhanced mandate and membership now encompassing all G–20 countries, the FSB has been a key venue for preparation for both the London and Pittsburgh Leaders Summits. Further, the expansion of the FSB to include all G–20 members has meant that officials around the world are working together to put in place best practices, that are designed to help reduce the potential scope for future regulatory arbitrage.

Mr. Chairman, while my testimony today focuses on the role of the G–20, FSB and international standard setting process, the Treasury participates in many other bodies with a view to fostering international financial market cooperation. In particular, we have strong and ongoing dialogues with the European Commission through the U.S./EU Financial Markets Regulatory Dialogue, Japan, China, India, our NAFTA partners and many more countries. These fora offer us the opportunity to delve deeper on a bilateral basis into financial market issues and share our views on the international agenda.

The FSB's Role in Promoting International Coordination

The FSB is an informal grouping. Working with national policy and regulatory officials and standard setting bodies, it promotes greater consistency and coordination in order to foster more effective regulatory, supervisory and other financial sector policies across the world. Since the onset of the current financial crisis, the FSB has been a critical mechanism for setting forth a comprehensive agenda for reform, reflecting an international consensus, and monitoring the implementation of G–20 Leaders' action points. Its role has been highly valued, and reflecting this, its mandate has been enhanced and its membership expanded, strengthening the network for global financial supervisory and regulatory cooperation.

- The FSB's Plenary is its decisionmaking body, which meets at least two times per year. Representation is at the level of central bank Governor or deputy; head or deputy of the main supervisory/regulatory agency; and deputy finance minister. The number of seats in the Plenary assigned to member jurisdictions reflects the size of the national economy and financial market activity of the member jurisdiction. Plenary representatives also include the chairs of the main standard setting bodies and committees of central bank experts, and high-level representatives of the IMF, the World Bank, the Bank for International Settlements, and the Organisation for Economic Co-operation and Development. Decisions are taken by consensus.
- Its Steering Committee provides operational guidance between Plenary Meetings to carry forward the directions of the FSB. The Steering Committee may establish working groups as needed which may include representatives of non-FSB members.
- Currently, three Standing Committees have been established to support FSB workstreams. These committees are for the Assessment of Vulnerability; Standards Implementation; and Supervisory and Regulatory Cooperation. In addition, there is an Expert Group on Non-Cooperative Jurisdictions and working groups on Cross-border Crisis Management and on Compensation.

- The Secretariat, located in Basel at the Bank for International Settlements, supports the activities of the FSB, including its Standing Committees and working groups. It also facilitates efficient communication among members.
- The Chair is the principal spokesperson for the FSB and represents the FSB externally. The Chair is appointed by the Plenary from members for a term of 3 years renewable once. The Chair has recognized expertise and standing in the international financial policy arena but when acting as Chair, owes duty entirely to the FSB and to no other authorities or institutions. The FSB's current Chair is Mario Draghi, who is also the Governor of the central bank of Italy.
- Given the FSB's vital role, its stature was recently enhanced through its Charter, which was set forth by its members and welcomed by the G–20 Leaders at the Pittsburgh Summit. Under this new Charter, the FSB will assess financial system vulnerabilities, promote coordination and information exchange among authorities, advise and monitor best practices to meet regulatory standards, set guidelines for and support the establishment of international supervisory colleges, and support cross-border crisis management and contingency planning.

Alignment of Domestic and International Reforms

In the United States, we have set out a proposal for comprehensive regulatory reform. But to promote a global race to the top, we need our G–20 partners to pursue equally ambitious reforms.

The agendas pursued by the FSB and United States have been and are closely aligned. This is a function of the close cooperation between U.S. and international officials through the FSB, especially through its Steering Group and Plenary, as well as standard setting bodies.

Effective coordination at the international level is only possible by ensuring a cohesive national vision. The President's Working Group on Financial Markets is a key coordinating vehicle. At a working level, Treasury has taken the lead in facilitating coordination among U.S. regulators, hosting weekly calls to share information and discuss work underway within the FSB, standard setting bodies, and other international organizations to implement the vision of G–20 Leaders. This dialog has allowed us to reconcile our perspectives and speak with one voice, positioning the United States as a leader on the global stage as we set the course for a stronger and more stable international financial system.

The FSB and standard setting bodies have allowed us to align our vision for the future of financial markets with that of the largest economies across the globe. Our proposed reforms have been informed by the international dialog, and international agreement on the path forward has been shaped by our own swift action domestically to prevent a return to banking as usual. The meaningful progress to emerge from the G–20 dialog on financial regulatory reform over the last eleven months is testament to the success of this strategy.

Looking forward, consistent national implementation will increasingly be our point of focus in the G–20. The FSB will be an important forum via which we will assess progress, and thematic peer reviews of members are planned on the implementation of many of the G–20 action items. Already, the FSB is poised to be a critical partner in implementing our strategy for dealing with non cooperative jurisdictions, particularly with respect to compliance with international standards for cooperation and sharing of prudential information. Further, in Pittsburgh, G–20 Leaders explicitly tasked the FSB to monitor implementation of commitments on compensation and OTC derivatives.

Conclusion

We have made substantial progress in strengthening the international financial system, but much more remains to be done. Strong national and international regulatory coordination and convergence have been driving forces behind our swift and effective response to this global crisis. But some of the flaws in our financial system and regulatory framework that allowed this crisis to occur, and in many ways helped cause it, are still in place. Importantly, our proposals for regulatory reform of our domestic financial markets are firmly entrenched in a shared vision for the future of the international financial system.

The United States has been a leader in the effort to create the FSB, shape its agenda, expand its membership and involve it closely in the work of the G–20. In turn, the FSB has been a key instrument for international policy development in response to the global financial crisis. Identifying a global response has been essential to avert regulatory gaps, arbitrage and spillovers and to safeguard market dynamism. In the wake of the most recent G–20 Leaders Summit in Pittsburgh, we can be confident knowing that the international machinery to strengthen the international financial system is in place, has set forth principles and standards for re-

form that are consistent with the Administration's plans for reform, and is working to bring global standards up. These efforts must continue, but building on the agreements made in the G–20, now is the time for national implementation of reforms.

PREPARED STATEMENT OF KATHLEEN L. CASEY

COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

SEPTEMBER 30, 2009

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

Why International Cooperation is Necessary

I am pleased to have the opportunity to testify on behalf of the Securities and Exchange Commission on this very important topic. International cooperation is critical for the effectiveness of financial regulatory reform efforts. In reaffirming their commitment to strengthening the global financial system, the G–20 Finance Ministers and Bank Governors recently set forth a number of actions to "maintain momentum [and] make the system more resilient." The G–20 banking statement correctly recognizes that due to the mobility of capital in today's world of interconnected financial markets, activity can easily shift from one market to another. Only collective regulatory action can be effective in fully addressing cross-border activity in our global financial system.

