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SYSTEMIC RISK AND THE FINANCIAL MARKETS

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BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

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CONTENTS

	Page
Hearing held on:	
July 24, 2008	1
Appendix:	
July 24, 2008	45

WITNESSES

THURSDAY, JULY 24, 2008

Cox, Hon. Christopher, Chairman, U.S. Securities and Exchange Commission	6
Geithner, Timothy F., President and Chief Executive Officer, Federal Reserve Bank of New York	9

APPENDIX

Prepared statements:	
Cox, Hon. Christopher	46
Geithner, Timothy F.	55

SYSTEMIC RISK AND THE FINANCIAL MARKETS

Thursday, July 24, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:06 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Watt, Ackerman, Moore of Kansas, Capuano, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Hodes, Klein, Wilson, Perlmutter, Murphy, Speier, Childers; Bachus, Royce, Manzullo, Jones, Biggert, Feeney, Hensarling, Garrett, Neugebauer, McHenry, Campbell, Putnam, Marchant, and Heller.

The CHAIRMAN. The hearing will come to order.

This is the second hearing we have had in a series that may continue in the fall and will certainly lead to action next year.

What we are dealing with here is the action that we ought to be taking as a Congress and as a government to the events that manifested themselves in the reaction of the Department of the Treasury and the Federal Reserve to Bear Stearns. We are not here specifically to look at that, although that is obviously one of the subjects, given the centrality of the role of the New York Federal Reserve. It is a subject that was discussed before. But what we want to do is to look at that in the context of what do we do going forward?

There is, I think, an increasing consensus that some extension of regulation is called for with regard to currently lightly-regulated aspects, lightly-regulated financial institutions. I say "lightly regulated" because we have represented here, our former colleague, the Chairman of the Securities and Exchange Commission. That institution has some responsibility, but I think it ought to be clear that Congress has never given the SEC the kind of full statutory mandate over systemic stability. They have a focus on investor protection and on keeping the markets functioning, and I don't think there was any basis for any criticism of the SEC's performance. Some, frankly, of what I have seen is based on a misunderstanding of their mandate. And the fact is that they have, I think, acted within their mandate. It is up to the Congress and the Executive Branch working together to decide whether that mandate should be expanded. And that is what we are talking about.

We are talking about the extent to which regulatory authority over the activities of investment banks and others, particularly

since they may now be asking for access to various instruments in the Federal Reserve, to what extent should we deal with this? I think we have shown an ability as an economy and as a government to deal on an ad hoc basis with crises.

It is important, however, that we do two things: First of all, examine what further instruments the regulators ought to have in dealing with the crisis; and even more important to me—because I do believe we can cobble together things in the short term, but that is not a very satisfactory long-term answer—what new regulatory approaches should we be taking to make the crises less likely? To what extent should we be giving some Federal entities in the regulatory field new powers over institutions that are not now heavily regulated, particularly from the standpoint of avoiding systemic risk?

Then the related question is, there are different functions here. This is investor protection. And I know that the gentleman from Pennsylvania and I were just telling the Chairman of the SEC privately, but we both will say it publicly, that we are very pleased with the action he has taken regarding short selling, and we think that has been very helpful from the standpoint of protecting the integrity of the market.

But there is a question as to what extent actions that are taken to protect the integrity of the market in the individual instance and the investor do or don't conflict from time to time with questions of systemic stability? It is, in fact, we don't want to take individual enforcement actions that, in a particular context—well, we may want to take them, but it is conceivable that individual enforcement actions, particularly against a number of institutions, could have some systemic impacts. How do we evaluate that?

That also leads to the question of what is the institutional arrangement? I congratulate the Federal Reserve and the Securities and Exchange Commission for the memorandum of understanding they signed. That was a very good example of how we get cooperation. And the memorandum of understanding was useful. It does open the question that is, should there be some statutorization of that memorandum of understanding? Are there areas that should be approached in defining the relationship of these two important entities that could not be reached without some further legislation? How do we structure it?

This is a noncrisis hearing. It is the second in our efforts to ask the responsible regulators here what their recommendations are to us for going forward. And of course, the goal I think we all share is very simple. We want to continue to reap the benefits of financial innovation, including securitization and the other creative ways of financial institutions serving the economy, while diminishing the risks. And you never hit 100 percent optimality there. But I do believe that there is room for us to take some action that will diminish risks without unduly impinging on the benefits we get from these operations. That is the purpose of this hearing.

Let me say, under the rules, having the Department heads here, particularly the head of the SEC, we will just have the four opening statements, the two Chairs and the two ranking members.

So the gentleman from Alabama is recognized for 5 minutes.

Mr. BACHUS. I thank the chairman for holding this second hearing on systemic risk.

And I welcome our two witnesses to the hearing. Chairman Cox and President of the New York Fed Geithner, you have actually been at the center of the government's response to recent turmoil in the financial markets. And I commend you both on the job you are doing. You are both very capable public servants, and I think the country is fortunate to have your expertise. We look forward to your perspectives as we go forward.

Nothing I say today should be taken as a criticism of anything you have done, particularly in the Bear Stearns matter, because I realize that sometimes decisions are made, and we don't know at the time whether they are the best, but we do the best we can.

I think we were faced with that yesterday on the Floor. We had a difference of opinion. But we make a decision, and then we all come together and hope that decision is right when it is collectively made.

I would say this to Chairman Frank, before we begin a serious discussion of greater government involvement in our capital markets, we need to have a clearer understanding of exactly where we are and how we got to where we are. I know the chairman has also said that. We need to know how we arrived at a system in which the issuers of credit default swaps are allowed to provide guarantees that far exceed their capital reserves and that there is virtually no possibility that they can pay in the defaults of the underlying obligations, commit themselves to obligations that they cannot possibly cover in worst-case scenarios.

We need a better understanding of why our regulations allow credit default swaps to remain essentially under-regulated when they have such a profound effect and are so intertwined with our larger financial markets and even our economy.

And in light of the Bear Stearns episode, and I think we all learned from that, we need to know whether the SEC's current approach to the supervision of investment banks and their holding companies is sufficient to prevent further meltdowns in that sector of our financial services industry. Or even, you know, we need to ask ourselves, can regulators really prevent such meltdowns? What are our obligations? Sometimes, it may be to stand back and allow companies to fail.

In this vein, and perhaps most critical of all, we need to know how we ended up with a financial system in which almost every primary dealer, at least on the surface, appears almost too big or too interconnected to fail or whether we have arrived at that point. If we accept that premise, that every primary dealer is too big to fail, then we also have to conclude that our financial markets are no longer capable of self-regulation and that government must exercise greater control, both as a regulator and as a lender, if not a buyer of last resort.

As I indicated at our first hearing 2 weeks ago, that is a conclusion I am not prepared to accept.

I think a far better approach is one that restores market discipline and discourages moral hazard. Does the Bear Stearns rescue and recent proposals to invest taxpayer dollars in the debt in equity of Fannie Mae and Freddie Mac, does that send a different

signal to the market, that taxpayers can be counted on, ultimately, to indemnify risk-taking that reaches levels sufficient to place the entire financial system in jeopardy? What we ultimately need is to ensure that our regulators maintain a framework in which individual firms can fail while the system continues to function. I think it has been referred to as an orderly liquidation.

We know that sudden failures like Bear Stearns, if they are not orderly, can definitely have systemic risk. And I think we all appreciate that.

We need to ensure that our firms strike the right balance between risk and leverage. Capital and credit must continue to flow where they are most needed, but our financial institutions should not be taking outsized risks that require repeated government interventions to save the system from recurring crisis.

Chairman Cox, you have taken significant steps to protect the integrity of our capital markets during these turbulent times. I think your efforts have been underappreciated.

One of your most important initiatives has been to help make sure investors have access to accurate and reliable information. In this regard, your credit rating agency reforms, your firm stance against the spreading of false information, and your emergency order to curb abusive short-selling practices in the securities of 17 primary dealers and Fannie and Freddie were welcomed developments. And we have seen now that they have had a positive effect.

On July 15th, the SEC also noted that it will undertake a rulemaking to address these issues across the entire market. I look forward to working with the Commission to ensure that a rulemaking recognizes the legitimate role of short selling and does not eliminate liquidity from the capital markets.

I think we all appreciate that short selling is a valid, valuable process. It serves a useful purpose. What isn't and what is presently prohibited is the spreading of false information to drive down the price of these stocks by some short sellers, not most, and that, you know, puts and calls, all those, are a valuable part of our market and indicate a sophisticated financial system.

Mr. Chairman, I want to conclude by thanking you for holding this hearing.

And my thanks to Chairman Cox and Mr. Geithner for being with us today. We look forward to your testimony.

The CHAIRMAN. The gentleman from Pennsylvania, the Chair of the Subcommittee on Capital Markets, is recognized.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

Today we continue our review of a systemic risk in financial markets. Although we passed the housing reform package yesterday, tremendous economic anxiety and uncertainty remain. Finding an effective regulatory regime to keep pace with increasingly complex financial products and markets remains our goal.

Striking an appropriate balance to enhance protection against systemic risk is also a difficult task. For just as the markets continually change and evolve, so must regulation. The explosive growth of complex financial instruments is well-documented. Credit default swaps and collateralized debt obligations are just two examples of comparatively new exotic products flooding our markets.

Warren Buffett famously labeled credit derivatives as "financial weapons of mass destruction." Some may view his characterization as extreme. But allowing these risky creations to thrive in a thinly regulated or unregulated market is a recipe for disaster. So, in order to better understand these instruments, I sent 2 days ago a request to the Government Accountability Office that it begin a study on structured financial products. This study will examine the nature of these instruments and the degree of transparency and market regulation surrounding them. From this study, we should obtain a clearer picture of how to improve regulation in the sector of our financial system.

Another area of regulation we should consider is the consolidation of regulation of our securities and commodities markets. The Treasury's recommendation to merge the Securities Exchange Commission and the Commodity Futures Trading Commission is something that ought to be discussed today. Such a merger illustrates the kind of streamlined regulatory system to which we should aspire.

Additionally, last week's emergency order on naked short selling has received much attention. This committee is due an explanation as to the reason for the order, the effect to date on the market, its possible extension, and whether it will be expanded to broader market segments. I dare say it is something that the Commission should be commended for. I have seen the results and they seem to be quite clear that they aid the free flow of the market.

Even to those of us who view short selling as a necessary provider of liquidity and market efficiency, naked short selling is worthy of closer scrutiny. People enter into trades with the expectation to complete them.

In closing, both the Commission and the New York Federal Reserve have played crucial roles throughout the current financial crisis. I very much appreciate Chairman Cox and Mr. Geithner being here today, and I look forward to their testimony.

The CHAIRMAN. On instruction from the gentleman from Alabama, I now recognize the gentleman from California, Mr. Royce, for 1 minute.

Mr. ROYCE. Thank you, Mr. Chairman.

I would like to thank you for your continued attention on this issue. I think it is important to be fully vetted.

I would also just like to briefly welcome my good friend and our former colleague here, Chairman Cox.

And just to say, Chairman Cox, while your leadership and insight while you were a Member here are missed, we do appreciate your hard work at the Commission, especially on behalf of investors and the securities industry during these rather difficult and challenging times with our capital markets.

And so, welcome back.

The CHAIRMAN. In the interest of bipartisanship, we will start Mr. Royce's minute now. We won't charge him for being nice. That is not necessarily a precedent around here, but we will do it today.

So, Mr. Royce.

Mr. ROYCE. I will yield back, Mr. Chairman.

The CHAIRMAN. Then we have 2 minutes for the gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

I find it somewhat ironic that we would be holding this hearing 24 hours after we gave the Secretary of Treasury a blank check to help bail out Fannie and Freddie. It seems that we took a huge step in the wrong direction with respect to systemic risk.

Moral hazard leads to more systemic risk. And I fear yesterday a very strong message was sent to every investment bank in America that if you are large enough, if you get interconnected, if you get well-connected in the halls of Congress, you can indeed figure out a way to privatize your profits and socialize your losses.

And just in case somebody missed the message, we are having a serious discussion now about giving the Federal Reserve increased responsibility and ultimate authority for financial stability in our markets. This may be a good thing. It may be a bad thing. But it is also a very risky thing. And I fear that the markets will interpret this as meaning, again, that potential Fed backing is around the corner if investment banks get in trouble.

I fear that, as we continue to lose market discipline, we substantially increase the chances of having yet another Fannie and Freddie debacle, perhaps another S & L debacle.

I am very concerned also about where we find the role of the Federal Reserve today in all the different directions they are pulled, starting with price stability and monetary policy, minimizing unemployment. On top of that, we add a healthy dose of consumer protection. Now we are about to add potential financial stability, and oh, I at least heard the chairman say once that he cared about taxpayer protection as well. That is pulling the Fed in a lot of different directions.

I do know that some believe that the ultimate answer is more regulation. I certainly believe we could have better regulation. We may need smarter regulation. I don't know if we necessarily need more regulation. And I do know that an overly restrictive regulatory regime will kill innovation and chase our capital overseas, something I do not want to see.

With that, Mr. Chairman, I thank you, and I yield back the balance of my time.

The CHAIRMAN. I thank the gentleman.

We will now proceed with the statements. And we will begin with the Chairman of the Securities and Exchange Commission, our former colleague.

STATEMENT OF THE HONORABLE CHRISTOPHER COX, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you very much, Chairman Frank, Ranking Member Bachus, and members of the committee.

It is a pleasure to appear on this panel with my regulatory colleague, Tim Geithner. Under his leadership at the New York Fed, the SEC and the New York Fed have established a very strong and positive working relationship.

I want to thank this committee for inviting me to testify on behalf of the SEC about reform of the U.S. financial regulatory system.

There is no question, as several of you have just pointed out, that the financial regulatory structure that was forged in the Great De-

pression has served this Nation well over the intervening 8 decades. Even today in the midst of current strains on the financial sector, the U.S. capital market is larger, deeper, and more liquid than any other market in the world. In large measure, that is due to the world-class protections that investors enjoy in the United States, and those are protections that we should secure.

In the decade since our regulatory agencies were chartered, the capital markets and the broader economy have undergone profound changes. The regulatory system in the main has adapted well to some of these changes, but other changes have presented new challenges that are rightly the subject of this committee's review as you consider legislative solutions.

I hasten to add that, given the many strengths of the current regulatory system, we don't need to start from scratch. Instead, we can build on what we know has worked. At the same time, we can take lessons from what has not worked and modernize, rather than replace, the current system.

One thing that has worked exceptionally well is the regulatory concept of an agency chartered to protect investors, to maintain fair, orderly markets, and to promote capital formation. If the SEC didn't already exist, Congress would have to invent it.

Each of the elements of the SEC's mission is mutually reinforcing of the others. The Commission's work to protect investors through our enforcement program has been greatly benefited by the expertise of the SEC staff who specialize in the regulation and supervision of broker dealers and investment advisors. The Commission's regulatory program, including our commitment to ensuring full disclosure of information about public companies, has been informed by the experience, in turn, of the enforcement and examination staffs.

But I hasten to add that, given these many strengths, there are many problems as well in the current system. Today when derivatives compete with securities and futures, and insurance products are sold for their investment features, it is no longer true that we can stovepipe regulation.

