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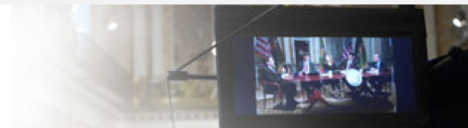

Remarks by Assistant Secretary Marisa Lago on International Financial Regulatory Reform

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As Prepared for Delivery

It is a privilege for me to lead off the discussions today, which will delve into critical issues such as risk and liquidity, Basel III, and addressing dangers to efficient market functioning such as cyber crime and fraud. These issues dovetail with my role as Assistant Secretary for International Affairs at the Treasury Department, where I deal with financial regulatory issues in international fora such as the G-20 and the Financial Stability Board (FSB).

My talk today will encompass financial regulatory reform in the wake of the financial crisis and the need for coordinated multilateral action to ensure a sounder and more resilient global financial system. This is a timely topic given both the discussions that will follow today, and the meeting of G-20 Finance Ministers and Central Bank Governors that will occur later this week in Washington.

One of the defining moments of our generation will be having lived through a financial panic of a scale and severity not seen since the Great Depression. The failures that led to the crisis were many. Over the two decades preceding the crisis, the financial system had grown rapidly in an environment of economic growth and stability. We saw significant growth of large, short-funded, and substantially interconnected financial firms. Huge amounts of risk moved outside the regulated parts of the banking system to where leverage could be more easily increased. Throughout the financial system, in the search for yield in a low-interest rate environment, firms and investors took on risks they did not fully understand. In Washington, regulators did not make full use of the authority they had to protect consumers, and to limit excessive risk and leverage. Legal loopholes and regulatory gaps allowed large parts of the financial industry to operate without oversight, transparency, or restraint. Policy makers were too slow to recognize and fix a broken system. And there is no doubt that, across the country, many Americans took on more debt than they could afford and many firms encouraged them to do just that. So, we all share responsibility for the crisis. And we all share responsibility for reform.

Reform, from the Treasury Department's perspective, has taken two major and complementary forms: reforms that we are undertaking at home and the financial regulatory reform agenda that we are pursuing internationally. Let me first address the sweeping reforms underway domestically.

U.S. Financial Reforms

Last July, President Obama signed into law the most comprehensive set of financial reforms since the Great Depression. The historic enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act lays the foundations for a sounder and more resilient financial system. Dodd-Frank is the law of the land, and work is well underway to implement the law's provisions decisively and effectively.

In broad terms, the Dodd-Frank Act accomplishes five core objectives. It provides tools to support the health of the financial system as a whole, strengthens prudential standards, establishes a comprehensive regulatory framework for the derivatives markets, addresses the problem of financial institutions perceived to be too big to fail, and unifies our approach to consumer financial protection.

First, these reforms give us the tools to look beyond the safety of individual firms or markets to the health of the broader financial system. The Dodd-Frank Act establishes the Financial Stability Oversight Council and the Office of Financial Research. Through the Council, supported by the Office of Financial Research, regulators have new tools and accountability to monitor and constrain risks to the financial system.

The Federal Reserve, which has examination and enforcement authority over all bank holding companies, will now also have similar authority over non-bank financial companies that are designated by the Council. This way, the largest, most complex financial institutions will become subject to consolidated oversight, regardless of their corporate form.

Second, these reforms require regulators to impose stronger prudential standards – robust, risk-based capital, leverage, and liquidity standards to help mitigate the costs of both firm-specific failures and systemic shocks.

Third, the reforms establish a comprehensive regulatory framework for the derivatives markets – the source of so much risk and uncertainty in the recent crisis. And at the same time, through a narrowly tailored end-user exemption, the reforms ensure that commercial firms will be able to hedge their risks effectively and efficiently.

Fourth, the reforms put an end to the problem of "Too Big to Fail" or what I will later refer to, in the international context, as systemically important financial institutions. The reforms in the Dodd-Frank Act give the federal government the authority to shut down and break apart large non-bank financial firms whose failure threatens the broader system. In addition, the new law makes absolutely clear that taxpayers will never be asked to bear the costs of a financial firm's failure.