As an SEC Commissioner and Chairman of the Technical Committee of the International Organization of Securities Commissions (IOSCO), I bring the perspective of both a national securities market regulator and a member of the international organization charged with developing the global response to the challenges posed to securities markets by the financial crisis. I also represent the SEC and IOSCO in the Financial Stability Board (FSB), where the U.S. financial regulatory policy representation is led by the Department of Treasury, with the SEC and the Federal Reserve Board both serving as members.

The financial crisis has made it clear that we must address regulatory gaps and overlaps. The Commission has recently proposed action to this end in a number of different areas, recognizing, however, that some regulatory gaps and market issues cannot be fully addressed without legislative action. The Commission already is working to achieve consistency on the domestic and international levels, including through IOSCO and the FSB, with banking, insurance, futures, and other financial market regulators. In this vein, the Commission also is working to ensure respect in the global regulatory environment for the integrity of independent accounting and auditing standard-setting processes for the benefit of investors. The Commission looks forward to continuing and improving on this cooperation as part of a reformed regulatory landscape.

Mechanisms for International Cooperation in Securities Market Regulation

The Commission has actively worked to achieve consistency in regulatory policy and implementation on an international basis through multilateral, regional, and bilateral mechanisms for many years. The SEC was a founding member of IOSCO, and has maintained a leading role in the organization. The Commission's commitment to international cooperation has become increasingly important to its mission in recent years in response to the increasingly global nature of financial markets.

In addition to my chairmanship of IOSCO's Technical Committee, Commission staff leads or is very active in IOSCO's standing committees and taskforces. Commission staff also represents IOSCO in the Joint Forum on Financial Conglomerates, which was established by the Basel Committee on Banking Supervision, IOSCO and the International Association of Insurance Supervisors (IAIS) to deal with issues that cut across the banking, securities and insurance sectors. For example, SEC staff participates in the Joint Forum's Working Group on Risk Assessment and Capital, which has undertaken a number of cross-sectoral initiatives that have arisen out of the financial crisis.

While IOSCO represents the primary vehicle for development of common international approaches to securities market regulation, the FSB is a key mechanism for the Commission to engage internationally on broader financial market issues. The FSB has a broader scope, with membership comprised of national regulatory and supervisory authorities, standard setting bodies and international financial institutions. In addition, its mission is to address vulnerabilities and to encourage the development of strong regulatory, supervisory and other policies in the interest of financial stability.

The Commission also is represented in oversight bodies charged with maintaining the public accountability of international accounting and auditing standard-setters. SEC Chairman Schapiro is a member of the Monitoring Board of the International Accounting Standards Committee Foundation. Through this Board, the SEC and other capital market authorities that permit, have proposed to permit, or require the use of International Financial Reporting Standards in their jurisdictions have a means to carry out more effectively their mandates regarding investor protection, market integrity, and capital formation. The Commission also is represented through IOSCO in the Monitoring Group for the Public Interest Oversight Board, which serves as a mechanism for promoting the public interest in the development of international standards for auditing by the International Federation of Accountants.

In addition to multilateral, global engagement, the Commission participates in regional and bilateral mechanisms for discussion and promotion of common approaches to regulation. SEC Commissioner Aguilar is the Commission's liaison to the Council of Securities Regulators of the Americas, or COSRA, which aims to develop high quality and compatible regulatory structures among authorities in the Western hemisphere. Commission staff, alongside staff of the Federal Reserve Board, the Commodity Futures Trading Commission, and other U.S. Government agencies, also participates in a number of Treasury-led financial regulatory dialogues, including with the European Commission, Japan, China and India, as well as Australia and our North American partners, Canada and Mexico.

Securities-regulatory-focused bilateral dialogues between Commission staff and our counterpart securities regulators in these and other jurisdictions also complement the broader financial sector dialogues; we are engaged in such bilateral efforts with, among others, the U.K. Financial Services Authority and the Japan Financial Services Agency, the Committee of European Securities Regulators (CESR), and the China Securities Regulatory Commission, Securities and Exchange Board of India, and Korea Financial Supervisory Commission. Furthermore, the Commission and a number of other securities regulators have recently entered into bilateral "supervisory" memoranda of understanding that go well beyond sharing information on enforcement investigations. These supervisory MOUs, such as those the SEC has signed with the U.K.'s Financial Services Authority and the German consolidated financial services regulator (known as the "BaFin"), represent groundbreaking efforts by national securities regulators to work together to cooperate in their oversight of financial firms that increasingly operate across borders.

Thus, the infrastructure for international cooperation on securities regulatory policy is well-developed, and the Commission plays a key role in promoting rising levels of cooperation. These efforts build on the success the Commission has achieved in raising standards of cross-border enforcement cooperation. Over two decades ago, the Commission entered into its first bilateral memoranda of understanding for the sharing of information in securities enforcement matters. To date, the Commission has concluded bilateral agreements with 20 jurisdictions that remain in force today. These bilateral agreements were the impetus for the creation of the IOSCO Multilateral Memorandum of Understanding (MMoU) in 2002. Since then, authorities in 55 jurisdictions, including the SEC, have already implemented the principles for cross-border enforcement cooperation contained in the MMoU and another 27 jurisdictions have committed to do so. With each additional MMoU signatory, the scope and ability of the SEC to pursue wrongdoers across borders significantly increases. This ability is increasingly important as more and more SEC investigations involve some international component.

In addition to continuing to work to increase the number of jurisdictions that share information pursuant to the MMoU, the Commission also is continually working to increase the level of enforcement cooperation that it provides foreign counterparts as well as the level of cooperation provided by our global counterparts. The SEC was among the first securities regulators to receive the legal authority to assist foreign counterparts in investigations of securities fraud. Today, the SEC has broad authority to share supervisory information as well as assist foreign securities authorities in their investigations using a variety of tools, including exercising the SEC's compulsory powers to obtain documents and testimony. To further facilitate international cooperation, the SEC supports the passage of H.R. 3346 that would give authority to the Public Company Accounting Oversight Board, which the SEC oversees, to share confidential supervisory information with foreign auditor oversight bodies. The Commission believes that granting this authority to the PCAOB would enhance auditor oversight, audit quality and, ultimately, investor protection.

Key Securities Regulatory Reform Issues and International Cooperation

The Commission has led or supported the development of a number of international securities market regulatory initiatives to support the strengthening of the global financial system in the wake of the financial crisis. These initiatives, developed through IOSCO, its joint working group with the Committee on Payment and Settlement Systems (CPSS), and the Joint Forum, have been developed in conjunction with calls from the G–20 and FSB to ensure that all systemically important financial institutions, markets, and instruments are subject to an appropriate degree of regulation and oversight.

