U.S.-EU FINANCIAL MARKETS DIALOGUE

Testimony of
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Introduction

I am pleased to be with you today to discuss the banking industry's views regarding the Financial Markets Dialogue between the United States and the European Union. Regulation of financial products and services imposes additional costs on financial firms and ultimately affects their customers' cost of capital. Unnecessary regulatory conflict, inconsistency, and duplication can only add to those costs and those of us in the financial services business strongly support the efforts of U.S. and EU officials to limit regulatory disfunction. We are grateful for this hearing and the full committee's earlier hearing on May 13th to examine this important subject.

I am testifying today as the immediate past president of BAFT—the Bankers' Association for Finance and Trade—an organization founded in 1921 by bankers from Buffalo, Cleveland, and Detroit to enable its members to "interchange opinions [regarding] the conduct of foreign business", "to urge the passage of wise and useful legislation", "to oppose the enactment of prejudicial laws," and "to aid the development

and maintenance of foreign trade." That mission, set out almost 83 years ago, seems particularly apt for the subject of today's hearing.

Today BAFT is an affiliate of the American Bankers Association and its membership includes most of the major American banks that are active in international banking and also many of the major international banks chartered outside of this country. My employer, Minneapolis-based U.S. Bancorp, is the 7th largest financial services holding company in the United States, with assets of $192 billion. Our principal bank subsidiary, U.S. Bank, has 2,275 retail banking offices and 10.6 million clients in 24 states throughout the Midwest and West. We focus internationally on providing trade and payment processing services to our domestic clients, and in that connection we maintain correspondent relationships with more than 2,000 banks in 125 countries.

Statistics on Trade and Investment Demonstrate the Importance of the U.S.-EU Relationship

The close economic relationship between the United States and the European Union can be demonstrated with just a few statistics. Transatlantic commerce is about 60 percent of the world's total trade and investment.[1] If you exclude Canada and Mexico because of their close proximity to the United States, five of our top ten trading partners are in the European Union.[2] More than 52% of the EU's foreign direct investment from 1998 to 2001 went into the U.S. and more than 61% of the foreign direct investment that went

[1] *Source: U.S. Department of Commerce, International Trade Administration.*
[2] Germany, U.K., France, Ireland, and Italy. *Source: U.S. Census Bureau, Foreign Trade Statistics Year-to-Date March 2004 at www.census.gov/foreign-trade/statistics/country/top/top0403.html.*

into the EU during the same period came from the U.S.[3] The total amount of two-way investment between the EU and the U.S. totals over $1.2 trillion.[4] It is clear that we have an important common economic interest; close cooperation to advance that interest should be good for both of us.

But that's easier said than done. The U.S. and the EU have different cultural, political, and economic structures and, consequently, many differences in the ways that we approach the conduct of business and the ways that we regulate it. These differences have long been recognized and over the years the U.S. and its economic partners in Europe have engaged in numerous efforts to accommodate our differences, including the 1990 Transatlantic Declaration on E.C.-U.S. Relations, 1995 Transatlantic Business Dialogue, 1998 U.S.-E.C. Mutual Recognition Agreements, 1998 Transatlantic Economic Partnership, and the 2002 U.S.-EU Guidelines for Regulatory Cooperation and Transparency. The current U.S.-EU Financial Markets Dialogue is the most recent of these efforts to build a closer, more cooperative economic relationship.

