Testimony Submitted to the Senate Committee on Banking, Housing, and Urban Affairs

Hearing on "The Role of the Financial Stability Board in the US Regulatory Framework"

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1. **The rationale for international financial regulatory coordination at this time –**

Generally, the US government has the lead in international economic negotiations—as the largest and most developed economy, as the incumbent creator of the rules and institutions started after World War II, often as having the most technical expertise on a given subject, and usually as having the model of a property-rights respecting rule of law in its commercial affairs that other economies wish to emulate or import. But even where the US government is not entirely dominant in the international policy agenda setting, there is room for the US economy and citizens to benefit from international coordination. The rest of the world economy exists, whether or not the US government chooses to engage with other governments in discussion of the rules by which it is partially governed. Economic activities abroad can have significant negative spillovers on US well-being, as well as present opportunities for (mutual) gain to be unlocked. Mostly, though not always, international economic coordination ends up raising standards abroad while constraining harmful behaviors in the United States that we would wish to limit anyway – and in fact, our own government's legislated intent is often more effectively applied by making it harder for US entities to skirt domestic regulations by moving abroad.

[1] I am grateful to the Alfred P. Sloan Foundation for its support of my research on global financial stability, and to my colleagues Morris Goldstein, Simon Johnson, Avinash Persaud, Edwin Truman, and Nicolas Véron for their suggestions for this specific submission of testimony. I remain solely responsible for the views and any errors in this statement, and thus it does not necessarily represent the views of the Peterson Institute, the Sloan Foundation, or any member of their staff or boards. Disclosure of the Institute's funders and transparency policy are available at http://www.piie.com/content/?ID=138 .

The benefits to the US economy and public from international financial regulatory cooperation are particularly high for a simple reason: Unnecessary financial volatility and misbehavior abroad is transmitted to the US economy directly, rapidly, and strongly. As other economies inevitably grow in size and financial depth relative to the US economy, the impacts of their problems on the United States grow. We can see this in the comparison between the real but limited impact of the Latin and Asian financial crises of the 1990s on the United States and the far greater harms felt from the European crisis of recent years and the swings in capital flows and commodity prices driven by Chinese financial instability. This can do us great harm, despite the size, depth, diversity, and general robustness of US financial markets and lending activities making us less vulnerable than other economies to any given shock.

We cannot simply live with the misbehaviors and even unintended weaknesses of other economies' financial systems. We need changes in those other countries to defend ourselves, as well as to help them. Furthermore, the usual concern in international economic governance about a race to the bottom of low standards winning out takes on a particular form in the financial sector: cross-border regulatory arbitrage. Given the mobility of capital and the availability of information technology and connectivity, jurisdictions where regulations are much weaker can become places where activities prohibited in the United States and elsewhere thrive. These activities can produce globally dangerous build-ups of financial risk very quickly and easily. While international regulatory coordination cannot rule these out completely, it can make it both much more difficult for such legal loopholes to arise, to be defended, to grow in size and riskiness, and to hide from at least supervisory awareness.

International regulatory coordination, in the manner in which it is currently led by US government and Federal Reserve representatives, is reducing these risks to US economic and financial stability. Please note that I said reducing, not removing, these risks – please note, also though, that I said reducing not raising. This reduction of foreign financial risks to the United States (including from US entities moving dangerous activities abroad to elude supervision) is happening along four channels at present:

- *Raising minimum standards for the soundness of major banks and banking systems*, including by setting minimums for bank capital, improving risk assessment (e.g., stress testing), creating liquidity/leverage limits, identifying systemically important institutions, making cross-border resolution more feasible, and so on.
- *Increasing cross-border transparency of financial systems' organization, institutions, financial flows, and build-ups of risk.*
- *Reducing the possibilities of regulatory arbitrage across major financial centers,* both in terms of getting agreement on activities to be restricted and monitored, and of providing a means for "naming and shaming" non-compliant regimes.
- *Promoting largely US-based versions of best practice for regulators, supervisors, bankers, and non-bank financial institutions in other countries.*

I would be remiss in my duty to this Committee, however, if I did not point out that other countries can legitimately expect better US behavior and practice to emerge from international regulatory coordination as well. Our regulators, supervisors, banks, and other financial institutions did not cover themselves in glory with their practices in the run-up to the financial crisis of 2008-10. At a minimum, having the US financial regulators and supervisors be confronted with international questions and standards should reduce the cognitive capture of that community by a set of blinders, as I have argued played a critical role in causing the US financial crisis.