IOSCO

IOSCO's Subprime Task Force issued its report in 2008, examining the underlying causes of the financial crisis and the implications for international capital markets. IOSCO launched a number of ongoing projects in response to recommendations in this report, including in key areas such as issuer transparency and investor due diligence; firm risk management and prudential supervision; valuation and accounting issues. Last fall, following on concerns highlighted by the G–20 Leaders, IOSCO also established task forces on unregulated entities, unregulated financial markets and products, and supervisory cooperation, each of which is discussed in greater depth below. The Commission has contributed significantly to these projects with a view to ensuring that global capital markets address issues relating to the current turmoil in a sound and aligned way.

Credit Rating Agencies

With regard to credit rating agencies, in February of this year, IOSCO established a permanent standing committee to continually evaluate and seek cross-border consensus for CRA regulation. IOSCO has built on the early work in this area that resulted in the IOSCO CRA Principles and Code of Conduct Fundamentals first adopted in 2003 and 2004. The Code Fundamentals, as amended in 2008 as a consequence of "lessons learned" during the early "subprime crisis," has already been substantially adopted by at least seven rating agencies, including the largest ones. Staff of the SEC chair this committee.

Unregulated Entities

With regard to unregulated entities, following extensive consultation, IOSCO agreed to a set of high-level principles for hedge fund regulation in June of this year. The six principles include requirements on mandatory registration for funds or their advisers, ongoing regulation and provision of information for systemic risk assessment purposes.

They also state that regulators should cooperate and share information to facilitate efficient and effective oversight of globally active hedge fund managers and hedge funds. Work continues in IOSCO on defining what type of information should be provided by the hedge fund sector (and their counterparties) to allow regulators to assess the systemic importance of individual actors and identify possible financial stability risks.

Unregulated Markets and Products

Earlier this month, IOSCO's Task Force on Unregulated Financial Markets and Products issued a number of recommendations concerning regulatory approaches that may be implemented with respect to the securitization and credit default swap (CDS) markets, as these two markets were key elements of the global financial crisis. The Task Force continues to consider whether additional work should be undertaken regarding implementation of the recommendations.

In addition, the Commission has worked closely over the past year with international regulators and central banks in gaining first-hand experience in applying the Recommendations for Central Counterparties (RCCPs) to proposed arrangements for OTC credit derivatives transactions. This has highlighted some challenges regarding the application of RCCPs to credit default swaps (CDSs), particularly with respect to valuation models. The CPSS, under the leadership of New York Federal Reserve Bank President William Dudley, and IOSCO have created a joint working group (co-chaired by the European Central Bank) to propose guidance on how central counterparties for OTC derivatives may meet the standards set out by the RCCP and will identify any areas in which the RCCP might be strengthened or expanded to better address risks associated with the central clearing of OTC derivatives. This working group will complete its report by the middle of 2010.

Supervisory Cooperation

As operations globalize, oversight and supervision require increased cross border cooperation. Supervisory cooperation is a critical tool in gathering information about

risks and trends within institutions and across markets. To this end, IOSCO established a Task Force on Supervisory Cooperation this spring to develop principles on regulatory cooperation in the supervision and oversight of market participants, such as exchanges, funds, brokers, and advisers, whose operations cross international borders. Final principles are expected to be published in February 2010.

Commodity Futures Markets

IOSCO's Task Force on Commodity Futures Markets, which was formed following concerns relating to price and volatility increases in agricultural and energy commodities in 2008, focused on whether futures market regulators' supervisory approaches were appropriate in light of market developments. The Task Force issued its report in March 2009 with recommendations aimed at ensuring that regulators have the appropriate information and tools available to them to monitor futures markets effectively and act against any market manipulation. The Task Force was recently revived, with CFTC Chairman Gary Gensler and U.K. Financial Services Authority Chairman Adair Turner as co-chairs, to continue to address concerns about access to relevant information for effective market surveillance and to promote improvements to regulatory frameworks that may inhibit the ability to detect and enforce market manipulation cases.

Joint Forum Cross-Sectoral Projects

The Commission, participating through IOSCO in the Joint Forum, which is led by Comptroller of the Currency John Dugan, is taking part in a review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated. The group's focus is on the differentiated nature of regulation in the banking, securities and insurance sectors; current consolidated supervision and unregulated entities or unregulated activities within a conglomerate structure; and the regulation of hedge funds; among other issues. The main deliverable of this workstream will be a report to the FSB and G–20 Finance Ministers and Governors, and is expected by the end of this year.

In addition, the Joint Forum's Working Group on Risk Assessment and Capital (JFRAC) recently finalized its report examining the range of various Special Purpose Entities (SPEs) used by financial firms to transfer risk for capital and liquidity management purposes as well as derivatives vehicles and transformer vehicles. Finally, in recognition of the reality that prudential supervision is becoming increasingly risk-sensitive in the different sectors, JFRAC has also undertaken a project to consider methods for risk aggregation that incorporate a characterization and quantification of diversification effects within financial firms. The primary focus of this work will be on aggregation across different types of risk—such as credit, market, insurance, and operational risk—and on similarities and differences between the commercial banking, investment banking, and insurance sectors. A preliminary draft paper will be discussed at the October Joint Forum meeting.

FSB / G–20 Participation and U.S. Government Coordination

With regard to my role at the FSB, I represent both the Commission and the IOSCO Technical Committee alongside the other U.S. Government participants, namely Governor Tarullo of the Federal Reserve Board and the Under Secretary for International Affairs of the Department of Treasury. 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 is accomplished through extensive and informal communication between the staffs of our agencies, including the Office of the Comptroller of the Currency (OCC), the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC) and the National Association of Insurance Commissioners (NAIC), among others, and has been highly effective. In this regard, the work that Comptroller of Currency Dugan and I jointly led, under theauspices of the Financial Stability Forum's efforts to reduce procyclicality of regulation, to explore possible improvements to the accounting for loan loss provisioning is particularly noteworthy.

Importance of the Role of Technical Experts and Independent, Consultative Rulemaking

The international financial regulatory architecture that I have just outlined has proven its robustness in the level of cooperation since the outbreak of the financial crisis. The G–20 leaders' focus on financial regulation has provided more high-level and political attention to these ongoing efforts. With the conversion of the Financial Stability Forum into the FSB and expansion of its membership to the G–20, the architecture is evolving to reflect the growing importance of emerging markets and international cooperation in light of the interconnectedness of the global financial system. While the Commission supports and participates in the work of all of these

international organizations, I would like to take this opportunity to highlight the different roles that these international organizations should play as nations increasingly seek to cooperate with regard to international financial regulatory policy.

The FSB, for example, comprises officials from across the spectrum of financial regulation, and so is very useful as a discussion forum to determine broad trends in the financial system. Through FSB discussions, gaps in regulation can be more readily identified and prioritized. The G–20 focus on these results also is helpful in ensuring that the pace of reform is maintained and that a clear international framework emerges.