As we approach the end of the first decade of the 21st Century, the growing gaps and crevices in our regulatory system are beginning to show. We all know that the current market crisis began with the deterioration of mortgage origination standards. As a result, it could have been contained to banking and real estate if only our markets weren't so interconnected.

But in today's world, these problems quickly spread throughout the capital markets through securitization, and at the same time, the explosive growth of the over-the-counter derivatives markets have drawn the world's major financial institutions into a tangled web of deeper interconnections. This has led to the realization that when a major commercial or investment bank is threatened, so, too, may be the entire marketplace. And it has cast a spotlight on the significant regulatory gap that currently exists when it comes to the regulation of investment banks.

When this committee devised the Gramm-Leach-Bliley Act in 1999, you—or perhaps I should say "I" because, along with many of you, I served on the conference committee that wrote the legislation—decided that the SEC would serve as the functional regulator

with responsibility over broker dealers, investment advisors, and mutual funds. And we decided that the Federal banking regulators similarly would be functional regulators for banking activities. Under this approach, the securities-related activities would be regulated by the SEC, which would also continue to be responsible for regulating broker dealers that are the central entities in investment banks. The Fed would be given consolidated oversight of holding companies that contain broker dealers and also most types of insured depository institutions. And finally, the SEC would retain the authority to regulate that net capital of broker dealers within the financial holding companies.

But no explicit arrangement was established for the regular sharing of information between the Fed and the SEC in order to take into account the need to view capital and liquidity on an entity-wide basis. And that is what the memorandum of understanding between the Federal Reserve Board and the SEC is accomplishing today.

Likewise, neither the Commission nor the Fed was authorized to exercise mandatory consolidated supervision over investment bank holding companies. As a result, today there is simply no provision in law that requires investment bank holding companies to compute capital measures and maintain liquidity on a consolidated basis.

In 2004, the Commission adopted our voluntary program, called the Consolidated Supervised Entities Program, to fill this regulatory gap. But now, recent events have highlighted the need for legislative improvements as well. We need to fill the Gramm-Leach-Bliley regulatory gap by amending the existing statutory authorization for voluntary SEC supervision of investment bank holding companies to make it mandatory for all firms that today are regulated as CSEs.

The Commission should be given a statutory mandate to perform this function at the holding company level along with the authority to require compliance. In addition, legislation should prescribe explicitly how the resolution of financial difficulties at investment bank holding companies will be organized and funded. Any regulatory reform that you undertake should recognize the very fundamental business, accounting, and regulatory differences between investment banks and commercial banks. Rather than extend the current approach of commercial bank regulation to investment banks, I believe Congress and regulators must recognize that different regulatory structures are needed for oversight of these industries and, in particular, that investment banks should not be treated like commercial banks by providing them with permanent access to government-provided backstopped liquidity. The added regulation that this would necessitate, following the commercial bank model, would fundamentally alter the role that investment banks play in the economy.

In addition, as you weigh other possible reforms, there are five points that should be carefully considered:

First, were the Congress to consider addressing the potential for future Bear Stearns-like rescues in statute, any such authority should be reserved for exceptionally rare cases.

Second, the securities and bankruptcy laws currently provide an explicit statutory framework for liquidating a failed securities brokerage firm and for protecting customer cash and securities. This framework generally works as well, even in instances of fraud. I would not recommend changing the system.

Third, for banks and thrifts, the FDIC has long served as the receiver for failed banks. The FDIC Improvement Act, FDICIA, mandates a least-cost resolution analysis and imposes intentionally onerous restrictions on a bank's ability to receive lender-of-last-resort funding. This is a useful model for resolving investment banks as well.

Fourth, FDICIA prescribes a detailed process involving supermajority approvals by the interested regulators and formal approval of the Secretary of the Treasury after consultation with the President. It also requires detailed findings of serious adverse effects on economic conditions or financial stability and a finding that the proposed action would mitigate any adverse effects. These, too, are important constraints.

Fifth and finally, OTC derivatives receive special treatment in bankruptcy proceedings. In particular, in the event of insolvency, counterparties can immediately terminate their contracts and seize any collateral related to OTC derivatives. As a result, today, unwinding a significant portfolio in bankruptcy can threaten market disruptions and raise systemic issues. To remedy this problem, the SEC should be given explicit authority to control the liquidation of investment bank holding companies or their unregulated affiliates that generally hold most of the derivative positions.

Mr. Chairman, I hope that these observations from the SEC will be of assistance to you and to the committee as you consider the broad questions of whether and, if so, how to reform the existing Federal regulatory system for financial services.

Thank you, again, for this opportunity to discuss these important issues. I look forward to taking your questions.

[The prepared statement of Chairman Cox can be found on page 46 of the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

You really did engage exactly what we were hoping to engage.

And now, Mr. Geithner.

STATEMENT OF TIMOTHY F. GEITHNER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL RESERVE BANK OF NEW YORK

Mr. GEITHNER. Thank you, Mr. Chairman, Ranking Member Bachus, and other members of the committee. I appreciate the opportunity to be here with you today.

We are dealing with some very consequential issues, and I think as a country we are going to face some very important questions going forward.

I am particularly pleased to be here with Chairman Cox from the SEC. We are working very, very closely together in navigating through the present challenges. And I want to express appreciation for his support and cooperation.

The U.S. and the global financial systems are going through a very challenging period of adjustment, an exceptionally challenging

period of adjustment. And this process is going to take some time. A lot of adjustment has already happened, but this process will necessarily take time. And the critical imperative of the policymakers today is to help ease that process of adjustment and cushion its impact on the broader economy, first stability and repair and then reform.

Looking forward though, the United States will look to undertake substantial reforms to our financial system. There was a strong case for reform before this crisis. Our system was designed in a different era for a different set of challenges. But the case for reform, of course, is stronger today. Reform is important, of course, because a strong and resilient financial system is integral to the economic performance of any economy.

My written testimony outlines some of the changes to the financial system that motivate the case for reform. These changes include, of course, a dramatic decline in the share of financial assets held by traditional banks; a corresponding increase in the share of financial assets held by nonbank financial institutions, funds, and complex financial structures; a gradual blurring of the line between banks and nonbanks, as well as between institutions and markets; extensive rapid innovation in derivatives that have made it easier to trade and hedge credit risk; and a dramatic growth in the extension of credit, particularly for less creditworthy borrowers.

As a consequence of these changes and other changes to our financial system, a larger share of financial assets ended up in institutions and vehicles with substantial leverage, and in many cases, these assets were financed with short-term obligations. And just as banks are vulnerable to a sudden withdrawal of deposits, these nonbanks and funding vehicles are vulnerable to an erosion in market liquidity when confidence deteriorates.

The large share of financial assets held in institutions without direct access to the Fed's traditional lending facilities complicated our ability as a central bank, the ability of our traditional policy instruments to help contain the damage to the financial system and their broader economy presented by this crisis.

I want to outline a core set of principles, objectives that I believe should guide reform. I offer these from my perspective at the Federal Reserve Bank of New York. The critical imperative is to build a system that is a financial—that is more robust to shocks.

This is not the only challenge facing reform. We face a broad set of changes in how to better protect consumers, how the mortgage market should evolve, the appropriate role of the GSEs and others, and how to think about market integrity and investor protection going forward.

I want to focus on the systemic dimensions of reform and regulatory restructure. First on capital, the shock absorbers for financial institutions, the critical shock absorbers are about capital and reserves, about margin and collateral, about liquidity resources, and about the broad risk management and control regime. We need to ensure that, in periods of expansion, in periods of relative stability, financial institutions and the centralized infrastructure of the system hold adequate resources against the losses and liquidity pressures that can emerge in economic downturns. This is important both in the institutions and the infrastructure.

And the best way I think that we know how to limit pro-cyclicality and severity of financial crises is to try to ensure that those cushions are designed in a way that provides adequate protection against extreme events.

A few points on regulatory simplification and consolidation. It is very important, I believe, that central banks and supervisors and market regulators together move to adopt a more integrated approach to the design and enforcement of these capital standards and other prudential regulations that are critical to financial stability. We need a more consistent set of rules, more consistently applied, that substantially reduce the opportunities for arbitrage that exist in our current very segmented, fragmented system.

Reducing moral hazard is critical. As we change the framework of regulation oversight, we need to do so in a way that strengthens market discipline over financial institutions and limits the moral hazard risk that is present in any regulated financial system. The liquidity tools of central banks and, to some extent, the emergency powers of other public authorities were created in the recognition of the fact of the basic reality that individual financial institutions cannot protect themselves fully from an abrupt evaporation in market liquidity or the ability to liquify their assets.

Now the moral hazard that is associated with these lender-of-last-resort tools needs to be mitigated by strong supervisory authority over the consolidated financial entities that are critical to the financial system.

On crisis management, the Congress gave the Federal Reserve very substantial tools, very substantial powers to mitigate the risk to the economy in any financial crisis. But I think, going forward, there are things we could put in place that would help strengthen the capacity of governments to respond to crises. As Secretary Paulson, Chairman Bernanke, and Chairman Cox have all recognized, we need a companion framework to what exists now in FDICIA for facilitating the orderly liquidation of financial institutions where failure may pose risks to the stability of the financial system or where the disorderly unwinding or the abrupt risk of default of an institution may pose risk to the stability of the financial system.

Finally, we need a clearer structure of responsibility and authority over the payment systems. These payment systems, settlement systems, play a very important role in financial stability. And our current system is overseen by a patchwork of authorities with responsibilities diffused across several different agencies with significant gaps.

It is very important to underscore that, as we move to adapt the U.S. framework, we have to work to bring a consensus among the major economies about complementary changes in the global framework.

Moving forward will require a very complicated set of policy choices, including determining what level of conservatism should be built into future prudential regulations and capital requirements; what institutions should be subject to that framework of constraints or protections; which institutions should have access to central bank liquidity under what conditions; and many other questions.

A few points, finally, about how to think about the role of the Federal Reserve in promoting financial stability.

First, the Federal Reserve has a very important role today, working in cooperation with bank supervisors and the SEC in establishing the capital and other prudential safeguards that are applied on a consolidated basis to institutions that are critical to the proper functioning of markets.

Second, the Federal Reserve, as the financial system's lender of last resort, should play an important role in the consolidated supervision of those institutions that have access to central bank liquidity and play a critical role in market functioning. The judgments we are required to make about liquidity and solvency of institutions in the system requires the knowledge that can only come from a direct, established, ongoing role in prudential supervision.

Third, the Federal Reserve should be granted clear authority over systemically important payments or settlement systems.

Fourth, the Federal Reserve Board should have an important consultative role in judgment about official intervention in crises where there is potential for systemic risk as is currently the case for bank resolutions under FDICIA.

And finally, the Federal Reserve's approach to supervision and to market oversight will need to look beyond the stability just of individual banks to market developments more broadly, to the infrastructure that is critical to market functioning, and the role played by other leveraged financial institutions.

I want to emphasize in conclusion that we are working very actively now today in close cooperation with the SEC and other bank supervisors and with our international counterparts to put in place steps now that offer the prospect of improving the capacity of the financial system to withstand stress. We are doing this in the derivative markets. We are doing it in secure funding markets, and we are doing it with respect to the centralized infrastructure.

I very much look forward to working with you and your colleagues as we move ahead in working to build a more effective financial regulatory framework in this country.

Thank you very much.

[The prepared statement of Mr. Geithner can be found on page 55 of the appendix.]

The CHAIRMAN. Thank you, Mr. Geithner, and also for directly addressing our—there are a couple of empty chairs here. We have two very well-prepared witnesses, so their revenues are smaller. They didn't need quite as many helpers, so there are a couple of empty chairs over there. People should fill themselves in. And there are some staff chairs; people shouldn't have to stand if there are chairs.

I am going to hold off on my questions for a while. I want to give members a chance. So I am going to begin the questioning with the chairman of the Capital Markets Subcommittee, not the Financial Institutions Subcommittee. I incorrectly designated the committee.

The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Geithner, I am trying to discern the bottom line of just how thorough a reform you are talking about, or reorganization, of our regulatory system. It sounds to me that you are going down to the

rudimentary rules and approach it perhaps even from a whole new philosophical view. Is that correct? Or am I overreacting to what you are saying?

Mr. GEITHNER. I think you have to look at everything.

You have to be prepared to look at everything. Our system has many strengths. But I think the challenges we have seen in this crisis justify a very broad-based fundamental look.

Mr. KANJORSKI. I agree with that proposition, and I think it would take a number of Congresses to succeed along those lines. We are particularly acutely aware of the international accounting standards that are going to come into play about 2012. And it seems to me we ought to coordinate our regulatory reform in this country to be consistent with that.

But then I anticipate a problem that prior to this immediate credit crisis that we ran into, the situation that people will argue that we ought to prevent the race to the bottom in reform shopping. And I see that as if we—you know, we could write great regulatory reform here and have all our companies go to Bermuda, if you will. So how do we prevent the two? And how do we get adequate and good responsible reform and, on the other hand, don't run into the escape psychology of companies that can do better in another jurisdiction?

Mr. GEITHNER. I think you are absolutely right. As we think about what makes sense for us, we have to figure out ways to get the world to move with us. And I don't believe it is possible, given how integrated our markets are, for us moving alone to adequately address the challenges we face here. So a critical part of everything we do will be to try to improve the odds that we get a more resilient system in place in the United States and get the primary supervisors of other major global financial institutions and the other major financial centers to move with us. And we have a very active cooperative effort now underway, including with Chairman Cox and his colleagues today. I believe we have a reasonable prospect, if we identify sensible things here, of bringing the major financial centers along with us.

Mr. KANJORSKI. Do you perhaps suggest that we could use an international conference or a summit with all the leading industrial nations of the world to establish international standards of regulations?

Mr. GEITHNER. Well, our predecessors built a very elaborate network of consultative bodies, the Basel Committee on Banking Supervision. I chaired something called the Committee on Payments and Settlement Systems. There is a group called the Financial Stability Forum, established in the late 1990's, that brings together central banks, market supervisors, market regulators, and supervisors. I believe that framework provides a lot of opportunity for us to build consensus.

But I just want to underscore your point. I think you are exactly right that we can't achieve what we need in this country that is in the interest of the United States without achieving progress outside of the United States, at least in the major financial centers.

Mr. KANJORSKI. I guess—and just before I lose my time here—Chairman Cox, how can we get the CFTC and your organization

merged so that we do not have this conflict? Or is that a hope that defies political solution?

Mr. COX. Well, obviously, the answer is through legislation. Short of that, and we are far short of that, what the SEC and the CFTC have undertaken under our existing regulatory authorities—and we administer statutory regimes that in some respects are significantly different—is to execute a memorandum of understanding so that we work together as closely as possible.

In some respects, I have observed over a period of many years, including when I first worked in the Executive Branch in the 1980's, that the SEC and the CFTC can be, for turf reasons, natural enemies. The chairs of the CFTC with whom I have worked have very much wished that this was not the case. And we have worked, I think, in the best interests of investors in the marketplace to make sure that, for example, new product approvals are done in a consultative way, not serially by the CFTC and by the SEC. This kind of deepened personal and organizational cooperation and collaboration between regulators is something that I think works very well. It typifies what we are doing with the Fed.