What the U.S.-EU Financial Markets Dialogue Has Accomplished and Some Suggestions of How it Could Be Improved

There is no doubt that the U.S.-EU Financial Markets Dialogue has been a constructive exercise and that it has accomplished a great deal simply by establishing new lines of communication. Since the Dialogue began in March 2002, U.S. government and EU officials have discussed numerous issues and developed approaches that likely will avoid several potentially serious problems. The discussions have included the EU's Financial

[3] *Source: European Union statistics on bilateral trade relations at www.europa.eu.int/comm/trade/issues/bilateral/countries/usa/index_en.htm*
[4] *Ibid.*

Conglomerates Directive and it appears likely that U.S. financial firms generally will be considered to have consolidated supervision equivalent to that called for by the Directive. In discussions of the EU's Prospectus and Transparency Directives the case was made for finding U.S. GAAP to be equivalent to International Accounting Standards (IAS), and the exchange of views supported a decision to include a grandfather provision for currently outstanding issues of fixed income securities (bonds). Discussions of the Investment Services Directive led to modifications that will allow the U.S. practice of internal order matching and price improvement in many transactions, and discussions of the Takeover Directive have brought EU assurances that non-EU firms will not be discriminated against.

We think this is a good start and we believe that the value of the Dialogue will increase as it continues and as relationships deepen and issues are added. But more can be done and we think that the Dialogue can be improved in several respects.

As it now stands, the Dialogue is conducted between U.S. government officials (from the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission) and officials of the European Commission. While it isn't being conducted under a shroud of secrecy, the Dialogue process isn't completely transparent either. I think it's safe to say that many American bankers really don't know much about the Dialogue, including what's being discussed and who's discussing it. (This is a concern that's shared by at least some of our colleagues in Europe as well.) It would be a big improvement if the U.S. participants made a greater effort to consult with U.S. banks, securities firms, and other financial firms early in the process and on an on-going basis.

This would give us a chance to provide our views as to what should be on the agenda and what the priorities should be, and also to inform the participants about market realities and other practical details that are best known to those of us doing business in the international arena every day.

The breadth of Dialogue participation is expanding in some respects, but we think that more can be done in that regard as well. In testimony before the House Financial Services Committee on May 13, 2004, both Ethiopis Tafara, the SEC's Director of International Affairs, and Alexander Schaub, Director-General, DG Internal Market of the European Commission, referred to steps being taken toward greater consultation and cooperation between the SEC and the Committee of European Securities Regulators (CESR). This is great and we hope that similar working relationships will develop among the other financial regulators in the U.S. and EU.

Carrying this one step further, we also believe that the Dialogue should include Members of Congress and staff, particularly those who are on this Committee. It isn't only the Treasury Department, the Fed and the SEC that deal with issues regarding the regulation of financial services and thus have a need to communicate and coordinate with policymakers in the EU. We think much could be gained if Members of Congress and their staffs engaged in a *continuing* Dialogue with appropriate officials in the EU, again with input from the private sector.

We think that the concept of "intelligent work sharing" advocated by Alexander Schaub could have useful application in both the regulatory and legislative spheres. The more effort put into anticipating and avoiding problems and sharing best practices when the

rules are first written, the less need there will be for difficult problem solving when they are applied. Among other things, we think the Congress and regulatory and other government agencies should consider a staff exchange program, in which staff with expertise in these areas are seconded overseas to work with their counterparts in the other governing body to share their own knowledge and experience and gain the benefits of others'.

In that regard, we also would like to recommend that the U.S. Treasury Department consider putting more of its people on the ground in Europe. As we understand it, the Treasury Department only has one person stationed in Europe, at the U.S. embassy in Frankfurt. In my experience there is nothing like local knowledge in order to anticipate, understand and react to new developments in particular markets. Treasury should seriously consider adding staff in various locations in Europe, particularly Brussels.

Banking Industry Issues

I'd like to comment on several specific issues that concern the banking industry and that are or should be on the Dialogue's agenda.

Implementation of Basel II

The Basel Committee (which includes representatives from the U.S. and the EU) is on the verge of finalizing new bank capital standards, set out in the Basel II Capital Accord. Bankers have several concerns. One is that the U.S. plans to continue using the leverage and well-capitalized requirements as additional capital standards for U.S. banks. These will effectively act as floors for any capital relief created by Basel II. Since there is no

foreign equivalent, U.S. banks could be required to hold more capital than their foreign competitors, increasing their costs and making them less competitive.

