"THE INTERNATIONAL FRAMEWORK FOR MODERNIZING FINANCIAL REGULATION"

PREPARED STATEMENT OF
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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, policy-makers 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 U.S. 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 build up. 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 Ministers 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 US/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 decision making 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 three 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 G20 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 US 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 dialogue 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 dialogue, 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 dialogue 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 reform 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.