Finally, the law addresses the fundamental failure of consumer protection in the years leading up to the crisis. The Consumer Financial Protection Bureau, an independent entity within the Federal Reserve established under the Dodd-Frank Act, has one mission: to promote transparency and consumer choice, and to prevent abusive and deceptive practices.

The law does much more, but these are the core elements: a focus on systemic risk; heightened prudential standards; comprehensive regulation of derivatives; an end to "too big to fail;" and robust consumer protection. Flaws in each of these areas helped precipitate or prolong the crisis and this legislation targets those flaws and fixes them.

Early on, the international dimensions of the recent financial crisis made it clear that greater international coordination would be a necessary component of the financial regulatory reform agenda. The challenge has been to ensure that the world's standards are every bit as high and as strong as America's standards. Financial firms, markets, and transactions are more

interconnected than ever before. The breadth and depth of these linkages require us, at the policy setting level, to coordinate across borders, and to support the setting of high standards that will be consistently applied across those borders, in order to protect America's economic and financial wellbeing.

In the wake of the severe, globally synchronized financial crisis, the G-20 members must develop the most convergent financial reforms the world has ever attempted. As the United States and other G-20 members have worked to strengthen global financial regulation, we remain mindful of the necessity of assuring consistency both across geographic borders and across the various sectors of the financial services industry. This is essential if we are to have fair competition and avoid a race to the bottom either in regulatory standards or in company practices. Achieving this is a hard task, and the G-20 and the Financial Stability Board have been hard at work for well over two years now. We remain committed to sustained coordination at the international level, coupled with consistent policy actions at the national level.

These are high order statements, which I assume are hard to disagree with, even amongst the most diverse members of this audience. But, what do they mean in practice?

From the U.S. Treasury perspective, we see three issues at the heart of the G-20 regulatory reform agenda. These are: capital, systemically important financial institutions (SIFIs), and the OTC derivatives markets.

Capital

As has become all too evident in retrospect, in the lead-up to the recent crisis, too many major financial institutions around the world held too little loss-absorbing capital to support their risky assets; they used excessive leverage to finance their operations; and they relied too much on unstable, short-term funding. The resulting dislocation in markets and the painful failure of several large and interconnected financial institutions imposed steep costs on households, workers, and businesses – costs that are still felt today.

That is why the G-20 Leaders focused on this issue and supported the Basel Committee agreement concluded in December which increased the quantity and quality of bank capital, introduced a supplementary leverage ratio, and issued new liquidity ratios. These actions should reduce the likelihood and costs of future financial crises, provide more certainty to the markets, and establish a level playing field for global financial institutions. The Secretary has committed to meeting the deadline of issuing national regulations for Basel III by the end of 2012.

Too Big to Fail

The second key issue on the G-20's agenda addresses the problem of financial institutions perceived as too big to fail. In the G-20 context, we more typically refer these institutions as systemically important financial institutions or SIFIs. We believe that no firm is too big or too complicated to fail. We believe an effective framework for addressing issues inherent in large, interconnected, financial institutions must include three facets.

First, an effective framework must incorporate enhanced supervisory oversight that includes appropriate and adequate supervisory powers and authorities. Current recommendations to do so include providing a full suite of powers available to all national supervisors to execute on their mandate; improving the set of standards for supervisors to encompass better micro and macro risk detection processes; and creating a stricter assessment regime that consistently drives supervisors to higher quality work, and alerts authorities to potential weaknesses in their oversight processes earlier. Enhanced supervisory oversight should also include regular stress tests.

Second, an effective framework must include higher loss absorbency capacity. The Basel III framework was an important step to achieving higher levels of loss absorbency capacity globally. In addition, the Financial Stability Board and standard setters are considering a number of possible options to address the need for even higher loss absorbency for globally systemic firms. These include: capital surcharges, innovative capital instruments such as contingent capital and bail-in instruments, systemic levies, liquidity surcharges, tighter limits on large exposures, and structural limits. However, full and thorough consideration of these options, based on robust analysis and sound economic rationale is needed before authorities decide on appropriate levels of loss absorbency to apply at the firm level.. Implementation of the best options for building loss absorbency capacity will underpin an international SIFI strategy that will help reduce systemic risk from these large firms.