Bankers also are concerned that there could be significant differences in the application of Basel II from country to country, and that these differences could impede banking across national borders. To address these concerns, we recommend that the U.S.-EU Financial Markets Dialogue include a discussion of how to coordinate the application of the new capital standards and that the following approaches be considered:

- adopt the principle of lead supervision by the home-country regulator,
- share supervisory information,
- clearly communicate the supervisory principles for capital adequacy, and
- take steps to limit the differences in application of Basel II from country to country.

Our main concern is that banks could be excluded from overseas markets by inconsistent interpretations of Basel II. The Accord gives individual national regulators considerable discretion over how the rules will be applied, particularly with regard to the operational risk-based capital charge and with regard to supervisory standards ("Pillar II"). Regulators in the U.S., EU and elsewhere are in the process of developing the rules that will implement Basel II in their respective countries. Each has the authority to require all banks, domestic and foreign, that want to do business in its country to abide by its own interpretations. If banks have to satisfy different requirements in each country in which they operate, then individual institutions might have to limit the scope of their

international operations. The result would be less competition in international markets, clearly an undesirable outcome.

One solution would be to adopt the principle of lead supervision, giving the regulator from a bank's home country the responsibility to certify capital compliance for the bank globally. In a May 12, 2004 release, the Basel Committee proposed that host-country regulators should accept capital approval and validation from a foreign bank's home country regulator, reducing the implementation burden on banks and conserving supervisory resources.

What will it take for a regulator to accept that a foreign bank operating in its markets will be subject only to home country capital supervision? The Basel Committee proposes that home and host country regulators coordinate and cooperate in supervising shared institutions. This would be an appropriate topic for discussion by the U.S. and EU in the context of the Financial Markets Dialogue.

To the extent application of the rules differs from country to country, regulators also should take steps to help multinational banks understand local discretionary differences in capital supervision. Basel II—especially the advanced approaches—is immensely complex. Regulators can help banks comply with their rules by providing as much detail as possible as to how they will examine banks for compliance. U.S. and EU regulators should explain the respective rules of home and host country supervision, as well as the exercise of discretion allowed under the Accord.

The best solution, however, would be for the U.S. and EU to work together to limit the use of national discretion under Basel II. This would promote both full and fair competition in financial services and a sound global financial system. As the homes of most of the world's major banks, the U.S. and EU should use the next three years before the Accord is implemented to harmonize their countries' approaches to application of the capital requirements.

Convergence in International Accounting Standards

The reliability of financial information reported by public and private companies is fundamental to sound economic growth and international trade and investment. For that reason, we believe it is appropriate that the U.S.-EU Financial Markets Dialogue include a discussion of accounting standards. BAFT supports the efforts of the International Accounting Standards Board (IASB) to harmonize international accounting standards, but we believe there are aspects of the IASB and its work that should be discussed by U.S. and EU officials. We recommend the Dialogue focus on three particular issues:

- transparency in the rulemaking process,
- principles-based accounting, and
- the costs and benefits of convergence of existing accounting rules.

The accounting rulemaking process should be more open. Active participation by industry experts in the development and interpretation of new rules will lead to better rules. In order to make the process more open, we recommend that IASB should do the following:

- hold periodic meetings with the private sector to provide information about what IASB is doing,
- form industry working groups that can provide information about complex transactions, processes and procedures relating to potential accounting rule changes,
- host more roundtable discussions to allow interested parties the opportunity to discuss concerns with the IASB; make these as open as possible, rather than exclusive sessions on an invitation-only basis,
- hold additional meetings with experts on issue-specific IASB projects or industry-specific issues,
- use field tests, something not previously considered by the IASB, to ensure that rules can be implemented, and
- improve public access to the IASB process by (a) posting all comment letters on the IASB website, and (b) making all Board meetings available as a webcast or by providing telephone access for constituents that cannot attend London Board meetings in person.

Many of IASB's proposals have been issued with very short comment deadlines. We are concerned that these time limits make it difficult to provide quality responses and thus limit the value of comments to rulemakers. It also is important that companies be given adequate time to understand and implement new rules.