Given the complexity of the financial markets, however, it is critical that technical regulatory bodies such as those represented in IOSCO, as well as statutorily mandated independent regulators, such as the Commission, have control over their agendas and the ultimate outcomes of their regulatory and standard-setting work. The regulators and supervisors of each financial sector have specific goals for regulation, which may differ slightly 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 technical experts to develop regulatory approaches to address areas of concern in their sector 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.

One example where this approach has been successful is raising standards for international securities law enforcement cooperation. The development of the IOSCO MMoU, and the push to further expand the number of jurisdictions providing cooperation as well as deepen the level of cooperation they provide, has significantly raised standards of cooperation in the securities sector over the past decade. The FSB's effort to promote standards in non-cooperative jurisdictions will provide opportunities to raise the level of cooperation across a broad range of financial regulatory enforcement concerns.

The Commission looks forward to continuing the constructive dialog with our colleagues at the Fed, Treasury, and other agencies, in continuing to develop the common U.S. position in the future. For more specifics on the outcome of the recent G–20 meeting, I defer to Mark Sobel of the Treasury Department, as the Commission did not directly participate in the Summit or the G–20 process leading to Pittsburgh.

Conclusion

While the Commission's particular focus—and that of IOSCO—on investor protection and efficient and fair markets has remained constant and somewhat distinct from that of banking supervisors and regulators of other market segments, our recent collaborative work—both at home and internationally—has shown significant progress in strengthening the global financial regulatory system. It remains the case that investor protection and a focus on efforts to enhance investor confidence are vital to interests of financial stability on national and global levels.

In its June White Paper, the Administration named as one of its five key objectives of financial regulatory reform the raising of international regulatory standards and improvement of international cooperation. The Commission, through IOSCO, the FSB, other cross-border mechanisms, and coordinating domestically with fellow financial regulators, stands ready to continue its collaborative work with the aim of enhancing our ability to identify and address systemic risks early across the world's financial markets. International cooperation is essential to the success of any financial regulatory reform that we undertake.

Thank you for this opportunity to address such timely and relevant global regulatory issues.

PREPARED STATEMENT OF DANIEL K. TARULLO

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

SEPTEMBER 30, 2009

Chairman Bayh, Ranking Member Corker, and other members of the Subcommittee, I appreciate the opportunity to testify today on the role of international cooperation in modernizing financial regulation. International cooperation is important for the interests of the United States because, as has been graphically illustrated in the past 2 years, financial instability can spread rapidly across national boundaries. Well-devised international financial regulatory standards can help encourage all nations to maintain effective domestic regulatory systems. Coordinated international supervisory arrangements can help ensure that every large, inter-

nationally active financial institution is effectively supervised. Both these forms of international cooperation can, at the same time, promote at least a roughly equivalent competitive environment for U.S. financial institutions with those from other nations.

In my testimony this afternoon, I will review the responses of key international regulatory groups to the financial crisis, including both substantive policy responses and the organizational changes in membership and working methods in some of those groups. Next I will describe specifically the role of the Federal Reserve's participation and priorities in these international regulatory groups. I will conclude with some thoughts on the challenges for international regulatory cooperation as we move forward from the G–20 Pittsburgh Summit and the exceptionally active international coordination process that has preceded it.

The Response of International Regulatory Groups to the Crisis

Over the past few decades, international cooperation in financial regulation has generally been pursued in a number of groups that bring together national authorities with responsibility for regulating or supervising in a particular area, or that served as venues for informal discussion. Several of the functional regulatory groups have undertaken initiatives in response to the recent financial crisis. During this period, the Financial Stability Board (FSB) shifted from being more of a discussion forum to serving as a coordinator of these initiatives. The FSB was also the direct line of communication between these groups and the G–20.

The Federal Reserve actively participates in the FSB as well as in the following international groups:

- In the Committee on Payment and Settlement Systems, we work with other central banks to promote sound and efficient payment and settlement systems.
- In the Committee on the Global Financial System, we work with other central banks to monitor developments in global financial markets, reporting to the central bank Governors of the G–10 countries.
- In the Basel Committee on Banking Supervision (Basel Committee), we and the other U.S. bank supervisors work with other central banks and bank supervisory agencies to promote sound banking supervision by developing standards for bank capital requirements and bank risk management, and by promulgating principles for effective bank supervision. The Basel Committee, which doubled its membership earlier this year, now includes supervisors from 27 jurisdictions, including both advanced and emerging markets.[1]
- In the Joint Forum, we and other U.S. financial regulators—including bank, securities, and insurance regulators—work with financial regulators from other countries to enhance financial regulation that spans different financial sectors.
- In the Senior Supervisors Group, we and other U.S. supervisors have worked over the past few years with the supervisors of other major financial firms to share information and sponsor joint reviews of risk management and disclosure.
- In bilateral and regional supervisory groups, we have discussed regulatory issues with Europe, China, India, Japan and other supervisors from the Western Hemisphere. Some of these groups have quite a long history. Both the Committee on the Global Financial System and the Basel Committee date back to the 1970s. These groups are not formal international organizations. They have operated with only a modest support staff—often provided, along with a location for meetings, by the Bank for International Settlements (BIS). The bulk of their activity is conducted by officials from the national regulators themselves.

The FSB is a relatively new group, established in the wake of the Asian financial crisis in 1999 as the Financial Stability Forum, with a broad mandate to promote global financial stability. The FSB is an unusual combination of international standard-setting bodies (including those mentioned above) and a range of national authorities responsible for financial stability: treasury departments and ministries of finance, central banks, and financial supervisory agencies.[2] Major international or-

[1] The Basel Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

[2] International standard-setting bodies participating in the FSB are the Basel Committee, the Committee on the Global Financial System, the Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors, the International Accounting Standards Board, and the International Organization of Securities Commissions.

Continued

ganizations such as the BIS and the International Monetary Fund (IMF) also participate.[3] At the request of the G–20 in April 2009, the Financial Stability Forum's name was changed to the Financial Stability Board, its membership was expanded to add the emerging market countries from the G–20, and its mandate was strengthened.

The financial crisis has underscored the importance of the original motivation for creating what is now the FSB. The connections among financial market sectors, and between macroeconomic policy and financial markets, mean that efforts to ensure international financial stability must incorporate a breadth of perspectives and include communication among the various international groups in which regulatory cooperation takes place. In its work to increase international financial stability and to promote financial regulatory reform, the FSB has tried to identify priorities and agree upon high-level principles. It has then requested that the relevant standard-setting bodies formulate detailed proposals and report back to the FSB.

All these international groups, including the FSB, operate by consensus. Although this institutional feature can create significant challenges in reaching agreement on complex topics, it also serves as a check on potentially undesirable policy directions. The process of developing proposals in the standard-setting bodies allows a variety of ideas to be explored and exposed to critical examination by expert staff. Like any other process, alternative viewpoints emerge and dissenting opinions are voiced. Once a consensus is reached, it is then up to individual members to implement any statutory changes, administrative rules, or guidance under local law.