We have also had a great deal of experience in the last few years doing this with international regulators, I should say, with foreign regulators as well in the international context. That was necessitated by such market occurrences as the NYSE Euronext merger and by the NASDAQ OMX combination. We are working with regulators in those countries of necessity, and we have deepened our collaboration also on the enforcement front.

So, in all of these ways, I think that, starting with the SEC and the CFTC, the question you put about collaboration among regulators, generally we can do a lot even if it is difficult to rationalize the whole thing with an entirely new statutory regime.

Mr. KANJORSKI. Let me ask you, on our committee right now, we are working on consideration providing legislation to have an optional Federal charter insurance. And of course, we were considerably along that line when the credit crisis occurred. I would like your honest opinion, both of you, actually, is this something that should be delayed on our part because of this tendency to confuse and complicate the existing crisis? Or is it something we should move forward with? Is it a tool that could be utilized to standardize regulatory reform within the system?

Mr. COX. Well, I think I will defer, only in part, to Tim on the subject of the across-the-board economic-wide systemic issues that you inquire about.

I will say, on the merits, I think it is a good idea. It is certainly important in any case for this committee to be considering it in a very serious way. There are obviously some significant issues to be worked out with the States. The background of State regulation in this area is rich with history, and people understand it. This is an optional charter that we are talking about. It is not unduly intrusive in that sense. But that kind of very close working relationship with the States as you consider this legislation, I think would serve the subject matter well.

Mr. GEITHNER. On the question of whether you need to do it now, I think that, in general, across the set of issues, I think it is going to be hard to get the ideal balance and mix until we are through

this crisis. And so I think most of the big questions need to be thought of in an overall context once we get to the other side of this downturn.

But I think, right now, there needs to be a spirit, and I think there is, a spirit of pragmatism at the State level among those insurance supervisors so that if capital can come into the parts of the system now where capital is necessary, that is able to happen with the necessary speed.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, before I ask questions of these two witnesses, I would like to make a statement that I think is very important.

There is an article in the American Banker today where Ralph Nader talks about the Deposit Insurance Fund. I won't criticize anyone. But let me say this, during the height of the Savings and Loan debacle, there were 1,800 financial institutions on the trouble list, and 800 or 900 of them failed. People are comparing the financial services banking industry, that to now. And it is not a valid comparison.

We only have 90 banks that are even on the troubled list. If we have a situation like Savings and Loan, as far as the number, then 40 percent of those may fail. And so you are talking 40 or 50 banks out of a large universe. Our banks are well capitalized. Our Deposit Insurance Fund is sound. There is absolutely no factual basis for saying that there is not money there to pay.

There is a crisis in confidence. There are a lot of people saying things that may be panicking the general public. But factually, it is irresponsible to say that. And I wanted to say that because I think it is very important—we have talked about short sellers, people spreading mischief, and whether it is for sensationalism, to sell magazines, or to grab attention, it is just not true. And we as Americans ought to all be concerned about that, not to say things which cause people—

The CHAIRMAN. Would the gentleman yield to me for just a second?

Two questions that have to be kept separate. One, the question of how at the Federal level we would finance any need to respond.

Two, are the insured deposits safe? The answer to two is, absolutely, completely, without question.

We will be dealing with question number one as it comes up. But nobody ought to think that there is any linkage between those two questions. Insured deposits are 100 percent safe.

Mr. BACHUS. Thank you.

I associate myself with those remarks. And I just hope the general public—I hope in our writing, we don't repeat rumors that are totally sensational without any basis.

And I think the story that the American people need to hear is that our banking system is sound. It is well capitalized, and their deposit—I wouldn't say that. As a politician, the worst thing I could say is that there is a problem with the solvency of that. I would never want to say that if I didn't believe it 100 percent.

Chairman Cox, in your June 19th editorial, you asked a question that I think this committee has to answer. And that is, should the extensive system of commercial banking supervision and regulation

developed in large measure to counter the problem of moral hazard be extended to investment banks? And if so, who should be responsible?

How would you answer your own question? And in doing so, are there characteristics that distinguish investment banks from commercial banks and argue for a different treatment, different regulatory treatment?

Mr. COX. I think that there are. And I think that the object of reform in this area should be to create the conditions in the marketplace that first give a lot of transparency to investors so they can see where the risk lies. We have had shortcomings that have been clearly identified in that respect of late. In addition, that can make it possible for interconnectedness, which can be a good thing, to be only a good thing and not also a bad thing with a dark side because we don't know where risk lies. So that when a firm is mismanaged, it can fail, as in a free enterprise economy it should, without threatening the entire financial system.

We need to get to a better place in that respect than where we are. I think it is for that reason that the authorities, the emergency authorities, that regulators have exercised in these circumstances are temporary. But the object should be to let market discipline govern risk and investment in risk and not to have the Federal Government have to step in in each of these cases.

Mr. BACHUS. Thank you.

And President Geithner, one of the particular, I guess, sources of systemic risk could be the credit default swaps. I know the credit default (CDS) market has grown over the past decade to more than $45 trillion, which is roughly twice the size of the stock market. And I know you have made efforts to create a central clearinghouse for these derivatives and to automate their trading and settlement. Those are welcomed initiatives.

How have credit default swap issuers been able to provide guarantees that vastly exceed their capital reserves to the point where there is virtually no possibility that they can pay in the event of a default on the underlying obligations? And in answering that question, how can we contain that systemic risk posed by CDSs but at the same time preserve the beneficial uses of CDSs as a valuable risk-management tool for these firms, because they are a valuable financial instrument?

Mr. GEITHNER. I completely agree. They do bring very important benefits to the financial system that we do want to retain, but they come with a lot of challenges.

So I think the two really critical things are that the institutions, the dealers that are at the center of this market, carefully manage their exposures in this area relative to their capital. So the first most important thing is to make sure that these institutions—and this is largely a group of 12 to 18 of the largest financial institutions of the world, banks, investment banks—carefully manage those exposures.

The second thing, as you noted, is to try to make sure that the trade processing infrastructure that supports what is now a bilateral market is modernized to the point that it offers a level of automation, a reduction in operational risk, a capacity for dealing with

defaults in the underlying, that is more appropriate to the centrality of these instruments and this market.

You can't say another way, but that infrastructure substantially lagged development of that market. We are working very hard at trying to close that gap. And that requires not just moving the standardized part of this market onto a central clearinghouse and moving to greater automation but a range of other things that are critically important.

You are going to see in the public domain in the next couple of weeks another set of clear objectives and targets and commitments from those dealers.

Mr. BACHUS. Thank you, Chairman Cox, and Mr. Geithner.

I appreciate you both.

The CHAIRMAN. I am now going to proceed. As I announced at the last hearing where we had Mr. Bernanke and Mr. Paulson, we are going to now go to the people who didn't get to ask questions there first, and then come back. The order, by the way, will be Mr. Ackerman, Mr. Scott, Mr. Perlmutter, and Mr. Wilson. And then we will get back to the regular order.

So Mr. Ackerman will begin.

Mr. ACKERMAN. Thank you. Thank you very much.

I would like to know why, at a time when we see a lot of abusive and manipulative short selling, especially in an economic climate where people are very mistrustful and lack confidence, that we would not reinstate the uptick rule.

Mr. COX. The uptick rule—

Mr. ACKERMAN. I have introduced legislation that would mandate that it be reinstated. It seemed to work very, very well when we had it for all of those years, and we seem to have all of these problems now.

Mr. COX. The uptick rule, as you know, went into effect in 1938 when a tick was a tick. It meant something.

We went to decimalization in relatively recent history, and a tick became a penny. There has never been an SEC action more carefully studied by economists both within and without the Agency. Indeed, in order to study this issue, which commenced under my predecessor, one third of the stocks on the Russell 3000 Index were put into a pilot; half of them had a tick test, half of them didn't have a tick test, and the effects on a number of parameters, including volatility, were studied.

What was discovered was that the tick test no longer had any effect. It wasn't effective in achieving its original purpose. The question that you raise, however, is a very good one; should there be a test that does work, should there be something that is meaningful? If it can't be a tick because a tick is now just a penny, and even when the stock is dropping like a stone it tends to drop with penny upticks along the way, is there a price test that could work with an increment of a nickel or dime or what have you? And the SEC is carefully studying this even now.

Mr. ACKERMAN. Maybe a tick is just a tick, but I think we are suffering from Lyme disease right now. In the movie The Producers, and the play, which is very successful, the hustlers in that game would go out and sell 150 percent or 500 percent, 1,000 per-

cent of this play and try to make it bad enough that it would definitely lose so that they could make money when it lost.

I think we are dealing with a market that is very, very rumor sensitive, especially in this day and age. And while betting on something going down is a legitimate game, I think that pounding it down and hammering it down is something that is disastrous, and a game that we should be protecting against, so that there is transparency and people understand what they are investing in; and at the same time, tie this in with the issue of naked short selling, where people can actually sell 150 percent because they are not really borrowing the stock. If you combine that with the tick rule or the lack of such, I think we are heading for an absolute total disaster. I would like to know why the change in rules has basically given a cloak of protection and security to 19 firms instead of protecting all of the banking institutions on naked short selling. Who are we protecting if we are not protecting everybody?

Mr. COX. Well, there is a regulation recently put into effect and recently tightened even further called Regulation SHO that targets naked short selling. It applies across the entire market. And so the norm, that you need to borrow a stock or you need to have a contract to borrow that stock or you have to have a reasonable expectation that you can—

Mr. ACKERMAN. But you have two different standards, one for 19 companies and one for everybody else as to what the standard of showing is.

Mr. COX. The difference between Reg SHO, which applies across the market, and our emergency order is that one of the three prongs of the test has been removed, so that now you have to either borrow or have a contract to borrow. Having a reasonable expectation that you can do so is no longer sufficient. And the universe of entities to which this emergency order applies is precisely the universe that the Federal Reserve has drawn.

Mr. ACKERMAN. And with the 19 to whom the full test applies, it seems to be very effective. If something is very effective, why not use that as a template and apply it to everybody, so that everybody has the same sense of confidence in the playing field?

Mr. COX. When the Commission issued its order, I made it very clear that is our intent; that we are going to propose a rulemaking that will put in operational protections for the entire market beyond even those in Reg SHO that presently exist.

The CHAIRMAN. The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman Cox, we had a previous hearing here in the committee on systemic risk, and we had the Chairman of the Federal Reserve here at that time and the Treasury Secretary. I mentioned a quote by former Chairman Alan Greenspan, and in that quote, Mr. Greenspan expressed his belief that private counterparty regulation or monitoring basically through market discipline generally has proved better at constraining excessive risk taking than has government regulation, in his view. I mention this quote again because as we look to potentially increase the regulatory authority of the Fed over investment banks and large broker dealers, I think it is critical that we preserve the rule of market discipline among

these institutions. We have to keep an eye, I think, on what happens when we lose that market discipline.

And I was going to ask you, Mr. Chairman, are you concerned that the potential increase in regulatory authority and overall regulation may in fact weaken the effectiveness of market discipline among these firms?

Mr. COX. Of course. I think the goal of our supervision of the firms and of any financial regulatory regime restructuring should be to eliminate the need for continued access to the Fed's liquidity facilities. No one more than the Federal Reserve appreciates the connection between the provision of government backstop liquidity on the one hand and moral hazard on the other. It gives rise in turn to the need then for more regulation and supervision. And ultimately, if one takes that to the logical extreme, the requirement would be for the government to have to supplant the wisdom of the entire market, and to do everything through regulation supervision clearly is not possible. So it is the wrong model. It is not what we should be building towards.

These are exigencies, as Chairman Frank noted and others noted in your statements. We are doing a good job of dealing with problems as they come up. But this hearing is about restructuring the thing so that you don't have to do this. And our objective should be—whether or not mankind can be perfect in this respect is perhaps another question. But there is no question what we should be trying to build, and what we should be trying to build is something in which the Federal Government isn't in this business.

Mr. ROYCE. It has been reported recently that many of the investment banks have scaled back their usage of the primary dealer credit facility that we established in March that was—in fact I think the window has gone unused, the discount window has gone unused for the past 3 weeks by these institutions. What should we make of this pullback? If there isn't this borrowing going on now through the discount window, is this a reflection of the health now of these institutions? Or is this a statement to regulators and lawmakers that these investment banks are not prepared to trade access to the discount window in exchange for the burdens of increased regulation? I was just wondering what your take is on that.

Mr. COX. I think you probably want to hear from both of us on this.

From the point of view of the SEC, I don't think it is the latter. I do think that it is a reflection of what Secretary Paulson has said on many occasions: It is much better to not use authority that people know exists, to not have to rely on backing that people know exists because it does its job better that way. I think that is a bit of what is going on here.

Mr. ROYCE. Let me ask then the President of the Federal Reserve Bank of New York. Mr. Geithner, what is your observation on that?

Mr. GEITHNER. It is hard to know. But my sense is that these facilities, all of them, are still providing a very important role in confidence as a backstop source of liquidity in extremis. And I don't think you can really judge the value today to the firms themselves or to the people who fund them from looking at use day-by-day. So

my own sense is that there is still plenty of kind of an important role, even though use has declined progressively over time.

Just to underscore one important point, we have been very careful from the beginning, along with the SEC, to try to make sure that while these facilities are in place the major investment banks move to adopt a more conservative mix of leverage and funding than they had on the eve of the Bear Stearns thing. And I think it is important to note, and I think Chairman Cox has said this, too, that they have made substantial progress in moving towards an appropriately more conservative mix, as I said, of the leverage and funding risk.

Mr. ROYCE. Thank you. Thank you, Chairman Cox.

The CHAIRMAN. The gentleman from Georgia.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Let me ask, do each of you believe that the action that has been taken by the Fed, the Treasury, and other central banks has done a good job in helping reduce risk, raise capital, and build liquidity? How can we improve upon this? And as the Fed is beginning to face added pressures from some regional Federal bank presidents regarding starting to raise the cost of credit to curb expectation of higher inflation, in your minds, is inflation indeed of greater concern right now?

Mr. GEITHNER. Congressman, it shouldn't surprise you to hear me say that I believe that what the Fed has done with other central banks to help ease the liquidity pressures in markets has been necessary and appropriate. And we try to be careful to underscore a commitment to continue to do things, as I said, to, "help ease this process of adjustment." That is important, and not just because the financial institution is still facing some pretty substantial pressures and we want to mitigate the risk that those pressures increase overall headwinds to the economy as a whole. But it is important to make monetary policy more able to deal with the full range of challenges we face as a central banker.

Mr. COX. I would be happy to address your question as well. As you know, the SEC is not responsible for monetary policy, but inflation is something about which investors—whom we look after—care a great deal. One of the things that the SEC concerns itself with every day is making investors comfortable, taking their money and putting it into investments where it can be productive in our economy, what you on this committee call intermediation. We want to make sure that can happen. And that is one of the best ways for investors to protect themselves against inflation if they think that is a risk or if in fact it is a risk.

So creating and maintaining market confidence is vitally important in this respect as well as in others. That is what we are focused upon.