Improvements also should be made in the process of appointing rulemakers. Similar to the way that accounting rulemakers are selected in the U.S. to serve on the Financial

Accounting Standards Board, members of the IASB are appointed by the Board of Trustees of the IASB Foundation. Although market participants are an important funding source for the staffing and operations of the IASB, they do not have a role in selecting IASB members. Both the process by which trustees are appointed to the IASB Foundation and the process by which the IASB Foundation identifies and selects candidates to serve on the IASB should be made more transparent.

The IASB has decided that future rules will be written using a principles-based approach. This could present preparers, auditors, accountants, and rulemakers with significant problems if the rules are too general. We believe that a balanced approach is needed; there has to be a sufficient level of detail to make consistent application of a rule likely. Otherwise companies will be faced with a large number of subsequent interpretations, possibly resulting in expensive changes to systems and procedures. Moreover, without sufficient detail, much of the implementation guidance will be provided by individual accountants, accounting firms, or securities regulators and their individual interpretations will likely result in varying applications of the rules. We recommend that the Dialogue include a discussion of the appropriate level of detail in new rules to encourage consistent application of International Accounting Standards.

Efforts are being made to bring about convergence in U.S. and IASB accounting rules. In many cases, both accounting methods are acceptable, and the rulemakers simply choose one rule over another. Accounting rulemakers have indicated that they expect many of these changes to be relatively minor, but relatively minor accounting changes can be costly to implement. We are concerned that the cost to make these changes in many

cases will outweigh the benefit and thus we recommend that the Dialogue include a discussion of how much convergence is really needed.

Privacy and Data Protection

Another important issue that should be considered in connection with the Financial Markets Dialogue is the impact of the European Union's Directive on Data Protection on U.S. banks and other financial institutions doing business in the EU.

The Directive, which was adopted in October 1998, sets forth the rights that individuals have over their personal financial information and the standards that companies must follow when collecting, using, sharing or selling that information. In November 2000, after two years of discussion, the United States and the EU completed negotiations on a safe harbor under which US companies could voluntarily certify that they meet specified privacy standards. While the safe harbor covers all industry sectors, including financial services, it does not cover personal financial information. The EU's position then was that more time was needed to examine the privacy provisions in the Gramm-Leach-Bliley Act. Provisions of the Fair Credit Reporting Act also were viewed as a stumbling block at that time.

Since 2000 the EU informally has committed to postponing enforcement of the Directive with respect to the financial services sector, pending the outcome of U.S. and EU negotiations. This standstill agreement expired on July 1, 2001, leaving U.S. banks and other financial services companies vulnerable to action by government authorities in EU countries. In fact, the directive also might create private rights of action, increasing the potential legal liability of U.S. firms.

One of the reasons that European countries are reluctant to accept U.S. privacy laws is that the U.S. allows financial services companies to share personal financial information among affiliates. This is necessary because financial institutions in the U.S. generally have a corporate structure that is quite different from that used in Europe. In the U.S., financial organizations offering a broad array of financial services utilize multiple corporate entities (*e.g.*, a bank, securities firm, or insurance company) affiliated with each other through common ownership under a holding company. The companies share information across the organization in order to offer and provide consumers a wide variety of customized financial services. In Europe, financial services are more likely to be are delivered through a single company, a universal bank, which eliminates the need to share information among affiliates. Because of these differences in organizational structure, restrictions on information sharing between affiliates could well give an unfair competitive advantage to European firms.

The European Union is an important market for U.S. financial services companies. Thus we are eager for the EU to acknowledge that the Gramm-Leach-Bliley Act and other financial privacy laws, such as the recently enacted Fair and Accurate Credit Transactions Act, provide adequate privacy protection for personal financial information. We urge the Treasury Department and other participants in the Dialogue to make this an important item on their agenda.