As already noted, the FSB has played a leading role in guiding the official response to the crisis. In April 2008, it made a range of recommendations to increase the resiliency of financial markets and institutions. These recommendations are broadly consistent with similar principles articulated by the President's Working Group on Financial Markets here in the United States. The FSB has acted upon priorities identified by the G–20 leaders and has delivered to those leaders a series of proposals that have been adopted by them, most recently at the Pittsburgh summit last week. With its role now expanded and in the process of being formalized in a charter, the FSB will have the ongoing mandate of identifying and addressing emerging vulnerabilities in the financial system.

The activities of some other groups have also broadened in response to the crisis. The Basel Committee was formed in 1974 in an effort by national authorities to fill supervisory gaps exposed by problems in a number of internationally active banks. Beginning in the late 1980s, its focus shifted to setting capital standards for internationally active banks. That emphasis continues today, notably with respect to strengthening capital requirements for securitization exposures and trading book exposures as well as disclosure requirements related to these areas. The Basel Committee has now begun to address a wider range of issues aimed at improving standards for capital, liquidity, cross-border bank resolution, leverage, and macroprudential supervision.

In March 2008, the Senior Supervisors Group released its first report on risk-management practices.[4] The report, based on extensive discussions with large financial institutions, provided near-real-time analysis of the major failures in risk management and internal controls that led to outsized losses at a number of firms, and highlighted distinctions in practices that may have enabled some other institutions to better withstand the crisis. The group is now in the final phases of preparing a second report that will focus on the challenges that emerged as particularly critical last year, notably related to management of liquidity risk, and present the results of the self-assessments by the largest financial institutions regarding their responses to the riskmanagement and internal control issues highlighted by the crisis.

International regulatory and supervisory bodies have been actively engaged in addressing a wide range of issues, many of which have been highlighted by the recent financial crisis. Let me now discuss in more detail a few of the areas that are most important from the perspective of the Federal Reserve.

The jurisdictions represented on the FSB are: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Spain, Switzerland, Turkey, the United Kingdom, and the United States.

[3] International organizations in the FSB are the BIS, the European Central Bank, the European Commission, the IMF, the Organisation for Economic Co-operation and Development, and The World Bank.

[4] See Senior Supervisors Group (2008), *Observations on Risk Management Practices during the Recent Market Turbulence* (Basel: SSG, March 6), available at Federal Reserve Bank of New York (2008), "Senior Supervisors Group Issues Report on Risk Management Practices," press release, March 6, *www.newyorkfed.org/newsevents/news/banking/2008/rp080306.html.*

Capital

The financial crisis has left little doubt that capital levels of many financial firms, including many in the United States, were insufficient to protect them and the financial system as a whole. The FSB has called for significantly stronger capital standards, to be agreed upon now and phased in as financial and economic conditions improve. The communiquE issued Friday by the G–20 leaders echoed and amplified the need for improvements in both the quantity and quality of capital.

One critical area for improvement is that of increasing capital requirements for many forms of traded securities, including some securitized assets. Some work has already been completed. We place a high priority on undertaking a comprehensive review and reform of these requirements. The Basel Committee is also working on proposals for an international leverage ratio to act as a supplement to risk-based capital ratios. The FSB has also devoted considerable energies to exploring sources of procyclicality in the financial system, which are those practices and structures that tend to amplify rather than dampen the cycles characteristic of financial markets, and to identifying possible strategies to reduce their effects, which were often quite visible during the recent crisis. One such strategy is to include a countercyclical capital buffer in the capital requirements for financial firms. Work on such a buffer is under way, though the technical challenges of devising an effective buffering mechanism are significant.

It will be important for the international regulatory community to carefully calibrate the aggregate effect of these initiatives to ensure that they protect against future crises while not raising capital requirements to such a degree that the availability of credit to support economic growth is unduly constrained. The Basel Committee plans a study of the overall calibration of these changes for early next year.

Liquidity

Liquidity risk is another key international agenda item. Although the Basel Committee had historically focused on capital standards, the crisis clearly demonstrated that adequate capital was a necessary but not always sufficient condition to ensure the ability of a financial institution to withstand market stress. We were reminded that the liquidity of a firm's assets is critical to its ability to meet its obligations in times of market dislocation. In particular, access to wholesale financing very quickly became severely constrained for many institutions that had grown quite dependent on it. The Basel Committee promulgated general guidance on liquidity risk management in June 2008 and is now in the process of incorporating those broad principles into specific quantitative requirements.

Cross-Border Bank Resolution

In the area of cross-border resolution authority, there is broad international agreement that existing frameworks simply do not allow for the orderly resolution of cross-border failures of large complex banking organizations and that changes are needed. Current frameworks focus on individual institutions rather than financial groups or the financial systems at large. These frameworks have proven problematic even at the national level. Policy differences and legal obstacles can magnify these shortcomings at the international level.

The Basel Committee's Cross-Border Bank Resolution Group has developed 10 recommendations for national authorities.[5] The recommendations, which aim at greater convergence of national resolution frameworks, should help strengthen cross-border crisis management. One key recommendation requires systemically important firms to have contingency plans that will allow for an orderly resolution should that prove necessary. Implementation of these recommendations is likely to require heightened cooperation throughout the international community.

Accounting Standards for Financial Institutions

The FSB and the Basel Committee have an important role in supporting improved accounting standards for financial institutions. For example, the FSB has developed recommendations for improving the accounting for loan loss provisions. The Basel Committee consults frequently with those who set international accounting standards on these and other topics and provides comments on important accounting proposals affecting financial institutions.

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[5] See Basel Committee on Banking Supervision, Cross-Border Bank Resolution Group (2009), *Report and Recommendations of the Cross-Border Resolution Group* (Basel: Basel Committee, September), available at *www.bis.org/publ/bcbs162.htm.*

Future Initiatives

A number of other initiatives are at an earlier stage of policy development. A good deal of attention right now is focused on mitigating the risks of systemically important financial firms. Two of the more promising ideas are particularly worth mentioning. One is for a requirement for contingent capital that converts from debt to equity in times of stress or for comparable arrangements that require firms themselves to provide for back-up sources of capital. The other is for a special capital or other charge to be applied on firms based on their degree of systemic importance. Many of these initiatives still require much work at the technical level before policy proposals will be ready for a thorough vetting in the national and international regulatory community.

How the Federal Reserve Pursues Our Objectives in International Groups

The Federal Reserve promotes U.S. interests in these international groups by actively participating and by coordinating with other U.S. participants.

The international groups that I mentioned earlier all hold regular meetings. The FSB meets at least twice a year, and the Basel Committee typically meets four times a year. Between meetings of the main groups, subgroups of technical experts meet to discuss proposals and lay the groundwork for issues to be discussed at the main groups. The Federal Reserve actively participates in both the main groups and the subgroups. For practical purposes, not all members of a group can sit on each subgroup, although the United States is well represented on all major topics and chairs important subgroups.

