Daniel K Tarullo: International cooperation to modernize financial regulation

Testimony of Mr Daniel K Tarullo, Member of the Board of Governors of the US Federal Reserve System, before the Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, Washington DC, 30 September 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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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 two 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, internationally 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 organizations 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

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[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.

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.

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 risk-management 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.

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 communiqué issued Friday by the G-20 leaders echoed and amplified the need for improvements in both the quantity and quality of capital.

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[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.

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

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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).

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.

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.

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. Cross-border 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

[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."

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 dialogue with the subcommittee on these issues. I would be pleased to answer any questions you may have.