There are other views which will claim that the current international financial regulatory process is either eroding desirable US regulations by having other countries force compromise on the United States through the process, or is imposing unnecessary additional regulations upon the United States to erode our competitive advantages, or both. I readily acknowledge that there are a few instances of this sort – I believe that the attempt by European Union [EU] regulators to impose Solvency II, their set of insurance requirements, on insurers in the United States and elsewhere is a particularly costly example, as I will explain – but I view that as indeed *instances* of bad regulation, not the overall international process being inherently harmful. Any regulatory process, domestic or foreign, will have debates and make some mistakes. Arguably, the domestic Financial Stability Oversight Council [FSOC] within the United States is if anything primed to be more biased towards lowest common denominator or group think leaving gaps in the US financial regulatory framework than the international Financial Stability Board [FSB]. So, the FSB is a useful check and occasional corrective to the US FSOC process.

Whether it is discussions of Trade Promotion Authority (which I commend the Senate for recently passing), of responses to climate change, of efforts to balance healthy global tax competition with the prevention of tax avoidance by multinational corporations and wealthy individuals, or of the need to prevent cross-border regulatory arbitrage by financial institutions, the US government has to confront the fact that behaviors and policies abroad affect us here at home. There is sometimes a paranoid tendency by some American politicians and pundits to assume that all international economic deals are about putting one over on the United States, eroding our high standards through subversion of domestic regulation, or eroding our marketbased competitiveness by imposing undue additional regulation. This is a profound misunderstanding on both the right and the left of our public debate. The United States advances the economic welfare of its people through constructive international engagement, usually gets its way in such efforts and extends the rules it wants to others, and sometimes even benefits from having constraints imposed from outside pressure that domestic special interests would be able to prevent absent that. Yes, sometimes other governments do pursue narrow interests of their national champions, whether state-owned or simply influential private businesses, through these processes. But American economic negotiators are grown-ups, they can handle it, just as they would when having business negotiations in the private sector. The fact that somebody tries something self-interested does not mean you cannot work with them; you simply call them on that attempt.

2. **The demonstrated utility of the Financial Stability Board –** Turning from the general issue of international coordination on financial regulation to the current process for pursuing it, what about the FSB? Does it serve US and global interests as currently constituted and operating? I believe that it clearly does, though with some inherent limitations, as well as some areas for improvement that can be fixed. I resolutely dispute any claims that the FSB is run amok, is undermining US domestic financial regulation, or is trying to, let alone succeeding in, forcing our diverse and unique private-sector financial system to converge on others' models. This is not because I am part of some technocratic self-appointed elite, or more crassly simply buddies with the people involved in the FSB process – I have been rather critical on the record of some of the FSB's decisions for lack of ambition and for too much clubbiness in its agenda

setting.[2] But I do believe that the FSB as an organization for international coordination is a reasonably good institutional response to the need for effective, legitimate, and well-motivated global financial regulation.[3] Among the positive attributes of the FSB are:

