For release on delivery
10:00 a.m. EDT
July 20, 2010

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Board of Governors of the Federal Reserve System

before the

Subcommittee on Security and International Trade and Finance

Committee on Banking, Housing, and Urban Affairs

United States Senate

July 20, 2010

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

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

Goals for International Cooperation in Financial Regulation and Supervision

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

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

Second, to prevent major competitive imbalances between U.S. and foreign financial institutions. A core set of good common standards will reduce opportunities for cross-border

regulatory arbitrage, even as it promotes financial stability. This goal is particularly noteworthy as the United States tightens its domestic prudential standards.

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

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

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

The Federal Reserve's Role in International Financial Reform Efforts

As a central bank with significant supervisory responsibilities, the Federal Reserve actively participates in both (1) central-bank-focused groups that monitor developments in global financial markets and promote sound and efficient payment systems and (2) supervisory forums, such as the Basel Committee on Banking Supervision (Basel Committee), which promotes high global standards for banking supervision and regulation. We also actively participate in the FSB,

which is coordinating many of the initiatives undertaken in response to the financial crisis and is directly communicating with the Group of Twenty (G-20).

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

Basel III

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

We agree with the yardstick set forth last month by the G-20 leaders in Toronto--that minimum capital requirements should "enable banks to withstand--without extraordinary government support--stresses of a magnitude associated with the recent financial crisis."[1] Our view is that large institutions should be sufficiently capitalized so that they could sustain the losses associated with a systemic problem and remain sufficiently capitalized to continue functioning effectively as financial intermediaries. Meeting this standard will require a

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

considerable strengthening of existing requirements, both with respect to the amount of capital held and to the quality of that capital. As to the former, it is particularly important that the risk weightings associated with traded instruments be substantially increased. As to the latter, the crisis confirmed what many of us have long believed--that common equity is by far the best measure of a firm's loss absorption capacity. During the crisis, regulators, counterparties, and market analysts all looked to levels of common equity as the key measure of a firm's durability in the face of extraordinary financial stress. We have conducted extensive analysis to inform our judgments on the specific rules needed to implement this standard. In this respect, the stress tests we conducted last year as part of the Supervisory Capital Assessment Program have been very useful in assessing the amount of capital needed to survive a financial crisis without unusual government support.

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

Although adopting a robust, common set of capital and liquidity rules for internationally active banks is critical, it is neither practical nor desirable to negotiate all details of financial regulation internationally. It is important that the United States preserves the flexibility to adopt prudential regulations that work best within the U.S. financial and legal systems. Within a

common set of agreed-upon global standards, each jurisdiction will want to tailor some of its rules and supervisory practice to national conditions and preferences. Along these lines, there have been recent discussions within the FSB on the possibility of formalizing consultations among member countries to examine how each member is using its own mix of instruments to achieve particular safety and soundness ends.

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

Cross-Border Crisis Management and Resolution

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

The FSB is developing concrete policy recommendations for the G-20 Summit in November. Specifically, the FSB is working to identify common principles and key attributes for effective national resolution regimes, including a menu of resolution tools for authorities to draw upon in light of the varying circumstances that may be associated with distress at a particular firm. Among these are restructuring and wind-down measures for firms that will be closed down, such as arrangements for providing temporary funding or the ability to establish a

bridge bank to take over essential functions. There is also considerable interest at the FSB in developing a resolution tool that could facilitate a restructuring of a firm's own capital and liquidity that would allow it to continue operating as a going concern. Specifically, the FSB is exploring whether there could be a viable mechanism for converting debt into equity through terms set out in the debt instruments.

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

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

Domestically, we have formed crisis management groups to cover the key internationally active U.S. banking organizations. In addition to the Federal Reserve, the groups include representatives from the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and relevant foreign supervisors and central

banks. The firms are each internally identifying and assessing their options and strategies to lower risk in the event of stress, including selling portfolios or business lines, restructuring liabilities and implementing contingency funding plans. The objective is to ensure that each firm has a concrete and viable plan to reduce riskiness, ensure the continuity of critical financial services, preserve liquidity, and make up cash flow shortages under severely adverse conditions. They are individually working with their own crisis management group to isolate key impediments to recovery and are focusing on work that should be undertaken in the near term to enhance recovery options. These plans will have to be dynamic to ensure they remain relevant and appropriate in light of changing business and economic conditions.

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

Incentive Compensation

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

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

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

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

We have adopted an approach that requires large financial organizations to establish and maintain internal governance and management systems to implement principles for assuring that incentive compensation arrangements are risk-appropriate. These principles, and the process by which we proposed that they be implemented, were issued by the Federal Reserve for public comment in October. The final supervisory guidance, which was jointly issued with the other banking agencies, was released last month.[3] We chose a principles-based approach because of the substantial variation in the actual incentives and risks associated with the thousands of executives and other employees within and among banking organizations. Our view continues to be that a uniform or formulaic approach to all such employees would be neither efficient in

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

motivating and compensating employees nor effective in preventing excessively risky activity, particularly among non-executives such as traders.

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

While both approaches have merit, we believe the option we have chosen is likely to be more successful in promoting risk-appropriate compensation practices. As already noted, we fear that a formula-based approach applicable to all covered employees may spawn efforts to circumvent the rules through creative new compensation practices, whereas our requirement that the banks internalize sound principles for incentive compensation and apply them to all such arrangements places a continuing responsibility on the firms themselves. Of course, considerable oversight is needed to ensure that a principles-based approach is implemented rigorously. We have already conducted an extensive horizontal review of compensation practices at 25 large U.S. financial holding companies and have sent detailed assessments to each firm commenting on their proposals for implementing the principles.

It may well be that over time the two approaches will converge somewhat. For example, we may determine on the basis of experience with many firms that there are certain best practices that should at least presumptively be applicable to certain classes of employees. Similarly, the

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

EU may find that more attention to internalization of the principles and customization of appropriate practices is necessary, particularly as applied to non-executive employees. We intend to continue information sharing and discussions through the FSB and the Basel Committee. For now, though, there is indeed a difference in approach, one that illustrates the point I made earlier that there need not be complete harmonization in all prudential regulation and supervision, even where there is agreement on basic goals.

Effect of the Dodd-Frank Act

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

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

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

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

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

Current and Future Focus of International Regulatory Groups

As my testimony makes clear, the international regulatory groups remain focused on responding to the crisis. The FSB is pursuing financial reform and working with the relevant standard-setting bodies to ensure that detailed proposals are developed in a timely manner. In some cases, the importance of the issues and the drive to respond quickly to the crisis have led to a proliferation of international working groups whose mandates may overlap. While this reaction is natural in the wake of a crisis, we will need to rationalize the activities of these groups as our focus shifts from policy development to implementation. So, too, we will need to ensure that the relatively new members of these groups are fully and effectively integrated into their activities, including in leadership positions.

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

The FSB itself has a valuable role to play by bringing together the international standard-setting bodies and key national authorities responsible for financial stability in the G-20 member jurisdictions. Its role might usefully be conceived as roughly paralleling the role to be played by the Financial Stability Oversight Council in the United States under the Dodd-Frank Act. The FSB can facilitate discussion and analysis of emerging risks to financial stability that cut across sectors or across the jurisdiction of more than one regulator. Because it consists of senior

officials from finance ministries, regulatory agencies, and central banks, it is well positioned not only to identify cross-cutting risks or regulatory gaps, but also to take action to address those risks.

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

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