We have found that success in pursuing our objectives in these groups depends upon having well-developed ideas. One important basis for leadership in international groups is the quality of the intellectual and policy contributions that an organization can offer. To this end, we have tried to use the extensive economic and research resources of the Federal Reserve, as well as our regulatory experience, to produce well-considered proposals and useful feedback on the proposals of others.

International groups operate on the basis of consensus. Policies are endorsed only when all members voice their support. This approach can make it challenging to come to agreement on complex topics. But international groups are made up of regulatory agencies or central banks, and they have particular responsibilities based on their own national laws. International groups are not empowered to create enforceable law, and agreements need to be implemented by member countries in the form of statutory changes, administrative rules, or supervisory guidance. Thus, the consensus orientation of the international policy development process is necessary to respect the domestic legal structures within which the various regulatory agencies operate.

The President's Working Group on Financial Markets is the primary forum in which regulatory issues are discussed among the principals of the U.S. financial regulatory agencies. These discussions often cover the same issues being discussed in international groups. We strive to maintain a degree of intellectual rigor and collegiality in these discussions where consensus is again the norm, despite the sometimes different perspectives of the various agencies. In the past, there were some notable instances of significant disagreement among the U.S. agencies, but my observation since being appointed to the Federal Reserve is that the coordination process is working quite well. Indeed, it can sometimes be an advantage to have multiple U.S. agencies involved in international processes because of the complementary expertise we each bring to bear. In addition, at the international level, having multiple U.S. agencies at the table provides an appropriate counterweight to our European counterparts, who for historical reasons are usually overrepresented in international groups relative to their weight in the global financial system.

Like other central banks, the Federal Reserve did not participate in the G–20 summit, which is attended by heads of state and finance ministers. However, we are involved in a significant part of the relevant preparatory and follow-up work, both through the FSB and in joint meetings of the G–20 finance ministers and central banks.[6] In preparation for the Pittsburgh summit, as well as for the previous G–20 summits in London and Washington, the Federal Reserve has also collaborated with other U.S. financial regulatory agencies in considering the financial regulatory issues on the agendas for these meetings.

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[6] The FSB prepared three documents that were presented to G–20 leaders at the summit: "FSB Principles for Sound Compensation Practices," "Improving Financial Regulation," and "Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability."

Challenges for International Financial Cooperation

The testimony that my colleagues and I have offered this afternoon reflects the breadth and depth of the tasks associated with improved regulation and supervision of financial markets, activities, and firms. An ambitious agenda has been developed through the interactions of the G–20, the FSB, and international standard-setting bodies, and much work toward completing that agenda is already under way. At the same time, there will inevitably be challenges as we all intensify and reorient the work of these groups. I will now discuss four of those challenges.

First, for all the virtues of the consensus-based approach involving the relevant national authorities, some subjects will simply be very difficult to handle fully in this fashion. Crossborder resolution may prove to be one such issue. Although there is undoubtedly potential for achieving improvement in the current situation through the international processes I have described, the complexities involved because of the existence of differing national bankruptcy and bank resolution laws may limit what can be achieved.

Second, there will likely be a period of working out the relationships among the various international bodies, particularly in light of the increased role of the FSB. We will need to determine how extensively the FSB and its newly constituted committees should themselves develop standards, particularly where an existing international standards-setting body has the expertise and mandate to address the topic. Similarly, while simultaneous consideration of the same issue in multiple international bodies can sometimes be a useful way to develop alternative proposals, there may also be potential for initiatives that are at odds with one another.

Third, the significant expansion in membership of many of the more important of these bodies may require some innovation in organizational approaches in order to maintain the combination of flexibility and effectiveness that the FSB and some of the other groups have, at their best, possessed in the past. The substitution of the G–20 for the G–8 at the level of heads of government is the most visible manifestation of the salutary trend toward involving a number of emerging market economies in key international financial regulatory arrangements. As I mentioned earlier, the FSB and the Basel Committee have recently expanded their membership to the entire G–20. Important as this expansion is for the goal of global financial stability, the greater number of participants does have an impact upon the operation of those groups, and we will need to adapt accordingly. I hasten to add that this is not at all a comment on the capacities of the new members. On the contrary, I have been impressed with the quality of the participation from the new emerging market members.

Finally, the financial crisis has understandably concentrated the attention and energies of many of these international regulatory groups on the new standards that will be necessary to protect financial stability in the future. Combined with the enlarged memberships of these groups, however, this focus on negotiating standards may unintentionally displace some of the traditional attention to fostering cooperative supervisory practices by the national regulators who participate in these international bodies. It is important that, even as we represent our national interests in these bodies, we also promote the shared interests we have in effective financial supervision.

Conclusion

Participating in international regulatory groups has helped the Federal Reserve and other U.S. agencies begin to shape an effective global regulatory response to the financial crisis. We look forward to continuing our collaboration in pursuit of effective, efficient financial regulation.

Thank you for inviting me to present the Board's views on this very important subject. I look forward to continuing dialog with the Subcommittee on these issues. I would be pleased to answer any questions you may have.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORKER FROM MARK SOBEL

On Resolution Authority

Q.1. The Administration's proposal asks for significant and broad resolution authority that is, in effect, TARP on steroids. While some will still advance the theory that the bankruptcy courts with a few tweaks would be enough of a solution, the challenges we have seen with Lehman's resolution abroad question the theory that with no globally astute and integrated resolution regime, the court systems will not function cohesively and instead will be inclined to ring fence and protect for their own taxpayers.

Explain to me how would the Administration's proposed resolution process work overseas? Do you think that is the optimal model? Propping up failed institutions around the globe at taxpayer's expense into perpetuity? Is the Treasury Department conducting any economic analysis so the impact of any proposal is fully understood before it is uniformly agreed to and adopted? And if so, when will you be willing to share this information to help us inform our policymaking?

A.1. The United States, led by the Federal Depository Insurance Corporation (FDIC), is working closely with international counterparts within the Basel Committee, to study the important issue of resolutions at the international level. The Cross Border Bank Resolution Working Group has conducted serious analysis and published two reports with ten proposals to strengthen international and national frameworks for cross-border resolution of international institutions and, importantly, used the recent crisis as "lessons learned." (Available at: *http://www.bis.org/publ/bcbs162.htm*) Recognizing that strictly national approaches are inefficient and global approaches may not be viable, the Group has recommended that major financial centers adopt comparable, consistent domestic resolution regimes similar to the FDIC approach. These proposals were issued for comment, with a deadline of December 31, 2009. The United States supports countries having strong and effective national resolution frameworks and an orderly resolution process, all of which will minimize the damage to the financial system and reduce cost to the taxpayer.