- Its national membership covers all of the world's major financial centers but is still limited enough in number to be able to make decisions.
- It usefully cuts across national and regulatory turf barriers in a way that is needed to confront regulatory arbitrage and address globally connected financial networks.
- It is coordinated with the G-20 economic leaders' meetings and processes, which means major agenda items from the FSB get on to the G-20 agenda for buy-in.[4]
    - This also creates scrutiny and oversight for the G-20 decisions, and a structure for issuing public progress reports for assessment.
- By including central bankers and financial officials, as well as bank supervisors narrowly defined, it avoids some of the narrow thinking and silo mentality that caused cognitive capture in the earlier Basel banking processes and in US supervisory decisions pre-crisis.
- It is a soft-law organization, meaning that agreements it reaches are only binding on member governments to the degree that not complying involves naming and shaming.
    - When a regulation issued becomes recognized as worthy, popular and market pressure to adopt a good standard are the main source of compliance, with the FSB simply providing public benchmarks and monitoring.

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[2] See, among others, Adam S. Posen, "Confronting the Reality of Structurally Unprofitable Safe Banking," in *Too Big to Fail III: Structural Reform Proposals: Should We Break Up the Banks?*, Andreas Dombret and Patrick Kenadjian, eds., Boston/Munich: De Gruyter, 2015 (available at http://tinyurl.com/oxc7wk2).

[3] For an earlier assessment of the FSB, many of whose recommendations have largely since been adopted, see Edwin M. Truman and Gary Schinasi, "Reform of the Global Financial Architecture," *PIIE Working Paper* 10-14, October 2010 (available at http://www.piie.com/publications/interstitial.cfm?ResearchID=1674).

[4] I am grateful to Morris Goldstein for this insight regarding the G-20 link.

  - This to me is a virtue in a world of sovereign nation states and the need to change regulations over time.

- It has grown out of leadership efforts by both Democratic and Republican administrations, including the creation of its direct predecessor the Financial Stability Forum, and as such is at its core a US-instigated nonpartisan institution.

The proof is in the pudding, even though it has had little time to cook. The FSB process has produced some useful achievements that are being applied globally as a result of these structural attributes. Banking transparency, standards, and particularly capital requirements have been raised in the major financial institutions of a wide range of countries, including in some critical emerging markets and some financial centers outside of the United States and European Union. Agreement on a set of G-SIFIs, globally systemically important financial institutions, and on capital surcharges for them as partial insurance for the public, has been mutual including all FSB member countries, and done on largely sound replicable criteria. Progress has been made on procedures and compelling conditional funding for safer expedited resolution of such important institutions when they run into trouble.[5]

Having widespread divergence on what different governments believe is adequate bank capital or what banks are systemically important would be a recipe for precisely the kind of race to the bottom that would imperil US financial stability – every country would get looser regulations for its preferred client banks, and some would compete to be the place the world's banks could engage in activities that should not be allowed. This will become increasingly

[5] Which matters if you believe that resolution threats are credible to large/important institutions, and that the inability to resolve Lehman Brothers and others was a cause of the financial crisis. I have my doubts that this is going to help much in preventing the next crisis. For this hearing, however, the point is that the majority of US officials do believe this is important, and the FSB has delivered in response to their belief some global adoption of measures desired in this regard.

important with large Chinese financial institutions, as we are seeing in today's news. Given China's membership in the FSB and G-20, we have a means to bring those potential dangers into the regulatory system beyond Chinese government bailouts and own soft-touch regulation (following the US and UK mistakes of the 2000s, sadly).

3. **Where and why bad regulation is emerging from the FSB process regarding non-banks –** As I mentioned earlier, the FSB can be a good process, producing some good international standards as a result, thus serving US economic interests, and *still* get some things wrong. This is inevitable, as getting things right is difficult, both because there are governments pushing compromises and proposals for the wrong reasons on any given issue, and because some issues are more difficult to tackle than others. Where the FSB at present is getting things wrong, in my opinion, largely has to do with its approaches to coordinating regulation of the non-bank parts of the financial system. Regulating non-banks is more difficult because some well-organized interest groups that were less weakened or tainted by the financial crisis have some sway, because intellectually the manner and extent of non-bank regulation is less obvious and certainly less well precedented, and because the kinds of national regulators and supervisors involved are much more diverse. I also believe that the FSB has demonstrated a tendency to treat non-banks as banks because it is something its technocratic members are more familiar with, it allows claims of neutrality across the financial sector, it utilizes off-the-shelf remedies, and it speeds the conclusion of the post-crisis agenda. In other words, treating banks and non-banks largely the same is the easy way out.