Mr. SCOTT. Another part of my question is yesterday, we made a very bold and I think a very, very, very good and substantial move with our housing package. And given the fact that now we have addressed our housing package, let me ask you, do you believe that a second round of stimulus package is necessary? Would you support a second round of stimulus in the face of what people are saying and economists, that we still expect sustained economic weakness to last, many say, for the next 2 or 3 years?

So my point is, given the housing package, given the earlier stimulus, do you foresee down the road a necessity to move with a second stimulus package? And what do you think the first stimulus package has done?

Mr. COX. I think economists will have to tell us what are the actual effects based on empirical data that even now they are collecting of the stimulus package that has already been put into effect.

Complementary to the SEC's role in instilling and maintaining market confidence is the policy that the Federal Government and that the Congress enacts, including fiscal policy, that stimulates economic activity and that promotes economic growth.

I would say, as the investors advocate, that investors rather obviously look for after-tax rates of return. And that when they are facing, as they are now, scheduled increases in taxes on dividends, capital gains, ordinary income, that there is probably a lot of room there to create positive incentives for people to put their money in the market that will also be consistent with promoting growth in the economy, and that for Congress to be examining those things.

Mr. SCOTT. My time is about up. So what you are saying then is that you believe that we have moved sufficiently with the housing, we have moved sufficiently with the economic stimulus package. Is that enough right now? Or where do you see us in terms of calming the jitters within the markets?

Mr. COX. I think we are far from achieving our potential as an economy, as a Nation, and that there is a great deal more that sound policy, promoting economic growth, can accomplish.

Mr. SCOTT. Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman. And I would like to welcome you to this hearing. My first year here was 1999, which was a very interesting year, of course, when Gramm-Leach-Bliley passed. And I thought that we did it rather quickly, until I realized that most of my colleagues on this committee had spent their entire congressional career working on that. I guess I was fortunate just to have 1 year of hearings.

But in looking at what you both have presented as outlines in what should be accomplished, and I know that the centerpiece of the Treasury Blueprint is the reorganization of regulators and the regulatory authorities along functional lines, is what you are proposing in line with that? They say it says to do a consumer protection regulator and insured institutions regulator and a systems risk regulator. And I must say, I haven't had time to really study what you both have proposed. But is this in keeping with the Treasury? Or is this a different way to do this? And most of all I am concerned about, how long will this take, what has to be legislated, and what can be done now?

Mr. Geithner or Chairman Cox, whomever would like to go first.

Mr. GEITHNER. The Secretary of the Treasury, I think, deserves a lot of credit for putting out a very comprehensive set of reforms with a very, I think, sensible set of objectives for those reforms.

I did not address in my written testimony the full range of issues that will be raised by that, including those that affect the specific rules of the Fed. But I think the basic idea of modernizing the

framework, of having a more clearly established, appropriately assigned set of rules more consistently applied is very important. I think the call for very substantial consolidation simplification is very important. I think the emphasis in trying to make sure that there is authority commensurate with the responsibility where that rests for financial stability, I think those are all absolutely sensible objectives, and probably should guide any framework of reforms going forward.

There are a lot of complicated things about how to do that that have to be thought through carefully, but I think at that basic level it is a very well-designed, comprehensive set of proposals.

Mrs. BIGGERT. Thank you. Chairman Cox?

Mr. COX. The Treasury Blueprint was a "big think" exercise going way outside the box and the boxes. We had a brief exchange here during this hearing about just what would be involved if one were to consider only the piece involving the CFTC and the SEC. Obviously, we would have to get the Agriculture Committee in this room and likewise on the Senate side.

While I think those exercises, those big think exercises are useful in many respects to challenge orthodoxy and to get us imagining all the possibilities, what I am here to testify about today is very focused and very different and, I think, much more tractable in real time even if real time is measured as next year or the year after. We are asking first that we plug the Gramm-Leach-Bliley regulatory hole concerning the lack of consolidated supervision for investment bank holding companies, and we are saying that the SEC should be given explicit authority to control liquidation of investment bank holding companies or their unregulated affiliates that generally hold most of the derivative positions.

I think those are things that this committee could do in something like real time.

Mrs. BIGGERT. So do you think then that you will be working with the Treasury after the real-time considerations that you have and then move on? Is there a move to really look at that, or was it just a think exercise?

Mr. COX. No, I don't think that this is merely an exercise. It is certainly big think. But I think the Treasury in issuing it, and you should all be aware as I am sure you are, that this was a Treasury product, not a Fed product, not an SEC product. It was meant by being purposefully nonconsultative to be internally logically consistent. And it is that. Whether or not it has the approval of every other regulator in every other respect, I think you can imagine it does not. But the Treasury acknowledged when they issued it that this wasn't going to happen right away. It might not ever happen, that this is a process that is getting underway.

We then had Bear Stearns. We had other events in the marketplace that have accelerated the pace of the people's thinking here. I think that has focused us much more on what can be done realistically, measured in terms of months. The Treasury, the SEC, the Federal Reserve, and the CFTC, through the President's Working Group are very focused on these and related questions on a regular basis. There will obviously be a change of Administrations before I think any thorough legislation is passed. So these are institutional questions. It is not so much a question of whether Chris Cox

is working with Hank Paulson or Tim Geithner or Ben Bernanke as it is that Congress is focused institutionally on these things and has a path and a way forward. I think this hearing is a wonderful way to institutionalize that process here in the House.

The CHAIRMAN. The gentleman from Colorado. The order now will be the gentleman from Colorado, the gentleman from Connecticut, and the gentleman from Ohio. Then, we will go back to the regular order. The gentleman from Colorado.

Mr. PERLMUTTER. Thank you, Mr. Chairman. Just a quick question back on that uptick rule. And the reason I am interested in it is that I am walking precincts on Saturday. As Chairman, you have had to walk plenty of precincts. A guy says, why did they eliminate the uptick rule? And you said it is because of the decimalization and the fact that a penny isn't worth very much anymore. But shouldn't there be some sort of stop in this system? Because when you look at Bear Stearns, when you take a look at what I think happened to Freddie Mac and Fannie Mae 2 or 3 weeks ago, these guys are betting against the house; they are betting in a big way. I think you used the words "distort" and "short." And something isn't right about all of that. So shouldn't there be an automatic stop?

Mr. COX. There are several questions I think that you have touched on in your comment, and I will try and address each of them.

First, the most virulent combination from a regulator's standpoint is intentionally false information being inserted into the marketplace by people who are then manipulating the stock and using short selling as a means to turbo charge the effect of it. It is that combination that we really need to be worried about, because that goes directly towards the credibility and integrity of the information in the marketplace that everybody depends upon. And particularly when markets are moving as fast as they do today, there is not a lot of time to get it right a week later. We want information to be right in real time, and we are focused a lot on real-time disclosure for public companies.

Second, the uptick rule itself was the subject of, as I mentioned earlier, a very elaborate pilot study in which essentially the provisions of the rule were suspended for one group of stocks and they were comparable stocks, so within the Russell 3000 they were studied not only by the Office of Economic Analysis within the SEC over a period of a year, but also by academics outside who replicated this and got similar results. And the findings were that there was no significant effect on market quality or on volatility.

We were then able in the subsequent more volatile markets to compare the effects on volatility, on the U.S. economy, with effects and changes in volatility in other countries, some of which had an uptick rule, some of which didn't. And there was found to be no correlation. So if one is focused on empirical results, we have a lot of them here, and that is generally the basis on which you want your regulators to make decisions.

But then the third question that you raised is whether or not you want something that does work. And I think that is very much under Commission consideration right now. The trade-off there, rather obviously, is a circuit breaker or something that can protect

investors from things running away on the one hand, and making sure that you don't interfere with liquidity and efficiency on the other hand.

Mr. PERLMUTTER. I appreciate that. And I guess I am more for putting a stop in there, because information does flow so quickly that for you to be able to catch up even a day or two later may be too late. And so we have seen huge swings in these organizations and their stock prices. And I think in one of your articles we talk about if you pump the stock up based on false information, you get jail time. And hopefully the same thing applies, if you drive the stock down based on false information, you get jail time. That is what I am feeling. Because a lot of people lost a heck of a lot of money in the last 3 or 4 weeks in some very significant stocks to this country, and we had to take some emergency steps yesterday to remedy that.

Now, I do want to get to the bigger question, which is Gramm-Leach-Bliley and Glass-Steagall. In my opinion, investment banks and commercial banks are very different animals and have very different purposes, equity side, debt side. And in one of your comments in your paper, you say: "Rather than extend the current approach of commercial bank regulation to investment banks, I believe Congress and regulators must recognize that different regulatory structures are needed for oversight of these industries."

My question is, shouldn't we separate these things again? There was an erosion of the separation between the two types of banks, the investment banks and the commercial banks, from 1980 to today. Has that been good for us? And shouldn't we separate them again?

And then I am done. Thank you.

Mr. COX. I think that the Gramm-Leach-Bliley essence of eliminating the Glass-Steagall in a wall of separation was a good thing and can be distinguished from what I am trying to point out here, which are the essential differences even in today's world that characterize investment banks on the one hand and commercial banks on the other. Some of those differences are regulatory, some of them are accounting, some of them are the nature of the business. The approach to leverage and risk is very different in investment banks than it is for commercial banks. For accounting reasons, investment banks have to daily mark to market everything they have. Commercial banks don't often have to do that.

If we don't appreciate these distinctions and appreciate the different roles that these institutions play, then I think we will find that applying the commercial bank model of regulation to investment banks will so restrain the role that they play in the economy that somebody else then in the marketplace is going to rush in to do that, likely an unregulated entity, hedge funds and others private pools of capital. Then we will have the same set of questions to ask all over again but now with a new set of entities, and we haven't really solved that problem.

The CHAIRMAN. I want to say to my friend from Colorado, I did a quick survey of some of my colleagues here, and we want to congratulate you on the financial sophistication of your district. None of us going door-to-door have ever been asked about the uptick rule. So we did want to either congratulate or console you on that.

The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Geithner, in my opening comments I asked a rhetorical question; now I would like to ask a direct question. And that is, just how will the Federal Reserve think about the balance between price stability, financial stability, consumer protection, full employment, and taxpayer protection? I am curious about how you, as head of at least the New York Fed, would think about this balance. And what would be the risk associated with increasing the charge to the Fed with more responsibilities, particularly at a time when at least many of our constituents, when they look at price stability, might not give you an A-plus?

Mr. GEITHNER. I think you are raising exactly the right question. I think that it is very important that we are not given responsibilities for which we do not have authority, and it is very important we are not given responsibilities which would conflict fundamentally with the basic obligations that the Congress gave us in the Federal Reserve Act.

It is important, though, to recognize that all central banks in any serious economy are given a set of mandates that require a balance between price stability and some mix of sustainable long-term growth objectives. That mix differs. But also financial stability. And in any central bank, the basic lender of last resort instruments that are given to prevent liquidity problems from becoming solvency problems along with some broader financial stability are inherent to the functions of modern central banks.

It is very important, though, to recognize that those instruments' responsibilities come with and have implications for moral hazard; and, therefore, it is very important they be complemented by a set of constraints on risk-taking and a framework for dealing with problems that can help limit and offset that moral hazard risk. But that basic framework of responsibilities, from price stability to financial stability, are integral to what all central banks live with every day, and those objectives do not need to conflict.

Mr. HENSARLING. As we seemingly have the Fed go down this road of taking on increasing responsibilities for financial stability, I believe it is now twice in 60 years that the Fed has chosen to open a discount window to nondepository institutions, those two occasions being within the last 4 months. I asked Chairman Bernanke the same question. I didn't leave with an answer that I felt necessarily was the model of clarity, and maybe that was on purpose. But I would like to know, in your opinion, who is this window open to? What is the criteria? Who is eligible? Why are they eligible? Is it simply bigness? Is it simply interconnectedness? What is the criteria? Who qualifies? And if that is difficult to answer, who doesn't qualify?

Mr. GEITHNER. Today, under the current facilities, two types of institutions qualify: Institutions that are what we call depository institutions, institutions that take deposits like banks; and institutions that we call primary dealers. Primary dealers come now in essentially two forms. They are affiliated with banks and those that are independent. The four large investment banks are examples of the latter.

The reason why they have access to those facilities now is because those institutions play critical and unique roles in market functioning. And in order to help facilitate this adjustment the economy is going through, they need to have the ability to finance less liquid assets with the central bank, but those are the institutions and that is where the line now exists.

Now, the Federal Reserve Act did give us the ability to go broader if we believe circumstances require that, but at the moment we have drawn the line there, I think appropriately.

Mr. HENSARLING. I see I am soon to run out of time. From the perspective of just dealing with systemic risk, notwithstanding what took place on the House Floor yesterday vis-a-vis Fannie and Freddie, but looking forward and not looking backwards since I assume ultimately the bill will become law, if in an orderly fashion, and your one goal was to reduce systemic risk, would you believe that a system where you had broken up Fannie and Freddie into a more atomistic market, lowered their conforming loan limits, and minimized their portfolio holdings, or, in the alternative, totally privatized them over, say, a 5- to 7-year basis, would you believe that would lead to less systemic risk in the economy?

Mr. GEITHNER. I believe that there is going to have to be some very fundamental rethinking of the future of these institutions going forward. It is hard, though, to say today with confidence what the optimal role will be in the future. But for the reasons you have said and many others, the current balance is probably untenable over the longer term.

Mr. HENSARLING. Thank you.

The CHAIRMAN. The gentleman from Connecticut, Mr. Murphy.

Mr. MURPHY. Thank you, Mr. Chairman.

Mr. Cox, I wanted to get specifically at the emergency order relevant to pre-borrow requirements for short selling. And I for one appreciate the SEC's action in this regard, but I have maybe a twofold question.

You have limited the order to 19 specific stocks. There are those of us in correspondence with your office who have been advocating for a pre-borrow requirement industrywide, and I appreciate the fact that you have recognized that at least for these particular companies, this is an immediate problem that necessitated the emergency order.

But I guess the two parts to my question are: First, why not apply this industrywide? You have had a regulatory process that has been ongoing for some time looking at this issue which has now been I think going forward for about a year, and I am interested to know why, if it makes sense for these 19 companies, it doesn't make sense for the entire industry? And second, what hazard do you potentially see with selecting only these companies and not others? We have seen just in the 2 days after the emergency order was put into effect, I think for all but two or three of those companies, a double digit percentage increase in the value of their stocks. I think across-the-board, I am looking at a 21 percent increase in their value in the 2 days after that order was put into place.

So the twofold question is: First, why not do it for the entirety of the industry? And, second, do you foresee any problems in pick-

ing only these 19, and leaving other companies then potentially with even greater exposure to short sales?

Mr. COX. Well, thank you for the opportunity to expand on this, because I think it is an important and a good question.

Our emergency authority is limited, as you can imagine. Our rulemakings are generally governed by the Administrative Procedure Act, which requires an elaborate process of notice and comment; it requires economic justification; it requires a fair amount of empirical analysis, historical analysis, and so on.

Our emergency order was tailored precisely to the emergency orders that the Federal Reserve had issued. We issued it in close consultation with the Treasury and the Fed as an ancillary, as a support for those actions. And so the universe of firms that are covered by the emergency extension of credit facilities by the Federal Reserve is the same universe of firms that the SEC order covers. And I think because of the nature of our emergency authority we are constrained in that respect.