As Secretary Geithner noted in his testimony before the House Financial Services Committee, the proposed resolution authority would not authorize the government to provide open-bank assistance to any failing firm. That is, the government would not be permitted to put money into a failing firm unless that firm is in FDIC receivership and on the path to being unwound, dismantled, sold, or liquidated. The receivership authority would facilitate the orderly demise of a failing firm, not ensure its survival, and would strengthen market discipline and reduce moral hazard risks, while protecting the financial system and taxpayers. It also is important that there are appropriate checks and balances and that the special resolution regime may be used only with the agreement of the Secretary of the Treasury and two-thirds of the boards of the Federal Reserve and the FDIC. In addition, any losses from a special resolution must be recouped with assessments on the largest non-bank financial firms.

On Insurance Issues

Q.2. I want to ask you a couple of questions regarding the G–20 and the Financial Stability Board's cooperative efforts on regulatory reform. I am curious if insurance issues fall under this effort and how so? I ask because it has been a challenge for European regulators' to not having a counterpart in the U.S. Executive branch on insurance issues. They complain that our current system not only represents inefficiency, but is also a barrier to global coordination on regulatory reform efforts. They also fear this is a potential problem in any future crisis and in resolving failed firms that have insurance subsidiaries.

Can you tell me specifically if cooperation on insurance regulation falls under the G–20 and FSB mandates, and if yes, does the U.S. Executive branch have adequate authority to take necessary actions under this mandate, or is the United States lacking the proper tools to address insurance issues as part of a comprehensive effort to address crises such as that which we have just lived through?

A.2. The Treasury Department's International Affairs Office coordinates the USG position and participation in the Financial Stability Board (FSB), which is mandated to: deepen the resiliency of domestic financial systems; identify and address potential vulnerabilities in international financial systems; and enhance international crisis management. Senior-level officials from the Federal Reserve, Securities Exchange Commission, and the Treasury Department represent the United States in FSB meetings. Other Federal financial regulatory agencies (the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission), as well as the National Association of Insurance Commissioners participate in USG preparation for the FSB meetings and provide input. Treasury Secretary Geithner and Federal Reserve Chairman Bernanke represent the United States at meetings of the G–20 Finance Ministers and Central Bank Governors. At the Pittsburgh Summit in late September, Leaders designated the G–20 as the premier forum for our international economic cooperation.

To date, neither the FSB nor the G–20 has offered regulatory guidance solely directed at the insurance sector. Certain cross-cutting issues, however, affect insurance, such as supervisory colleges, heightened prudential regulation for large, interconnected financial institutions, and cross-border resolution. The regulatory reform agenda in these fora largely reflects effective U.S. leadership and is consistent with the approach taken in the Administration's proposals, which are pending action by the Congress.

As you have noted, some Europeans suggest that the absence of a Federal regulatory representative complicates their international dealings on insurance supervision, for example on issues of reinsurance collateral or Europe's evolving supervisory regime. The Administration's proposals would give the Treasury Department the authority to represent American interests in international fora regarding prudential measures for insurance. While the Office of National Insurance is not a regulator, it would provide a single coordinated USG voice on prudential matters related to insurance. It

would serve as a Federal authority to represent U.S. interests to work with other nations within the International Association of Insurance Supervisors (IAIS) on prudential regulatory issues, cooperation and agreements.

Transparency of the FSB

Q.3. As it builds out to handle its new mandate, how will it be held accountable, to whom, how will input flow into the process?

A.3. The FSB membership consists of national and regional authorities responsible for maintaining financial stability (ministries of finance, central banks, and regulatory authorities), international financial institutions, and international standard setting, regulatory, supervisory and central bank bodies. All members are entitled to attend and participate in the Plenary, which is the decision-making body of the FSB. Representation on the Plenary is at the level of: central bank Governor or immediate deputy, head or immediate deputy of the main regulatory agency, and deputy finance minister or deputy head of finance ministry. Representation by the international financial institutions and the international standard setting bodies is at a similar level.

The U.S. delegation to the FSB, represented here today by Treasury, the Federal Reserve and the SEC, supports and encourages the publication of FSB reports on its work. Many reports on the FSB's work and the work of member organizations are available to the public on its website at *www.financialstabilityboard.org*. We are also pleased to make Treasury staff available to brief your Committee, Members, and staff at your convenience on any issue relating to the FSB.

Q.4. I think it's important to talk about how our interactions with the FSB and Basel Committee will go with regard to the new regulations that they will recommend. We don't possess a treaty with these bodies, so in order for enactment to take place Congress will have to legislate and/or the independent regulatory agencies will have to adopt and adapt. The question that many are left with is if this will happen? How quickly? Will Congress end up leading the effort or lag? How is it all going to work? I think that the FSB/Basel agreements actually carry the force of law—or for conforming efforts—within the EU (hence the adoption of Basel II). Of course the United States did not adopt because small banks believed they were at a disadvantage. If this is indeed the case, won't a Basel III present a similar situation where the Europeans adopt the findings and we either do not adopt at all or adopt at a much slower pace. Quite frankly, the Europeans do not trust us to implement what we might agree to do, and they do not want to be put in a weakened position *vis-a-vis* the United States. All that said, I'd be interested in your thoughts on the role that the G–20 will play in the regulation writing process? Will it guide with specifics or simply bless proposals put forward?

A.4. The U.S. banking regulators are members of the Basel Committee on Banking Supervision (Basel Committee), as are banking authorities of all of the other G–20 countries. The U.S. banking regulators have adopted the Advanced Approaches of Basel II by issuing regulations after notice and comment. The Basel Com-

mittee is currently considering changes to Basel II in light of the weaknesses in it exposed by the financial crisis. The Basel Committee normally issues international standards following a notice and comment process and we expect this to continue for changes to Basel II. The Basel Committee does not currently have plans for a Basel III. Neither the G–20 nor the FSB has any legally binding rulemaking authority.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORKER FROM KATHLEEN L. CASEY

Credit Rating Agencies

Q.1. It's clear that the Credit Rating Agencies have not been quite up to snuff over the last few years but it seems that the Basel accords and the regulatory regimes rely a lot on them. I know that you have discussed the idea of moving to simple leverage ratios, but how do you square the problem of continuing to rely on a system that has failed us in the past? Should we reform the agencies, reduce regulatory reliance or encourage a new system to evolve?

A.1. In my view, the Securities and Exchange Commission ("SEC" or "Commission") should continue its efforts to both reform the credit rating industry and reduce the regulatory reliance on credit ratings issued by Nationally Recognized Statistical Rating Organizations ("NRSROs"). Over the past 2 years, pursuant to authority granted by Congress under the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"), the SEC has adopted some significant reforms relating to credit rating agencies. These reforms are intended to further the Rating Agency Act's explicit goals of enhancing the transparency, accountability, and level of competition in the rating industry.

But, in my view, the SEC needs to do more in this area. It is essential that the Commission finish its work with respect to the regulatory use of credit ratings. The Commission should adopt the remainder of its pending proposals to address overreliance on NRSRO ratings by removing the regulatory requirements embedded in numerous SEC rules.

