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Before the Committee on Banking, Housing, and Urban Affairs
Subcommittee on Security and International Trade and Finance
United States Senate
July 20, 2010

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

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

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

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

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

Setting High-Quality Standards

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

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

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

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

Addressing Too Big to Fail

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

Constraining Risk-taking by Major Financial Firms

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

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

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

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

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

Improving Market Discipline through Enhanced Disclosures

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

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

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

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

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

In turn, the traditional banking system had important exposures to this parallel banking system with its risks of asset bubbles, runs, and collapse. Banks provided credit to, and engaged in large amounts of over-the-counter (OTC) derivative transactions with, the major securities firms and

other non-bank financial institutions. Banks also provided payment, clearing, and settlement services to the parallel banking system. In significant part because of these exposures, the collapse of the non-bank financial sector during the crisis threatened the safety and soundness of the banking system itself.

In particular, the build-up of risk in OTC derivatives markets became a major source of contagion during the crisis. To reduce risk from the web of bilateral derivatives trades between the major financial firms, U.S. financial reforms require clearing of standardized OTC derivatives through well-regulated central counterparties; exchange trading of standardized derivatives to promote transparency, price discovery, and liquidity; and supervision and regulation of all derivatives dealers and major market participants, including conservative capital and initial margin requirements on all non-centrally cleared derivatives. Moreover, trade repositories will provide regulators with information about standardized and customized transactions so that they can assess the potential for derivatives trades to transmit shocks through the financial system.

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

Providing Better Tools to Resolve Major Financial Firms while Safeguarding the System

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

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

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

Finally, it remains vital that the financial sector, not taxpayers, bear the burden of risks imposed on the system as a whole. In Toronto, G-20 Leaders agreed on the principles that financial

institutions—not taxpayers—should bear the burden of extraordinary support provided in crisis to the financial sector, that any fees be based on risk imposed on the system, and that such fees be undertaken in a manner that allows for broad international adoption. This is a significant achievement.

Tying Compensation to Long-term Value Creation

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

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

Extending the Perimeter of Regulation

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

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

While supervisory and regulatory institutions vary across jurisdictions, there is broad recognition within the G-20 of the need for supervision to be consolidated and to address risks to the system. European policymakers are now creating a macro-prudential supervisory function—the

European Systemic Risk Board—to assess systemic risks and vulnerability, as well as issue risk warnings.

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

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

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

Strengthening the International Architecture for Financial Cooperation

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

Building Stronger Global Cooperation

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

To help coordinate the formulation and execution of strong and consistent rules across key financial jurisdictions, last spring, G-20 Leaders agreed to re-establish the FSB with a strengthened mandate and expanded membership. The FSB is a critical part of our collective efforts to identify vulnerabilities in the global financial system, promote financial stability, and encourage coordinated and comprehensive regulatory standards through peer review. The FSB

brings together representatives from 25 major jurisdictions, including all major global financial centers, along with international regulatory, supervisory, and standard-setting bodies. The FSB is working closely with the BCBS to coordinate international efforts to strengthen bank capital and liquidity standards, and to devise policy recommendations for winding down large, interconnected financial institutions. Currently, the FSB and BCBS are preparing recommendations on this set of issues for the next G-20 Leaders Summit in November.

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

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

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

Building Stronger Bilateral Cooperation

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

Looking Ahead

In conclusion, as we prepare for historic financial regulatory reform to be enacted into law in the United States, we must work to level up the playing field across all major and emerging financial centers internationally. By pursuing and implementing high-quality standards, addressing the moral hazard associated with too big to fail, extending the perimeter of regulation, and

establishing a stronger international architecture to prevent future crises, we will enhance the soundness and resilience of our own financial system to better serve America's households, workers, entrepreneurs, and corporations for generations to come.

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

Thank you.