However, it is vitally important for us to look after fraud in the entire market, and we are doing so in real time. This isn't the only initiative that we have announced. As you know, we have a sweep examination that we have undertaken with FINRA and also with other regulators, and that covers the intentional spread of false information in the marketplace that is generally part of this witch's brew of distort and short, to which you alluded.

In addition, beyond that we have immediately pivoted to a broader rulemaking so that we can use the APA process to extend this kind of procedural protection to the entire marketplace. I think that very soon we will be in a position to issue a proposal on that.

Mr. MURPHY. And let me ask again the second part of that question: Do you have concerns? And Mr. Geithner, you can answer this as well. Do you have concerns as has been expressed, for instance, by some of the banking organizations in letters to your office, that by limiting this order to a small set of stocks, you are creating greater exposure for those that weren't included in this order? And, again, I think this has been expressed to you at the very least by some community banking organizations that believe this might be the case.

Mr. COX. I think the concerns in the marketplace are chiefly focused on the potential for illegal manipulation through the insertion in the marketplace of false information. And that is something that we are policing across the entire market.

I think it is important to note that our emergency order concerning naked short selling was not based on an analysis of a big problem in this area that exists currently. It is prophylactic. It is preventative. It is designed to shore up confidence. But because there was not an epidemic in the first place, I don't think that there is a risk that the epidemic that didn't exist is going to be moved to somewhere else.

We also have Reg SHO. We have the opportunity because of the step-up in enforcement that we are doing in this area, we have the opportunity to enforce it across-the-board. So I think any financial institution, and indeed any public company, can expect much greater protection and confidence for their investors that the marketplace is operating on the level as a result.

The CHAIRMAN. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman. And good morning, gentlemen.

We are here for a hearing on systemic risk in the financial markets. And I guess it is typical of the way government and Congress works that we are doing this today, only the day after we voted in Congress on perhaps one of the most significant changes to our financial marketplace and the taxpayers with the potential for a $5 trillion impact upon the taxpayer and extension of authority to the Treasury Secretary. But perhaps that is just the way Congress works; we do the hearings following the action. But I do appreciate your coming here today to talk about some of these actions, and I will begin with what we did yesterday with regard to the GSEs and Fannie Mae and Freddie Mac.

Secretary Paulson, prior to us taking this action, was sort of in the marketplace trying to calm it down, if you will, trying to facilitate the debt sales and that sort of thing. But Chairman Cox, during that period of time, if you were a trader in Fannie or Freddie, in their equities, if you were long on their positions, was everyone's ability still in margin accounts? Or were there some of the brokers requiring cash accounts basically for Fannie or Freddie during that period of time and even today as well?

Mr. COX. I am not sure—

Mr. GARRETT. Were the brokers requiring marginal—raising the margin requirements on the trades?

Mr. COX. No.

Mr. GARRETT. So there were none of them out there asking for, basically treating it as a cash transaction, to your knowledge?

Mr. COX. I think the answer to that is "no."

Mr. GARRETT. My understanding is that perhaps that is not the case, and that some of them were looking at it, trading it as a cash requirement. Maybe I am wrong. I will ask you to get back to me to clarify to assure me that is not the case.

If that was the case, that they were in essence raising the margin requirements at the same time that the Secretary was out there trying to smooth things over, calm the marketplace, then that would be going exactly in the opposite direction. Wouldn't that be?

Mr. COX. I think that is right.

Mr. GARRETT. And is that the SEC's responsibility to be looking at that sort of thing?

Mr. COX. Obviously our concern is that, first, the information in the marketplace on which investment decisions are being made is accurate. And then, second, in terms of maintaining orderly markets, to make sure that the trading itself is disciplined.

Mr. GARRETT. The other thing, this is a general question, this is a step back, is looking for stability in the marketplace, is stability with all you folks. Where are you guys going to be? I know where I hope to be a year from now if everything works out well in November. Where will you both be a year from now?

Mr. COX. A fascinating question.

The CHAIRMAN. Chairman, your wife may be watching television.

Mr. COX. I hope that at least the market environment in which I am operating at that time will be a positive one and a strong one. That is what we are working on building here.

Mr. GARRETT. And you will still be with the Bank?

Mr. GEITHNER. Life is uncertain, but I certainly expect to be.

Mr. GARRETT. I say that in jest in some sense, but also in the sense that it is reassuring that the players who are here today will be the players who will be here a year from now, all present company included up here on the panel as well.

Back with the SEC and the Bear Stearns situation, was it your responsibility or were you engaged in the process of looking at Bear Stearns, their situation, their liquidity, and their management at the time prior to the "collapse?" If you were, what were your findings? And did you feel that there were any shortcomings in what you were doing?

Mr. COX. The SEC through our consolidated and supervised entity program was monitoring capital and liquidity at Bear Stearns. And in fact, on a daily basis in January, February, and March, the liquidity position of Bear Stearns as a result of that interaction more than doubled between January and February. They were in a position of, going into March, having between $18 billion and $20 billion of liquidity. The CSE program, managed rigorously against the standards that it had been set up with for liquidity to ensure that—

Mr. GARRETT. I only have about 10 seconds, sir. I will put my question out again, sir. Should there have been any other red flags that you should have seen going up to that time? Because other people on the street were not seeing them as well, should the SEC have seen the red flags prior to obviously what just happened?

Mr. COX. Beginning with the failure of Bear Stearns hedge funds, there were market rumors in Europe about loss of secured funding sources that caused us to take a look at all of their secured funding sources. We found out, in fact, that their secured funding had increased.

Using the capital and liquidity standards that the SEC program put in place, including the Basel II standards, including liquidity standards that require that you be able to go a full year without access to unsecured funding, the capital and liquidity cushions for Bear Stearns going into the week of March 10th were above regulatory requirements. But what we discovered during that week, and what banking regulators of all kinds in the United States and in other countries have not seen up to that point was that there could be this run on the bank phenomenon, where customers withdraw their free cash balances, where people novate their contracts and so on. The result in the Bear Stearns case was that it lost 89 percent of its liquidity in 3 days.

Mr. GARRETT. Thank you.

The CHAIRMAN. The gentleman from Ohio.

Mr. WILSON. Thank you, Mr. Chairman.

Gentlemen, I would like to address my question to both of you, if I may. One of the concerns I have had through this whole process has been the oversight and the lack of connection or the not having connection among the oversight groups. So I have two questions. One is, how important is it that the central banks, governments, and supervisors look more carefully at the interaction between accounting, tax, and disclosure, and capital requirements and their effect on the overall leverage and risks across the financial system?

Mr. GEITHNER. Very important. There has not been enough attention paid to that interaction in the past, largely set by entities with independent authority and responsibility. And so I think it is a central imperative going forward.

Mr. WILSON. Mr. Cox?

Mr. COX. I strongly agree with that. And because of the nature of these different responsibilities, the fact that they of necessity fall in the hands of different regulators, some of what in the past has been ad hoc'ery and is now increasingly formalized, the cooperation through a memorandum of understanding, for example, is absolutely vital.

Mr. WILSON. As we look and move forward to work on this, I think it is very important that be one of the primary goals that we have. And sometimes it surprises me how much we get off of the real issue we are trying to accomplish.

As Congress considers the Fed's bid to expand authority over the financial services industry, what do you believe is fair regarding additional powers for what you will do to help with the oversight and the stability of the financial services market?

Mr. COX. I am sorry, is your question directed to the SEC?

Mr. WILSON. I was basically addressing it to both of you. I can specifically make it to you, Mr. Cox.

Mr. COX. All right. To begin with, the SEC. First, the SEC already has in statute the authority to run a voluntary program of consolidated supervision with respect to an oddly defined category of investment bank holding companies. We need to strengthen that legislation so that the program is not voluntary, it is mandatory, so that the SEC has the authority to mandate compliance, and also so that each of the CSE firms that presently today are regulated under that program are covered.

Second, we have asked to be given explicit authority to control the liquidation of investment bank holding companies and their unregulated affiliates, particularly with respect to derivative positions that they hold.

Mr. WILSON. Mr. Geithner.

Mr. GEITHNER. I don't believe that we need a dramatic expansion or redefinition or change of our rule. As I laid out in my testimony, I think there are some areas which represent continuity where there are additional responsibilities, where I think you need to tighten up responsibility and authority and give us a better balance of ability to compensate for the moral hazard that is created by things we have to do in crisis.

So I would say, just to repeat them, it is very important that we have, as we do now, a rule in thinking about and setting the capital requirements and other prudential requirements that apply to core institutions. It is very important that we have a rule in consolidated supervision of those institutions, because you will not have good judgments made by this Bank, this Federal Reserve in the future unless we have the direct knowledge that comes with supervision.

It is very important in crises that central banks are able to move with force and speed when circumstances require it, and that won't happen unless you have a tighter match between that responsibility for lender of last resort functions and the knowledge that can

only come for some role going forward. It is very important in the payments area, where we have substantial responsibilities now, that you have a little more clarity about who is accountable for a level playing field and a broader systemic stability. And it is very important in crises that have systemic implications that we have a consolidated framework.

That basic framework is very consistent with the responsibilities we have now, but our system has changed a lot since that was designed, and so we just need to look at how to make sure we get a better match between responsibility and authority.

Mr. WILSON. Thank you. We will certainly try to do that.

Thank you, Mr. Chairman.

Mr. COX. Mr. Chairman, if I might, just before this next round of questions, clarify my response to Congressman Garrett. I was not sure in his question whether he was asking about brokers' individual or required margins. The question that I answered concerned required margins. Required margins did not change. But it is also the case that brokers can raise their own marginal requirements. We don't have data about that at this hearing, but if Congressman Garrett would like that for the record, we would be happy to provide it.

The CHAIRMAN. Thank you.

Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman. This question is to Chairman Cox.

There is wide agreement that the credit rating agencies need to be reformed, and there needs to be reform instituted by them as well. Your rulemaking goes a long way towards that end to resolve some conflicts of interest and create some greater transparency within the credit rating agencies so the market can truly know what is happening. And I believe we need to ensure that issuers and originators are providing credit rating agencies with adequate information on assets underlying a structured security.

So does the SEC currently have the authority to ensure that originators and issuers are providing NRSROs the information they need to rate structured securities?

Mr. COX. Our authority under the Credit Rating Agency Reform Act runs to the rating agencies. But we certainly have authority concerning their disclosure of the information upon which they rely and their internal procedures for using that information. We don't have the authority in statute to regulate precisely how they come up with their ratings, nor do I think that you want the Federal Government to regulate that. We want to deal with that through competition and disclosure. But the net result of this, which will be covered amply in our very sweeping set of rule proposals, is that we will get directly at this problem.

Mr. MCHENRY. Can the SEC intervene when NRSROs, basically if the credit rating agency fails to advise the investing public of material information?

Mr. COX. Absolutely. That authority is clearly given to the SEC under the credit rating agency format. By the way, these authorities just kicked in last fall. We have been aggressively using them since that time. But there has been a great deal of change in that industry in just a few months.

Mr. MCHENRY. I have legislation, H.R. 6230, which would clarify the intent of Congress that the SEC has this authority and the prudential steps thereafter to take action here to further clarify that.

Mr. COX. I have not reviewed that legislation, but I think we would welcome that authority, because it is consistent with the authority I believe that Congress meant us to have.

Mr. MCHENRY. Because in terms of material information, I think that has to be clarified so that you can take those actions and steps necessary. Because, after all, part of the credit challenges that we are facing currently are because the credit rating agencies did not accurately detail the risks in the marketplace and actually rate products effectively.

And another question for both of you, but starting with you, Chairman Cox, is the SEC—and to you, Mr. Geither. Are you all studying the implications of the FASB fast tracking and elimination of the qualified special purpose entities? Basically, what allows for securitization in the marketplace. Are you studying the effects that this rulemaking—because they are trying to push it and have it implemented by the end of the year—could have in the marketplace?

After all, in my opinion, the Federal Reserve, but more importantly the Treasury, stepped in on Fannie Mae and Freddie Mac because of a report, a Lehman Brothers report, that explained the risks going forward with the FASB rule the possibility that they might need $75 billion in capital. And that was just based on an assumption that the rule would go into place.

So this FASB rule about qualified special purpose entities, if you could discuss that.

Mr. COX. I think it is wrong to say that this is being fast tracked. I think the likely scenario is that there will be a period for public comment, consideration, and that—

Mr. MCHENRY. They have said publicly they want to have it done by the end of the year.

Mr. COX. And in terms of effective dates that they are considering in their proposals, we are talking years into the future.

Mr. GEITHNER. Could I have—

Mr. MCHENRY. So is that, no, you are not studying it?

Mr. COX. Well, the answer to your—I am sorry, if you asked a yes or no question, the answer is yes. We are not just studying it, but we have discussed it extensively with the FASB. We have also discussed it with the Federal Reserve Bank of New York. And just yesterday I discussed this with Chairman Bernanke. So we are very, very focused on this, and we understand precisely the environment in which we are operating.

So on the one hand we have the important question of reforming accounting in this area, something the President's Working Group asked the FASB to do in March of this year. On the other hand, we want to make sure that the discussion of this and the implementation of this is conducted in such a fashion that the market can absorb it and it doesn't create any unnecessary shocks.

Mr. MCHENRY. Mr. Geithner.

Mr. GEITHNER. I just want to reinforce exactly what Chairman Cox said. Of course we are studying this carefully. And you are

right to point out this has very substantial implications to the dynamics of this crisis.

There are a range of issues in the accounting area, not just the treatment about balance sheet commitments, enterprises, that need to be thought through. And there are implication with changes in the capital regime, too. I think it is important that those be done thoughtfully and carefully, and be done in a way that doesn't add to uncertainty and risk, amplifying what is still a pretty special set of tensions in the markets today. And I welcome Chris's careful attention to those issues and willingness to consult more broadly with the Fed and others about those implications.

The CHAIRMAN. I will recognize myself.

First, there was a reference previously to one of the great fantasy figures that is now circulating, and that was the $5 trillion obligation that theoretically just passed the vote yesterday. Nonsense rarely gets so graphic—$5 trillion is the total value of all the mortgages held by Fannie Mae and Freddie Mac. If none of them ever paid a penny, presumably there would be a $5 trillion loss. No one thinks that is remotely realistic in any case. Nothing that the House did yesterday or that the Senate will do or that the President will sign, misguided though some consider him to be in this regard, will obligate us to anything if those mortgages don't pay.

But, again, we ought to be clear about the $5 trillion figure. It is based on an assumption apparently that there would be a liability because all of the mortgages they hold would fall to zero, that none of the houses behind them would be worth anything. Not a serious figure.

I want to talk about one potential conflict we have had and it affects both of your organizations. We have to think about this going forward. Between actions that protect investors and the integrity of the market and systemic stability, and there are times when those two could theoretically fall in different directions, and we obviously want to make sure we can reconcile those. And then that has implications for, are there two organizations or one organization? In terms of one specific example, mark to market; clearly investors are entitled to know what is the real value of whatever it is they are asked to buy into. It is also the case—and I thought Mr. Cox's phrase, warning us against hard wiring consequences, here was a useful one.