Third, an effective framework requires an effective resolution regime. In the United States, we start from the basic view that no firm should be "too big to fail," and therefore each must face the consequences of risk-taking. The Dodd-Frank Act addresses the moral hazard created by an expectation of governmental intervention by making clear that failing financial firms will be wound down, and that culpable management, shareholders, and unsecured creditors will be allowed to bear losses. A key provision of the Dodd-Frank Act provides authority to the FDIC to resolve systemically important non-bank institutions in a manner modeled after the FDIC's existing, and effective, bank resolution regime.

The issues posed by today's large, interconnected financial institutions are not simply ones of national regulation and resolution regimes. These institutions often conduct operations and transactions that cross multiple jurisdictions. Putting in place an effective cross-border resolution mechanism is a core – and critical – challenge that we face. A lot of work already has been done by the Basel Committee in developing its Recommendations on Cross-Border Resolution. Further work is well underway in the Financial Stability Board, which is looking at more far-reaching concepts such as a global resolution memorandum of understanding or treaty, and gone-concern capital.

G-20 Leaders already have agreed that all countries need to have effective national resolution systems. Of course, this is more easily said than done. Extraordinarily complex issues surround the legal authority and provisions needed to shut down institutions. Effective implementation will be critical. In addition, more work still needs to be done: in creating incentives for firms to reduce the complexity and interconnectedness of their group structures and operations; in undertaking advance planning for orderly resolution should it be needed; and in developing exit strategies for government intervention that promote market discipline and reduce moral hazard.

In some cases, creating an adequate regulatory regime for large, interconnected financial institutions will require the creation of new institutions capable of developing and promptly implementing robust new rules. In the United States, the newly created Financial Stability Oversight Council (FSOC) started its work agenda by taking up two big issues in this area: implementation of the Volcker Rule, which imposes activity and size restrictions on depository institutions; and establishment of the criteria and methods for designating non-bank financial institutions that will be subject to regulation by the Federal Reserve. In the process of rulemaking, sequential rounds of public comment periods have offered important opportunities for individuals and businesses to express their views and to enhance the comprehensiveness and robustness of the FSOC's deliberations on these issues.

OTC derivatives

The third key G-20 priority relates to increased transparency, and continued improvement in the regulation and supervision of the over-the-counter derivatives markets. To reduce risk from the web of bilateral derivatives trades among the major financial firms, the Dodd-Frank Act requires clearing of standardized OTC derivatives through well-regulated central counterparties; transparent trading of standardized derivatives on exchanges or electronic platforms to promote price discovery and liquidity; reporting of all derivatives trading to trade repositories; and supervision of all derivatives dealers and major market participants. For those transactions that must remain customized and are not cleared through central counterparties, regulators will require more capital and impose initial margin requirements. Regulators will have access to information about both standardized and customized transactions, so that they can assess the potential for derivatives trades to transmit shocks throughout the financial system.

A lot of globally-coordinated work has already occurred, but more remains to be done. Treasury and our international counterparts are now focused on making certain that critical OTC derivative market infrastructure is subject to appropriate oversight. A key element of our discussion is ensuring that we have cooperative oversight frameworks to address the information needs of multiple supervisors.

By focusing on these three key priority areas of regulatory reform – capital, systemically important financial institutions and OTC derivatives markets, I don't mean to suggest that this represents the entirety of the G-20's agenda. On the contrary, the breadth of the G-20 financial regulatory agenda encompasses work in many other important areas, notably: implementing sound compensation practices; achieving a single set of high quality, global accounting standards; reducing reliance on credit rating agencies; and promoting adherence to international standards in areas such as anti-money laundering, tax information exchange, and core prudential supervision.

Conclusion

Protecting the safety and soundness of our respective financial markets as well as the interests of retail investors and consumers of financial services will require increasingly close regulatory cooperation, including cooperation on supervision of firms operating across borders. The United States Treasury Department remains committed to greater cooperation, both multilaterally through fora such as the G-20 and Financial Stability Board and bilaterally through the financial dialogues that Treasury has established to bring together the Treasuries, or Finance Ministries, and financial regulatory authorities in the United States and key financial markets such as China, India, Japan, and Europe.

Thank you for your attention, and I wish you many productive discussions over the remainder of your time here.