Diversity in financial systems is, however, a virtue. As I have argued for some time, a major reason that the United States and Germany recovered from the financial crisis more rapidly and strongly than other advanced economies was that they had more diversified financial systems, and thus were more robust in continuing to provide financing to non-financial businesses and households.[6] This financial diversity so helpful to the United States comes along at least two dimensions: first, that we have a relatively unconcentrated banking system, despite the existence of megabanks, which includes community banks and various regional lenders; second, that we have a variety of non-bank means of providing finance for investment, including corporate and junk bonds and commercial paper, venture capital and private equity, pension funds and insurance firms, as well as newly emerging forms of direct lending. This makes the US economy far more resilient to financial shocks, even the worst ones we have seen. We do not want any global regulatory process to interfere with this diversity in US finance.

That is not the same, though, as saying any international regulation of non-banks is a bad thing. If one remembers all the different kinds of financial firms engaged in bad lending and investment decisions, fraudulent behavior, speculation with other people's money, and reliance on implicit government bailout guarantees, during the 2000s in the United States, there is a prima facie case, which I support, for more entities coming under regulation than fewer. What the FSB needs to do, and the US representatives there need to encourage, is serious discussion of *which* parts of the non-bank financial sector need further regulation, and which do not, and *what form* that regulation should take. Simply amping up capital requirements, for holding "safe assets," and calling everything a "shadow bank" that provides funding and is not a bank, misses the point and potentially does harm.

Right now, the biggest mistake the FSB is making in this regard is in the attempt to extend Solvency II, the European Commission's regulation for insurance firms, to global application. This is a bad idea for European insurers on its own lack of merits – as argued by my

[6] See Adam S. Posen, "Why is Their Recovery Better than Ours?", speech at the National Institute for Economic and Social Research, London, 27 March 2012 (available at http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech560.pdf).

colleague Avinash Persaud, long-term investors like life insurers with clear payout obligations need a very different approach to their portfolios than do asset managers or banks, and what constitutes safe investment for them is different than for banks.[7] Insurers certainly need regulation and supervision, including clear capitalization to meet their policyholders' expected payouts. But almost every jurisdiction, and certainly the US states, already provides such pure protective supervision. Solvency II tries to add on capital holding requirements of government bonds and short-term assets akin to what is (rightly) required for banks. This is not only ill-suited for insurers, it is likely to result in a short-fall of private funds for long-term investment like infrastructure in the jurisdictions that adopt this set of requirements – where those investment funds for the long-term are desperately needed.

This bad outcome from the FSB illustrates what happens when the United States goes into international processes with its own house not in order. We have 54 state and other local insurance commissioners, and despite the addition of a Federal oversight, no real one representative to strongly present in the FSB. Meanwhile, the European Union has a coherent Commission point of view on this, which has huge bureaucratic momentum after years of preparation centrally. The insurers in Europe for the most part rightly hate it, but since it seems inevitable to be imposed on them, they have given up fighting Solvency II, and instead back using the FSB to impose it on US, Japanese, and other competing insurers. They figure if they will be limited, they want to be sure their global competitors are as well. The United States needs to stand up against this in the FSB. This is the exception that proves the general rule that the FSB process serves US interests, but it reflects an instance of bad regulation, not an overall assault on US financial diversity. And it should be responded to as such within the FSB process.

[7] Avinash D. Persaud, How Not to Regulate Insurance Markets: The Risks and Dangers of Solvency II, *PIIE Policy Brief* 15-5, April 2015 (available at http://www.piie.com/publications/interstitial.cfm?ResearchID=2777).