It is also the case that going not simply to a mark to market requirement, but insisting that various consequences immediately follow on the mark to market could have a procyclical effect, and that our interest in fully informing the investor by mark to market, if we are not careful, could generate negative consequences. No one is, I think, suggesting or should expect to be able to suggest that we back off mark to market. But I thought Mr. Cox would take some unusual steps. This is an example of how we could combine investor protection, which is part of what mark to market is, but also with some concern for the stability of the system by having some flexibility in the consequences as to how much capital has to be raised and how quickly, as to whether or not other entities have to divest.

There is a question about mark to market. I will take my own case, my investment is largely in Massachusetts municipal bonds

because that is the only investment I can make without members of the media harassing me any more than they already do, because I presume people would think it is in my interest as a Member of Congress to support the financial structure of Massachusetts even though I wasn't helping. In fact, I work against interest because I think the municipalities pay an unfairly high-risk premium from which I benefit. And I wish that I was getting less interest because I wish people weren't being overcharged.

But the point I want to make is this: I don't plan to trade those things. I plan to hold them for my retirement. Marking them to market is really irrelevant to me to some extent because I am looking at the interest going forward. So I guess—let me just put the question now: Generally, what guidance can you give us and will you be giving us on how you reconcile those two, and particularly if you take sort of investor protection actions at a time like now when there is weakness, can you avoid procyclicality and is mark to market an example of this? How can we handle it? Let me begin with Mr. Geithner.

Mr. GEITHNER. Those are deep existential fundamental theological questions for people involved in the central bank and supervision. And I personally don't know how we get a better balance between the accounting regimes that now apply, particularly to those institutions that exist to quota the system. But I would just say one basic point is that what you want to assist is have a system where you have a level of cushion in terms of capital reserves, liquidity, etc., in the good times that you can allow so that when things change, confidence erodes, risk goes up, that those cushions are stabilizing rather than destabilizing.

If you run a system where people hold cushions that are too thin against plausible states of the world because they expect to be able to catch up and raise those in extremis, then you risk amplifying the crisis. And what you need to do is make sure you look at the interaction between the incentives we create for capital and those created through accounting regimes to make sure that they reinforce that basic objective. But this basic issue of procyclicality, very complicated, and you have very thoughtful people spend a lifetime advocating the benefits of both those regimes, and we live now in a somewhat uncomfortable middle.

The CHAIRMAN. Mr. Cox.

Mr. COX. I think, first of all, you are absolutely right about the general perspective of investors when it comes to fair value accounting. Investors appreciate it. On July 9th of this year, the SEC hosted a roundtable, it is what we call our hearings, on this topic; and we heard from a wide variety of participants in the marketplace. The general consensus was that fair value has been a help to investors in these difficult circumstances. They want more of it, not less of it, and that it has not been the cause of volatility in the markets or other problems that we have seen in the current market turmoil.

We, also at that same roundtable, got into the kinds of issues that Tim is talking about. There are, particularly in Europe as they consider fair value, existential questions about fair value or not. I don't think we are having that debate just now in the United States. The real question is, you know, at the margin when you are

away from instruments that the market generates prices for and you have a model that is trying to generate your price, but at the same time that asset is throwing off some cash, do you have to value it at zero? There are practical questions that people want answers to, and we are hoping that we can provide those answers in something like real time in the form of guidance. I don't think that there is, when it comes to fair value, necessarily a conflict between the investor protection mission and the systemic risk mission. I think fair value, properly used, can be very helpful.

The CHAIRMAN. Let me ask you, you did talk though, about the danger of hard wiring, when you say—and I agree, I don't think anybody should be backing away from the fair value. And it is a good way to call it that. But there has been a set of rules in place that have had some consequences automatically flow from a downward valuation. And the question is whether we should explore flexibility there.

Mr. COX. I think there is a lot of need for people to be able to understand what fair value accounting is all about. And depending on which investors you are talking about and in which country, sometimes those questions are very acute. There are some significantly counterintuitive results from fair value accounting that can startle some investors. For example, when fair value accounting is applied to your own debt on your own balance sheet when your debt becomes less valuable, it runs—in other words, your firm is doing worse, that generates income that you then run through the income statement.

So I think there is a lot of work that we can do in terms of investor education so that people understand how to use these accounting tools. And those are all legitimate questions when it comes to fair value.

The CHAIRMAN. We are going to have votes soon. We can say stay until the votes come. Let me ask my colleagues to each ask one question, the three who remain. Would that be fair? The gentlewoman from New York.

Mrs. MALONEY. First, I want to welcome all of our witnesses, particularly Tim Geithner from New York. So I have to put that in.

Chairman Cox, in your recent op-ed in The Wall Street Journal, you wrote that for financial institutions whose lifeblood is trading, not lending, there is yet no agreement upon apples to apples, comparison of balance sheets and leverage metrics. Regulators must determine whether the different kinds of risks both types of institutions bear within the context of their business models are appropriate for our financial system as a whole.

And one of the concerns that I have had that many people have expressed since the collapse of Bear Stearns is that certain entities have become overleveraged. How much is overleveraged? How do you determine to balance that in the future? And as you pointed out in your comments, it is hard to have an apples-to-apples comparison of balance sheets and leverage metrics. Do you think that we need to have a mechanism that allows for an apples-to-apples comparison? And if so, how would you suggest that we do this?

Another question connected to this is, as we move forward with reorganization, many of my constituents have expressed concerns

of putting too much power into the Federal Reserve, whose primary focus is monetary policy. Will that diminish their ability to be effective on monetary policy and are we putting too much in one area? Thank you.

Mr. COX. The apples to apples comparison is emerging day by day. It is really one of the things that we are focused on in our collaboration, the SEC's collaboration with the New York Fed, and with the Federal Reserve Board. Obviously, for some of the very accounting reasons we were just discussing, there are significant differences between the way commercial banks, investment banks report for financial reporting purposes. There are, though, sometimes translate into differences in the way regulatory capital is computed. But as we are now getting information from the Federal Reserve about financial holding companies so that we can look at what had been, you know, treated as banking regulatory beasts for regulatory purposes up until now in a more holistic way and they are getting from us investment bank holding company information so that they can take a look at things in a more systematic way as well.

That is generating the need to be able to compare all this and analyze it under some if not common metrics then at least common principles. So this is a work in progress and we are very, very busy at it. Ultimately what accounting regulators do also matters here.

The CHAIRMAN. Mr. Geithner.

Mr. GEITHNER. Just two quick things. The Federal Reserve cannot bear the sole responsibility for responding to the kind of challenges that the United States is going through. I think that the Fed has an important role but I think as the Congress has recognized, the Administration has recognized and it is truly in all financial crises. You need a set of policy measures to be responsive to these challenges. And monetary policy cannot bear the sole burden of responding to those challenges. We have been very careful to make that line there.

On the broad question about scope of authority, what I want to underscore again is how important it is not to give us broader responsibility without authority, that we cannot compensate for—without basic authority. If you gave us more responsibility, that would probably come with a broader increase in moral hazard, with less capacity to mitigate that risk. And getting that balance right is very important.

Mrs. MALONEY. Thank you.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. Let me start with the assumption that we are not going to do anything else this year after yesterday. It took us forever to get the Senate to do what we did yesterday. So in this discussion, I am really more looking at the longer-term reform issues. And it seems to me that the only person who has really done any creative proposals and suggestions about that has been Secretary Paulson.

I was pretty aggressive with him because he left some gaps in what he proposed. But at least he came out with a proposal that is a real reform proposal under which he suggested a regulator that deals with market stability across the entire financial sector, a second regulator that focused on safety and soundness of institutions

supported by Federal guarantee, and a third regulator focused on protecting consumers and investors. Everybody else who has been here, including, with all due respect, all of you today, has been tinkering around the edges of the existing structure rather than looking creatively at a more comprehensive reform of the regulatory structure.

And it is the third of those really that captures my attention more than anything else, which is the protecting consumers and investors regulator, which I think the markets, the economy, everything you all have talked about will always get taken care of based on my experiences. It is the consumers and the investors that I always worry about.

The proposal that I have heard that—not in this room but off the record—is that since most of what consumers and investors are buying now are products, financial products, that we ought to be creating something like a consumer protection agency or an Environmental Protection Agency or some kind of agency that protects people against bad toys or you know that kind of thing. And so I want to ask your opinion about two things, and you probably won't be able to do it in answers. Just give me the—and particularly, Chairman Cox, give me your—if you would—your suggestions about responses to Secretary Paulson's overall proposal, these three different areas of regulation.

And number two, what is your reaction to a really robust protector of consumer and investor interest patterned on somebody who is really going to look out for how do you give them the authority they need to do that? I know they can't do that.

The CHAIRMAN. Let him start with the second because they did touch, to some extent, on the first before. I would ask that they hit the consumer product safety piece, because we did get some response earlier on the broader plan. But if we could get that.

Mr. COX. In financial services, consumers are investors indeed. And the investors' advocate is the Securities and Exchange Commission. I think when one looks at the Treasury Blueprint, it is a little bit difficult to find precisely where existing regulatory functions fall, in which box, and whether—some people have inferred from this report that it would enlarge the responsibilities of the SEC, and others that it would substantially diminish them. The point of my testimony today is that we don't need to remake the world. We have a lot that works and what works in particular is the idea of a regulator whose foremost responsibilities are investor protection, making sure that we have orderly markets and making sure that we promote capital formation. The mutual reinforcing aspects of the different responsibilities of what the SEC does, for example, understanding the business of investment advisors, understanding the business of mutual funds, understanding the business of investment banks and broker dealers, regulating public companies, and getting honest disclosure to the market, all of that is vitally important to our enforcement function and vice versa.

And so to have a strong consumer protection regulator, you need these supporting buttresses. I don't think one can imagine a design, a mission for a regulatory agency that has investor protection more clearly at heart than does the existing charge for the SEC. So I don't think that we need to remake that in any respect.

Mr. GEITHNER. Could I just add one thing?

The CHAIRMAN. Yes.

Mr. GEITHNER. It is very important to focus not just on the standards and the rules, but also on improving the consistency and enforcement of those rules. Because you can very carefully design rules with appropriate protection for consumers, but if you allow vast disparities in how they are enforced across different institutions, what you have just created is incentive for that to move where enforcement is weaker.

So as part of thinking through this, you want to make sure not just that you get the broth standards right with the appropriate balance between consumer protection and other objectives, but that you have oversight enforcement incentives for complying that are more even. And that is a complicated thing to do in a country designed as ours is with a Federal structure and a lot of competing authorities.

The CHAIRMAN. The gentleman from Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman. Let me go one step further, and this is sort of related to the chairman's question about investor protection.

I agree that we need a strong regulator. But I also believe that some of these instruments, as you said in your opening statement, Mr. Geithner, that our current laws and regulations were put in place when we had a much different market. And they don't necessarily address the situation we have today.

I think one of the fundamental needs of our reform system, and I wish it was in one of your lists, is basic understanding within the market, by the market, by the individual investor. And it is great to have a policeman in the background of a strong regulator. But the best protection would be allowing the investor to protect themselves. And I have to tell you, I think Warren Buffett was right. He calls some of these complex derivatives the financial weapons of mass destruction, and he predicted this whole fallout.

These complex instruments, the CDOs, the credit default swaps, these complex derivatives, based on models are so complex, our own rating agencies couldn't figure out who owned what or how to value them. And when I asked Mr. Bernanke at our most recent hearing who was addressing this, he indicated that you were, Mr. Geithner. So I hope he wasn't throwing you under the bus. Can you tell me what we are doing to just equip the investor with the ability to make those smart determinations on their own?

Mr. GEITHNER. I wish we had the power to do that. I completely agree with you, that people who take risks should understand the risks they are taking and make sure they are not taking risks they cannot handle and absorb. That is a very hard thing to do with regulation. What you want to do is to design a system that doesn't prevent people from losing money and making mistakes because that is inevitable. What you want to do is make sure you run a system where the consequences of those mistakes are less damaging and consequential for the more prudent and for the economy as a whole. And that balance is very hard. I think, again, the fundamental objective is to try to make sure that the institutions at the center of this system are run with a set of shock absorbers against all the risks they assume, in derivatives and elsewhere, so they can

withstand pretty bad outcomes. And you want to make sure that the infrastructure is able to better deal with the consequences of default by major institutions.

Mr. LYNCH. I am talking something much more basic. I am just talking about price, putting the right price on this product, how do you do that?

Mr. GEITHNER. I think you can't do that with regulation because fundamentally that price is set by the people who are on both sides of that—

Mr. LYNCH. What about a clearinghouse or something of that nature that could vet some of these derivatives?

Mr. GEITHNER. Absolutely. So for the standardized part of the credit default market, which is very large now, there is a very broad basis support in the dealer community to move that into a central clearinghouse over the next 6, 12, 18 months. And they are likely, I believe, to move quite quickly to take the standardized piece into that structure with appropriate risk management framework so the system stays safer. That is a very valuable thing. There are other things you can do in terms of disclosure that would also help that broad outcome which we are, along with Chris Cox and a whole bunch of others, are working very hard to advance.

And I completely agree with you. Fundamentally what you want is people to better understand the risks they are taking and not take risks that are going to threaten their viability if that is going to have consequences for the system as a whole.

Mr. LYNCH. I yield back, thank you.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. Mr. Cox, during my term as Mayor of Kansas City, there was a vicious rumor put out about our police chief and what he did was—I didn't think it was possible—he put some detectives on it. And they just went from person to person to person, who told you, who told you, who told you? It eventually landed on the desk of a secretary who confessed that she was just joking. Of course she wasn't. And she was fired. And so I know it is possible to track down a rumor. And the rumors that caused the collapse of Bear Stearns is more than just some little harmless rumor about sex. It is a rumor that has done devastation to our economy.

I know that you have said that you are interested in this rumor-mongering. But does the SEC investigating unit deal with this? Or is there a financial purgatory section existing out here where we have no one that deals with that? Or do we need a rumor-mongering monitor with some teeth so that when people spread these rumors, they pay? Bear Stearns was the smallest, most vulnerable of the big five. Now Lehman Brothers is. I mean, what can you say that would cause the people who do this on Wall Street to tremble?

Mr. COX. Well, first of all, you are right, that in the circumstance that you outlined or in any market circumstance, it is possible for people to believe false information and make decisions based upon it. We have to make sure that this variant of false or misleading information, which is really what our whole honest public disclosure mission is all about, gets interdicted as early as possible. Pre-

vented if at all possible, which we can do through the public example of our ongoing enforcement examinations.

That is why this year we have been very high profile in what we have been doing in this area. As you know, we brought the first-ever case in the Agency's history this April where because of technology, we were able to do what you did in a different environment, in the market context. The individual who had manufactured very specific information about price, time and so on, board action of a prospective merger and put it in the marketplace so that he could trade on the false information was tracked down through his instant messages.

So the same technology that is spreading these rumors around the world faster than ever is also now the friend of law enforcement. We have also announced a very significant sweep examination. The former case that I talked to you about was from our division enforcement. But our Office of Compliance Inspection Examination has also now joined with FINRA, the New York Stock Exchange regulation, to do a sweep examination of broker deals and hedge fund advisors to make sure that the existing rules, because there are rules, very specific rules against spreading these kinds of rumors, are being enforced, that there are programs in place so that there has to be compliance. Because sometimes it can be someone who is just working at a desk. And the firms that employ these people have to be responsible for implementing compliance control. So we are going at it that way as well. Enforcement and examination.