The considerable unintended consequences of the regulatory use of ratings—preserving a valuable franchise for the incumbent and dominant rating agencies, inoculating these government-preferred rating agencies from competition, promoting undue reliance and inadequate investor due diligence, and uneven ratings quality—have been evident for some time.

It is vital that the Commission remove the government imprimatur from all SEC rules, particularly those relating to money market funds. The market, not the government, should decide which credit ratings have value.

On Regulation

Q.2. Other countries look to the United States for leadership in financial services regulation. I am especially, and increasingly, concerned about the potential for overregulation in the United States, not only for the effect on U.S. companies and the U.S. economy, but

also for the example that it would set for regulators and policymakers in Europe and elsewhere.

The financial crisis was not caused by deregulation. If anything, it was caused by too much government intervention with respect to entities such as Fannie Mae and Freddie Mac, artificially low interest rates by a hyperactive Federal Reserve, and so on.

Now for my question: What would, in your view, be the dangers of overregulation in the United States? Let's take two issues that are mentioned in your testimony, hedge funds and credit rating agencies. What would be the practical impact on those two industries?

A.2. I share your concerns relating to excessive regulation. Overregulation would not protect or benefit investors. Instead, it would only serve to harm the competitiveness of the U.S. capital markets. Such a result hurts every American who is looking for a job, investing his money, or paying taxes.

In my view, too much regulation of hedge funds would have the predictable effect of moving fund assets to jurisdictions with a more favorable regulatory approach. Regulators and policymakers cannot lose sight of the fact that capital is highly mobile. We can protect investors and oversee hedge funds in a responsible way that does not harm the competitiveness of U.S. markets. Those goals are not necessarily mutually exclusive.

With respect to too much regulation of credit rating agencies, it is my view that before adopting additional regulations that are not market-based, the Commission needs to step back and take stock of all the new rules it has adopted over the past 2 years. The simple fact is that rating agencies are highly regulated today. That is not to say that they will always issue accurate ratings for investors. Government regulation could never deliver such results. And it does not mean that we can second-guess their rating judgments or seek to regulate their rating methodologies. The Rating Agency Act precludes the Commission from such actions, and properly so, in my view. But what it does mean is that we have adopted comprehensive regulations in many key areas. We should seek to establish regulatory *certainty*. At some point, we need to be able to see if the rules we have on the books are having their intended effect.

Too much regulation of rating agencies would not protect investors by improving ratings quality. In fact, it would only increase the regulatory costs and burdens associated with being or becoming an NRSRO, and lead to predictably anticompetitive results. Ironically, these costs are manageable for the incumbent rating agencies, but serve as a competitive barrier to those contemplating entering the NRSRO space.

Avoiding too much regulation and enhancing competition would have another important effect: As the Commission noted recently, "[R]educing the barriers to entry in the market for providing NRSRO ratings and, hence increasing competition, may, in fact, reduce conflicts of interest in substantive ways."

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORKER FROM DANIEL K. TARULLO

On the Financial Stability Board

Q.1. At the G–20, there was general agreement to match up the membership of the Financial Stability Board with that of the G–20 and a focus on the "monitoring of the international economy" for new points of weakness and instability, I am skeptical that the FSB would be able to actually enforce actions by its member nations in response to any emerging risk it perceives. In April, the Economist magazine even said that domestic political pressures would trump any FSB call to action. The article said "But if it warns, who will listen? Imagine the scene in Congress in 2015. The economy is booming but Americans cannot get mortgages because some pen pusher in Basel says the banks are taking too much risk. The banks would be freed faster than you can say "swing voter"." Governor, what can we do to ensure that these moments of pro-cyclicality and crisis response are measured and consistent from the top down, end to end across the globe if the crisis is global and systemic?

A.1. Did not respond by printing deadline.

On Trade Finance

Q.2. U.S. manufacturers continue to struggle in these credit markets to get trade finance and this is yet another example of regulatory treatment creating a self fulfilling prophecy that will slow down the economy.

The rules of Basel II discourage banks from extending trade finance by forcing them to assign to it unreasonably high risk weighting and too long a maturity. The G–20 in April promised to ask their regulators to use discretion when applying the rules. There has been some limited flexibility from the U.K.'s Financial Services Authority, banks say that capital restrictions continue to hinder the market and that there is a disconnect between what the G–20 is saying and the effect of banking regulation on trade finance.

Because of the nature of the trade finance market would you see the necessity of a program of this nature to be kept in place past the 2 years it is authorized for?

A.2. Did not respond by printing deadline.

Q.3. Is Basel II hindering the recovery of the trade finance market?

A.3. Did not respond by printing deadline.

Q.4. Is the G–20 asking regulators to "use discretion" enough to alleviate regulations that may make extending trade finance difficult? Or will the G–20 have to address this in a more formal manner? Is that something you would support?

A.4. Did not respond by printing deadline.

Q.5. Is there anything else that can be done in the international finance community to mitigate the risk of these markets seizing and to ensure liquidity? Is the use of the Export Import Bank and its guarantees appropriate here?

A.5. Did not respond by printing deadline.

Q.6. Is there anything more that can be done to assist developing countries, like Africa, in assisting with the current high cost of trade?

A.6. Did not respond by printing deadline.

On Bank Regulation

Q.7. As we work on our regulatory structure and debate the merits of more or less regulators and the value or lack of value in friction and different sets of eyes and opinions looking at our regulated entities, I wonder if this plays out even more aggressively on the world stage. We worry about regulatory arbitrage . . . and should . . . but how do you avoid a rush for all regulators agreeing to the most draconian standards and then that be the way the contagion spreads? In other words, does the least common denominator equate to squeezing good risk and entrepreneurship out of the system.

A.7. Did not respond by printing deadline.

Transparency of the FSB

Q.8. As it builds out to handle its new mandate, how will it be held accountable, to whom, how will input flow into the process?

A.8. Did not respond by printing deadline.

Q.9. I think it's important to talk about how our interactions with the FSB and Basel Committee will go with regard to the new regulations that they will recommend. We don't possess a treaty with these bodies, so in order for enactment to take place Congress will have to legislate and/or the independent regulatory agencies will have to adopt and adapt. The question that many are left with is if this will happen? How quickly? Will Congress end up leading the effort or lag? How is it all going to work? I think that the FSB/Basel agreements actually carry the force of law—or for conforming efforts—within the EU (hence the adoption of Basel II). Of course the United States did not adopt because small banks believed they were at a disadvantage. If this is indeed the case, won't a Basel III present a similar situation where the Europeans adopt the findings and we either do not adopt at all or adopt at a much slower pace. Quite frankly, the Europeans do not trust us to implement what we might agree to do, and they do not want to be put in a weakened position *vis-a-vis* the United States. All that said, I'd be interested in your thoughts on the role that the G–20 will play in the regulation writing process? Will it guide with specifics or simply bless proposals put forward?

A.9. Did not respond by printing deadline.