Other Issues for Discussion

There are numerous other issues that concern U.S. banks and other financial institutions that might be appropriate for discussion in the context of the Financial Markets Dialogue.

For example, U.S. banks want to ensure that the information gathering obligations imposed on them under the USA Patriot Act are not more intrusive and burdensome on their customers than the duties imposed on banks in the EU. This could create a competitive disadvantage for U.S. banks and they feel that their interests would be served by a discussion of ways to ensure consistency among major financial markets wherever located. This would also serve the interests of the international law enforcement community because an anti-money laundering system that lacks substantial uniformity from country to country is bound to fail.

U.S. banks also are concerned about efforts by tax officials both in the U.S. and the EU to impose reporting obligations on banks that hold deposits of nonresident aliens. In addition to policy issues that should be discussed up front, such as the likelihood of deposits being shifted to countries that are not participating or that maintain high levels of privacy protection, these efforts undoubtedly will give rise to technical compliance issues that should be the subject of consideration and discussion that includes some level of participation by the private sector on which the compliance burden will fall.

There also are issues regarding cross-border securities business that concern U.S. banks that have securities affiliates and we generally share the views expressed in the testimony of the Securities Industry Association. Among other things, banks and other financial firms are concerned about their ability to meet customer needs across national borders. This includes their ability to continue serving customers that move to another country and also their customers' ability to make investments in foreign countries. The SEC and European securities regulators should discuss these issues with the overriding objective

of giving investors the greatest possible investment opportunities and flexibility, without compromising standards of investor protection. Mutual recognition of regulatory systems that provide comparable levels of investor protection would seem to be the right approach.

Differences in insurance regulation might not readily be resolved in the Financial Markets Dialogue, but they deserve mention because they have important international ramifications. Some outside of the U.S. argue that our system of state-level insurance regulation constitutes a trade barrier because foreign insurance companies cannot sell insurance throughout the U.S. unless they get a license in each state. (Of course domestic U.S. insurance companies are treated the same—they also have to get a license in each state where they sell insurance—so it would seem the U.S. approach is one of national treatment which ordinarily is unobjectionable.) By way of contrast, U.S. insurance companies generally can qualify to sell insurance throughout the EU on the basis of a single license. The Dialogue can't do much to address this difference in approach because changing the structure of insurance regulation in the U.S. would require federal legislation.

House Financial Services Committee Chairman Mike Oxley and Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee Chairman Richard Baker have developed a plan to standardize certain aspects of state insurance regulation. BAFT's insurance affiliate, the American Bankers Insurance Association (ABIA), supports the Oxley-Baker plan and believes it is an important step in modernizing domestic insurance regulation. But ABIA and other financial trade associations think

Congress should consider whether to go further and create an optional federal insurance charter. We respectfully suggest that the Financial Services Committee hold additional hearings in the future to examine the international ramifications of insurance regulation in the U.S.

Summary

BAFT strongly supports the U.S.-EU Financial Markets Dialogue. It has accomplished much, both in fostering a healthy climate of trust and openness and in exploring particular issues that either have been or are likely to be resolved in a mutually satisfactory manner. Notwithstanding this very promising beginning, however, we also believe that the Dialogue could be improved in several respects. We urge the U.S. participants to do more to reach out and consult with firms in the private sector. We also believe that the Dialogue could be enhanced by expansion. It should include discussions among regulators, and also discussions among Members of Congress, their staffs, and counterparts in the EU. The Treasury Department should consider enhancing its own resources by adding staff in key European financial capitals.

The specific issues that concern U.S. banks operating in Europe include implementation of Basel II, convergence among different national and multinational accounting standards, and privacy and data protection measures. U.S. banks also are concerned about competitive disparities that could arise out of U.S. anti-money laundering requirements, new tax reporting obligations, steps that can be taken to enhance cross-border securities business, and the international implications of insurance regulation in the U.S.

We are very encouraged by the progress that has been made so far, and we are enthusiastic about the potential the future holds. Thank you very much for holding this hearing and allowing us to participate.