Mr. CLEAVER. We don't need any new laws?

Mr. COX. I think we have a lot of laws. We also have a lot of law enforcement and regulatory attention. Best of all, we have some technology now that is helping us in an area that in the past has been very difficult. Because what you described was parsing the difference between the person who started it and then mere intermediaries who were passing it along. Passing around what you heard is not a problem. Markets thrive on information. Markets have to evaluate whether it is true or false. But the people who are deliberately putting false into information into the mix, those are the people you want to go after.

Mr. CLEAVER. Thank you, Mr. Chairman. I yield back the balance of my time.

The CHAIRMAN. The gentlewoman from California will finish.

Ms. WATERS. Thank you very much, Mr. Chairman. I came in at a time when Congressman Watt was raising some questions about protection for consumers. And my staff had talked with me about the notion of suitability in the lending and broader financial services industry. It gets down to a discussion that was, I guess, led by Harvard law professor Elizabeth Warren's notion of the financial product safety commission as analogous to the Consumer Product Safety Commission.

Have you been involved in any extended discussion or given any thought to this idea of a Consumer Product Safety Commission that would be for either—well let's start with Chairman Cox.

Mr. COX. I think the idea of taking a look at insurance products, at derivatives products, at securities, at all financial products, which presently fall within the rubric of—and the jurisdiction of a

variety of regulators has a certain appeal. It also has a certain danger, and that is, that it might be so ambitious as to fail of its own weight. Because, as you know—I was just talking with Secretary Chertoff about this because during my 4 years chairing the Homeland Security Committee and the work we have spent here in Congress trying to do something similar in the homeland security area caused me to ask the basic question, what is the line, where are you better off merging things? And where are you better off sharing with existing structures? That is an issue that Secretary Chertoff is still managing within the Department and outside of it.

I think it is vitally important to recognize the connection between the sophistication of law enforcement. President Geithner was talking about the enforcement piece and how important it is. The sophistication of that enforcement is really what makes the difference. If it weren't necessary, we would just have the NYPD or the Los Angeles Police Department go after this as a matter of routine law enforcement. But the cops on the beat really have to understand these markets. The products are very sophisticated. The trading techniques are very sophisticated. They are global markets. There is a lot of complexity here. Indeed I would go so far as to say that in all the major market disruptions and frauds that we have had, complexity has been a significant ally of the fraudsters because they kick a lot of dust up in the air, and they get away with things because people don't understand at first what they are doing.

So there is a trade-off that has to be made. I like the idea of knitting this together as much as we possibly can. The question of whether you actually try and merge functions all into one agency gets a little harder because, you know, mergers present management difficulties. There are other organic statutes that are administered that might not fit together. There are a lot of complexities there as well.

Ms. WATERS. President Geithner, I am very concerned about what we are experiencing in the subprime meltdown. What disturbs me is, there were so many products that were introduced into the market. And it appears that there was no oversight responsibility for the no doc loans. They are not sophisticated ARMs. They are just trickery ARMs. The ARMs that have the teaser rates at the beginning, that are very low and then the resets quadruple. I mean, there is nothing sophisticated about that. Rather, it is organized in such a way that it entices, it encourages, and it supports people getting into situations that they cannot control and they cannot afford. And there are those who say, well, the consumer should know better. It is their responsibility. I take a little bit different approach.

The average working man or woman who goes to work every day, who may be very well-educated, who is raising their family, who is trying to make the best use of their dollar, paying their bills, they don't know about these trickery products. Most of the Members of Congress didn't know about these products. Nobody reviewed these products and said to the initiators, I don't know. This looks a little bit difficult. I think this is going to create some problems in the market. And that is what I am talking about. I am talking about a kind of consumer protection that does not assume

that the consumer is just a little bit too dumb, a little bit too stupid to understand these sophisticated products. What do you think about this Consumer Product Safety Commission idea?

Mr. GEITHNER. I haven't looked at that specific proposal, but I want to underscore the point that the Federal Reserve Board did put out for public comment some pretty comprehensive changes to underwriting standards last week, I believe. And I think they would go some direction to meeting many of the concerns you laid out. The challenge, of course, is to make sure that they are evenly enforced. And you want to really make sure you are careful not to make sure that working family you described is unable to borrow, to meet the needs of health care or to finance education or to help create a business.

And finally getting that balance right is important. I don't think we have that balance right today. I don't think anybody can say that. And it is going to require things like what the Federal Reserve Board laid out last week as well as a broader improvement in the sophistication and quality of supervision oversight and enforcement of the full range of institutions that are engaged in making those kind of loans.

Ms. WATERS. Thank you. If I may, there is just one other question that I have. I have gotten a partial answer from some of the staff members back here. I had an opportunity to meet with minority bankers. Some of them were from the Gulf Coast area, New Orleans in particular, who had experienced considerable destruction during Hurricane Katrina. And they were complaining about not getting a lot of support, a lot of help from anybody. Of course, they brought up Bear Stearns, look at what happens when Bear Stearns gets in trouble, but nobody is there for us. I don't know a lot about the use of the Federal Reserve discount window. Is this available to these bankers?

Mr. GEITHNER. If they are banks, they have access to that window.

Ms. WATERS. How does it work?

Mr. GEITHNER. You have the ability to come and borrow from the Fed under a set of conditions. And that privilege existed before Katrina, before Bear Stearns. It exists today.

Ms. WATERS. Did any of the banks who had been impacted by Katrina take advantage of the opportunity to borrow from the discount window?

Mr. GEITHNER. I would have to consult with my colleagues in the Fed and get back with you in writing on that specific question.

Ms. WATERS. But you don't remember any discussion that you were involved with anyone?

Mr. GEITHNER. Well, I am responsible for the institutions of New York and can't speak to the others.

Ms. WATERS. Okay.

Mr. GEITHNER. What we do disclose once a week is broad use of our facilities. We never disclose individual institutions for a bunch of understandable reasons. But yes, they have access to those facilities today and have had for some time.

Ms. WATERS. Thank you very much. I think I am the only one left, so there can't be any other questions. I was not given permis-

sion, but I am going to adjourn this hearing. Such is the order. Thank you.

[Whereupon, at 12:39 p.m., the hearing was adjourned.]

A P P E N D I X

July 24, 2008

Testimony Concerning

Reform of the Financial Regulatory System

by

Christopher Cox
Chairman
U.S. Securities and Exchange Commission

before the
Committee on Financial Services
U.S. House of Representatives

July 24, 2008

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission about reform of the U.S. financial regulatory system.

Unquestionably, the financial regulatory structure that was forged in the Great Depression has served the nation well over the intervening eight decades. Even amidst the current strains on the financial sector, the U.S. capital market is larger, deeper, and more liquid than any other market in the world. In large measure due to the world-class protections that investors enjoy in the United States, more capital is raised, and more capital is efficiently allocated within our market economy, than anywhere else on earth. These are accomplishments which should be protected.

In the decades since many of the critical institutions of the financial regulatory system were chartered, the capital markets and the broader economy have undergone profound changes. The regulatory system has adapted well to some of these changes. But other changes have presented new challenges that are rightly the subject of Congressional review. Given the current regulatory system's record of accomplishment, we don't need to start from scratch. Instead we can build on what has worked, take lessons from what hasn't worked, and modernize the current system to reflect developments in the markets.

One thing that has worked exceptionally well is the regulatory concept of an agency chartered to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Each of these elements of the SEC's mission is integrally important and mutually reinforcing of the others. An important reason the SEC has been able to accomplish so much is the expertise gained in each of its complementary roles.

The agency's work to protect investors through the enforcement program has been greatly benefited by the expertise of SEC staff who specialize in the regulation and supervision of broker-dealers or investment advisers. The agency's regulatory program, including our commitment to ensuring full disclosure of public company information in the capital markets,

has been informed by the experience of the enforcement and examinations staffs. Our ability to oversee accounting and auditing standard setting has likewise been aided by our concurrent responsibilities in each of these areas.

Regulation, as well as the approach the government takes to the enforcement of law and regulation, cannot be viewed as static. Our markets are characterized by the innovations of thousands of firms and millions of market participants that keep America's capital markets at the leading edge. For this reason, securities and capital markets regulation can never stand still. With the tremendous benefits of innovation also come new problems that must be managed. Some of the new challenges can be met within the traditional regulatory system, and only require the focus of regulators. But addressing others in the best way will almost certainly require new authority from Congress.

The current market turmoil has demonstrated how interconnected markets have become. In the past, stovepipe regulation of different products could be justified on the grounds that the boundaries in the marketplace were clear enough. Today, when derivatives compete with securities and futures and insurance products are sold for their investment features, that is no longer true. As we approach the end of the first decade of the 21st century, the growing gaps and crevices in our venerable system are beginning to show.

Because the current credit market crisis began with the deterioration of mortgage origination standards, it could have been contained to banking and real estate were our markets not so interconnected. But in today's markets these problems quickly spread throughout the capital markets through securitization. And while the securitization process served at first to disperse risk, it did not eliminate it – and ultimately, the growing size of the risk combined with its dispersion created a need for greater transparency for financial institutions of all kinds. This is but one way in which the seamlessness which characterizes today's markets has confronted our regulatory system with new challenges.

One example, where the regulatory system has responded well is in the area of disclosure. In recent months the SEC's Division of Corporation Finance has asked financial institutions, including both commercial banks and investment banks, to provide additional disclosure regarding off-balance sheet arrangements and the application of fair value to financial instruments. The Division also provided suggestions to improve the transparency and content of this disclosure to investors. It encouraged disclosure about the types of events that could require consolidation of off-balance sheet arrangements, as well as the implications of consolidating if it were to occur. And it encouraged disclosures that would help an investor understand the significance of fair value measurements, including how they were determined by management and the judgments used by management. Financial institutions have improved their disclosures in subsequent public filings by taking into consideration these suggestions. A related set of issues concerns the application of accounting rules to balance sheet consolidation and fair value accounting. The Commission's Chief Accountant has asked the Financial Accounting Standards Board to revisit the underlying accounting guidance to determine whether the subprime experience points to the need for changes, and this review by the FASB is underway. Here the problems that have arisen in the credit crisis have been amenable to resolution within the current framework.

The need for greater transparency to rebuild confidence in the financial system, however, extends beyond the public reporting that is a bedrock of the U.S. capital markets. The explosive growth of the over-the-counter derivatives markets in recent years is a case in point. OTC derivatives have grown largely in the interstices of the current regulatory system. These innovative financial products have increased the efficiency of capital markets and offered new opportunities for firms to manage risk efficiently. At the same time these markets have drawn together the world's major financial institutions into a tangled web of interconnections. These interconnections are not necessarily bad for the system, but the lack of readily available information about who is exposed to whom creates a situation ripe for rumor and misinformation. While the SEC has undertaken enforcement and examination action to limit the spread of intentionally false and misleading market rumors, the ultimate solution lies not only in enforcement but in greater transparency that provides investors with better information.

One way that this can be achieved is to improve the infrastructure of the market itself. In close cooperation with the Commodity Futures Trading Commission and the Federal Reserve and building on our long experience with the regulation of securities clearance and settlement, the SEC has been working to strengthen the OTC derivatives infrastructure so that these markets are more transparent and less vulnerable to failures in confidence in the event of financial difficulties at a major financial institution. President Geithner and the New York Federal Reserve Bank have taken a special interest in this because of the importance of reducing the risks that the current system presents to bank safety and soundness.

Another way in which changes in the marketplace have challenged existing regulatory norms is the supervision of investment banks.

When this Committee, and eventually the entire Congress and the President, devised the Gramm-Leach-Bliley Act in 1999, you – or rather we, since I was a member of the Commerce Committee which then had jurisdiction over securities and the Conference Committee at the time – decided that the SEC would serve as a functional regulator with responsibility over broker-dealers, investment advisers, and mutual funds. And we decided that the federal banking regulators similarly would be functional regulators for banking activities. Under this approach, the securities-related activities would be pushed out of banks and savings associations, and into broker-dealers and investment advisers where the SEC could examine them. This was a valiant attempt to reconcile the traditional model of regulation with the increasing interconnectedness of the securities and banking industries.

After considering the very different aims and methods of banking regulators and securities regulators, Congress decided that the SEC would continue to be responsible for regulating broker-dealers that are the central entities in investment banks. The Federal Reserve Board was given consolidated oversight of holding companies that contain both broker-dealers and most types of insured depository institutions, while the SEC retained among other things the authority to regulate the net capital of those broker-dealers. But no explicit arrangement for regularly sharing information between the SEC and the Federal Reserve Board was established that took into account the desirability of viewing capital and liquidity on an entity-wide basis. Likewise, neither the Commission nor the Federal Reserve Board was authorized to exercise mandatory consolidated supervision over investment bank holding companies.

Therefore, there is simply no provision in the law that requires investment bank holding companies to compute capital measures and maintain liquidity on a consolidated basis. Nor do the statutes explicitly provide for a consolidated supervisor that is knowledgeable in their core securities business, and that would be recognized for this purpose by international regulators.

In 2004, the Commission adopted two regimes to fill this statutory gap. One provided group-wide supervision of holding companies that include broker-dealers based on the specific statutory authority in the Gramm-Leach-Bliley Act concerning voluntary consolidated supervision of investment bank holding companies. The other provided for voluntary consolidated supervision based on an exemptive authority. Both regimes imposed similar requirements on the holding companies of broker-dealers.

Only one investment banking group, Lazard, currently participates in the first regime based on the specific Gramm-Leach-Bliley Act provisions granting the Commission limited authority over holding companies that voluntarily submit to consolidated supervision. (This is because the four largest investment bank holding companies in the United States are ineligible by virtue of their specialized bank affiliates, such as industrial loan companies or certain savings banks.) The second regime, our Consolidated Supervised Entities program, is based on the Commission's long-standing and comprehensive authority regarding the financial responsibility of broker-dealers. Today, Goldman Sachs, Lehman Brothers, Morgan Stanley, and Merrill Lynch participate in this voluntary program.

The programs' objectives are clearly important in light of recent market developments. It is important to keep in mind, moreover, that all of the other parts of the SEC's regulatory program for investment banks' broker-dealers, including all of our sales practice rules, remain in effect as well. This mutually reinforcing aspect is of vital importance, for example, in reviewing the adequacy of internal controls and their implementation, and in monitoring firms for financial and operational weaknesses, where taking into account the unique business of the firm is highly relevant.

An important component of the CSE program is the regular interaction of Commission staff with senior managers in the firm's own control functions, including risk management, treasury, financial controllers, and the internal auditor, as well as onsite testing to determine whether the firms are implementing robustly their documented controls. These interactions with the investment banks are informed by and build upon the Commission's experience regulating their broker-dealers and their securities business for three-quarters of a century.

Immediately after the events of mid-March, when the run-on-the-bank phenomenon to which Bear Stearns was exposed demonstrated the importance of incorporating loss of short-term secured funding into regulatory stress scenarios, the CSE program revised the analysis of liquidity risk management, with enhanced focus on the use and resilience of secured funding. The SEC has also worked closely with the Federal Reserve in directing this additional stress testing. This testing incorporates new scenarios involving severe dislocations. The SEC and the Federal Reserve have conveyed revised supervisory expectations with respect to liquidity for CSE firms as a result of these stress tests. Additionally, the SEC has directed firms to strengthen their balance sheets, in part by shedding or marking down illiquid assets, a deleveraging process that continues.

Moreover, the SEC is closely scrutinizing the secured funding activities of each CSE firm, to encourage the establishment of additional term funding arrangements and a reduced dependence on "open" transactions, which must be renewed as often as daily. We are also focusing on the so-called matched book, a significant locus of secured funding activities within investment banks, to ensure that the firms are guarding against potential mismatches between the "asset side," where positions are financed for customers, and the "liability side," where positions are financed by other financial institutions and investors. We are obtaining expanded funding and liquidity information for all CSEs on a continual basis, and monitoring the amount of excess secured funding capacity for less-liquid positions available to each firm. The additional stress scenarios that we have developed with the Federal Reserve are being layered on top of the existing scenarios as a basis for sizing liquidity pool requirements. Also, we have discussed with senior management of each CSE firm their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets.

While maintaining broad consistency with Federal Reserve bank holding company oversight, the CSE program is tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE regime reflects the reliance of securities firms on the daily marking-to-market of positions as a critical risk and governance control. (Because of applicable accounting standards commercial banks are not required to mark-to-market in many cases.) Second, the design of the CSE regime reflects the critical importance of maintaining adequate liquidity for holding companies that rely on ongoing credit market funding. This reflects a fundamental difference between commercial banks with insured deposits, which have access to Fed liquidity, and investment banks, which except for the current emergency provision of external liquidity do not. Our latest stress scenarios are based on the assumption of no external liquidity provider.

While the CSE program itself is perhaps the most obvious way in which the SEC has adapted regulation to changes in the marketplace, information sharing among regulators is another important area in which this has occurred.

The importance of good information flow among regulators, especially during periods of market stress, is essential if the government is to meet its responsibilities to investors and the marketplace. To this end, the SEC has recently executed memoranda of understanding with the Commodity Futures Trading Commission and the Federal Reserve Board, and we are exploring similar undertakings with the Department of Labor and other agencies.

The MOU with the Federal Reserve is relevant to the regulation of investment banks because it includes, in addition to pledges of cooperation on anti-money laundering, bank brokerage activities, and clearance and settlement in the banking and securities industries, information sharing and cooperation in each agency's execution of its responsibilities for the regulation of bank holding companies and the CSEs that own securities firms. The MOU will improve the ability of the SEC to perform its role as primary supervisor of CSEs and Primary Dealers, and improve the ability of the Federal Reserve to perform its role in overseeing the stability of the financial system.

On a regular basis, and particularly in light of market developments, the SEC has also engaged broadly with both international and domestic regulators to draw the appropriate lessons

from recent market events. In particular, we participate in the Senior Supervisors Group, which published a paper highlighting risk management practices that proved particularly effective or ineffective over the last year, and are participating in the Policy Development Group of the Basel Committee on Banking Supervision that is overseeing a number of projects aimed at increasing the resiliency of financial institutions, including publication of revised liquidity guidance and capital standards.

The Commission also engages bilaterally with other financial supervisors, notably those who supervise regulated entities affiliated with CSEs. While the Commission defers to those functional regulators with respect to the legal entity, we recognize that these supervisors have an interest in and need to obtain information about the financial and operational state of the consolidated entity. We regularly share relevant information concerning the CSE holding company with such fellow regulators, both domestically and internationally.

The recent formulation of the CSE program, and the establishment of information sharing arrangements with both domestic and international regulators, have gone far to adapt the existing regulatory structure to today's exigencies. But I believe that legislative improvements are necessary as well. In particular, recent events have highlighted the need to fill the Gramm-Leach-Bliley regulatory gap by amending the existing statutory authorization for voluntary SEC supervision of investment bank holding companies to make it mandatory for all of what today are regulated as CSE firms. The Commission should be given a statutory mandate to perform this function at the holding company level, along with the authority to require compliance. In addition, legislation should prescribe explicitly how the resolution of financial difficulties at investment bank holding companies will be organized and funded.

The core business of investment banking is facilitating capital raising – whether through trading, underwriting, or ancillary services – while the core business of commercial banks is taking deposits and making loans. As a result, investment banks' assets are overwhelmingly securities and other financial instruments that must be financed (often through repurchase agreements). These assets are marked-to-market daily. In addition to deposits, commercial banks have larger portfolios of loans which, under applicable accounting standards, are treated as held at the originating institution until maturity or for investment. This means that while investment banks must mark their assets based on an exit price or market conditions, commercial banks value their loans on, for instance, the performance of the loan itself. In addition, investment banks are prohibited from financing their investment bank activities with customer funds or fully-paid securities held in a broker-dealer. Commercial banks, however, can fund their banking business with customer deposits.

It is because of these essential differences between investment banks and commercial banks that Congress has sought to insulate the government-insured deposit funding advantage that commercial banks enjoy from broader business risk. To this end, the commercial bank supervisory regime administered by the Federal Reserve and other bank regulators limits commercial banks' entry into certain lines of businesses such as merchant banking and commodities, and limits affiliations with commercial enterprises.

Nonetheless, investment banks and commercial banks compete in a number of lines of business. Many of the bright lines that previously distinguished them have blurred. For this reason, it would be exceptionally useful for regulators to have common financial reporting and

supervisory metrics for both industries. As yet, however, there is no agreed upon "apples to apples" comparison for assessing balance sheets and leverage metrics of investment banks and commercial banks.

Given these business, accounting, and regulatory differences, imposing the existing commercial bank regulatory regime on investment banks would be a mistake. It is conceivable that Congress could create a framework for investment banking that would intentionally discourage risk taking, reduce leverage, and restrict lines of business, but this would fundamentally alter the role that investment banks play in the capital formation that has fueled economic growth and innovation domestically and abroad. Such a course could be justified, if at all, only on the grounds that, like commercial banks which have long enjoyed explicit access to government-provided liquidity, investment banks' activities must be controlled in order to protect the taxpayer. This, however, makes clear that the more fundamental question is not whether investment banks should be regulated like commercial banks, but whether they should have permanent access to government-provided backstop liquidity. And if Congress were to answer that question in the affirmative, it is difficult to imagine that our markets would not produce new entities, perhaps hedge funds or other non-regulated firms, to take over the higher-risk capital markets functions of the formerly robust investment banks. That, in turn, would simply raise today's questions anew.

Rather than extend the current approach of commercial bank regulation to investment banks, I believe Congress and regulators must recognize that different regulatory structures are needed for oversight of these industries. Put simply, regulatory reform should not, and need not, amount to the elimination of the investment banking business model.

The mandatory consolidated supervision regime for investment banks should provide the SEC with several specific authorities. Broadly, these include authority, with respect to the holding company, to: set capital and liquidity standards; set recordkeeping and reporting standards; set risk management and internal control standards; apply progressively more significant restrictions on operations if capital or liquidity adequacy falls, including requiring divestiture of lines of business; conduct examinations and generally enforce the rules; and share information with other regulators. Any future legislation should also establish a process for handling extraordinary problems, whether institution-specific or connected with broader market events, to provide needed predictability and certainty.

If Congress were to deem it necessary to identify a category of complex, systemically important institutions that cannot be allowed to fail upon insolvency, it should take care to limit any changes to the bankruptcy rules to such entities. In particular, there are five aspects of the current regulatory regime that should be carefully considered.

First, the Federal Reserve based its decision to provide funding to Bear Stearns through JPMorgan Chase on Bear Stearns' extensive participation in a range of critical markets, which meant that a chaotic unwinding of its positions could have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties, including many commercial banks. This decision was made under severe time pressure, in a matter of days, without the benefit of explicit statutory guidance on the conditions for any government intervention. Were the Congress to consider addressing the potential for future action of this kind in statute, any such authority should be reserved for exceptionally rare cases and clearly targeted to achieve not only the

objective of addressing an immediate critical situation, but also the objectives of mitigating moral hazard, protecting investors, avoiding unnecessary preemptive takings of private rights and property, and maintaining a robust investment banking business model.

Second, the securities and bankruptcy laws currently provide an explicit statutory framework for liquidating a failing securities brokerage firm, and for protecting customer cash and securities. This framework generally works well, even in instances of fraud. I would not recommend changing this system. Specifically, for broker-dealers with customers the Securities Investor Protection Act of 1970 ("SIPA") replaces the process for liquidation under Title11, though these processes are similar in many respects. SIPA also established the Securities Investor Protection Corporation ("SIPC"), which administers a fund that can be used to fund the liquidation of a broker-dealer. SIPC is a nonprofit membership corporation. Its members are, with some exceptions, all broker-dealers registered with the Commission. SIPC has seven directors, five are appointed by the President subject to Senate approval, one is appointed by the Secretary of the Treasury, and one is appointed by the Federal Reserve Board. I should note that SIPA was intended primarily as a liquidation mechanism. However, it follows the Bankruptcy Code provisions that permit a trustee to operate a business for a limited period if it is in the best interest of the estate. The trustee in a SIPA liquidation is responsible for distributing customer property and liquidating the failed broker-dealer. Whenever feasible, customer accounts are quickly transferred to another operating broker-dealer to facilitate customers' orderly receipt of cash and securities and continuing access to brokerage services. If customer securities or cash are missing, the trustee can use advances from the SIPC fund to pay up to $500,000, per customer ($100,000 for cash claims) to replace missing securities or cash. The SIPC fund currently stands at approximately $1.5 billion and maintains $1 billion in revolving credit lines with a consortium of banks. The SEC may also borrow up to $1 billion from the Treasury on behalf of SIPC.

Third, for banks and thrifts, the FDIC has long served as the receiver of failed banks. In 1987, after the failure of Continental Illinois, Congress provided the FDIC with authority to charter bridge banks and expanded the FDIC's authority for open bank assistance. A bridge bank is a temporary national bank that assumes deposits and certain liabilities and preserves as much of the going concern and status quo as possible until a more permanent resolution can be achieved. Later, when Congress enacted the Federal Deposit Insurance Improvement Act ("FDICIA") in 1991, the FDIC and the other banking regulators obtained additional authority to take preemptive action to resolve a troubled bank or other federally insured depository institution. FDICIA also mandates a least-cost resolution analysis except in the case of systemically important institutions, and mandates supervisory and regulatory examination standards and new tiers of capital requirements tied to ever-increasing supervisory restrictions. FDICIA also prescribes intentionally onerous restrictions on a bank's ability to receive lender-of-last-resort credit leading up to a bank's failure.

Fourth, for resolution of systemically important banks and other insured depository institutions through other than the least cost method, FDICIA prescribes a detailed process involving super-majority approvals by the interested regulators (FDIC and the Federal Reserve) and formal approval of the Secretary of the Treasury after consultation with the President. It also requires detailed findings of serious adverse effects on economic conditions or financial stability, coupled with a finding that the proposed action or assistance would avoid or mitigate the adverse effects. Further, in the event a commercial bank must be wound down, a special assessment on

the entire industry is mandated to pay the costs of a systemic risk resolution. Once systemic risk findings are made, however, the statute contains no prescribed method for dealing with the resolution, no limits on how this may be resolved, and no guidelines on the procedures that may be followed. These provisions ensure that the appropriate parties are involved while not dictating methods that could be unduly restrictive during a significant crisis. The statute does not speak to how to handle non-bank affiliates and the parent holding company.

Fifth, bank holding companies, financial holding companies, and CSE holding companies are all Title 11 bankruptcy-eligible entities as long as the holding company is not itself a bank or registered broker-dealer. Financial contracts, such as OTC derivative instruments, receive special treatment in a Title 11 proceeding, which is similar to the treatment in commercial bank or SIPA liquidation. In particular, in the event of insolvency, counterparties may exercise self-help to terminate contracts and to seize and sell collateral related to OTC derivative contracts. When there is considerable interconnectedness among financial firms, unwinding a significant portfolio would potentially cause market disruptions and systemic issues. An additional risk always exists when a major holding company is troubled, because neither the FDIC nor SIPC can control the liquidation of the holding companies or of their unregulated affiliates that generally hold most of the derivative positions. No one today has sufficient authority to take effective action if a major financial enterprise experiences rapid financial deterioration. In the statute, the SEC should be given explicit authority to do this for all investment bank holding companies in the statute. It is exceptionally important in crafting any future framework for resolution that provisions be carefully drafted to avoid precipitating anticipatory movement of business or breaches of OTC derivatives contracts before any intervention occurs.

Mr. Chairman, I hope that these observations from the SEC will be of assistance to you as the Committee considers the broad questions of whether, and if so how, to reform the existing federal regulatory system for financial services. It is the agency's view that an expanded statutory framework for mandatory SEC supervision of investment banks should be harmonized with other aspects of the existing statutory scheme, such as SIPA, and should be based on a thorough appreciation for the unique attributes of the securities broker-dealer business. The framework that has already been established by Congress for the resolution of difficulties experienced by commercial banks under the banking laws provides useful guidance for any reform effort, but it cannot be applied to investment banks without modification. The SEC, as the supervisory authority focused on the securities business and markets, should be vested with the responsibility for implementing this modified framework, as well for closely coordinating with other relevant supervisory agencies.

Thank you again for this opportunity to discuss these important issues. I am happy to take your questions.

For release on delivery
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July 24, 2008

Statement by

Timothy F. Geithner

President and Chief Executive Officer, Federal Reserve Bank of New York

before the

Committee on Financial Services

U.S. House of Representatives

regarding

Systemic Risk and Financial Markets

July 24, 2008

Good morning, Chairman Frank, Ranking Member Bachus, and other members of the Committee. Thank you for giving me the opportunity to testify today.

I very much welcome the opportunity to appear before you with Chairman Cox of the Securities and Exchange Committee (SEC). The Federal Reserve and the SEC are working very closely together in navigating through the present challenges, and my colleagues at the Fed and I very much appreciate his, and his colleagues', support and cooperation.

The U.S. and global financial systems are going through a very challenging period of adjustment. The critical imperative today is to help facilitate that adjustment and to cushion its impact on the broader economy. The forces that made the system vulnerable to this crisis took a long time to build up, and the system will need some time to work through their aftermath.

Looking forward, the United States will have to undertake substantial reforms to the framework of policy, regulation and oversight of the financial system. There was a case for reform before this crisis. The regulatory framework in the United States was designed in a different time for a very different type of financial system than the one we have today. Nonetheless, many observers believed that this framework, although messy and complex, worked reasonably well. It is harder to make that case today.

The financial system plays a vital role in long-term economic growth by helping to efficiently allocate the resources of savers to those individuals and firms with ideas and the capacity to put those ideas into action. And the financial system plays a critical role in economic stability by affecting the capacity of the real economy to withstand shocks and the ability of macroeconomic policy to mitigate the impact of those shocks.

The challenge is in achieving the right balance between efficiency and resilience, between innovation and stability. Our financial system has many strengths, and we need to examine ways to build on those while making the system more resilient to future shocks. Achieving this balance will involve a very complicated set of policy choices. Until we get through this crisis, it will be hard to make definitive judgments about the appropriate scope and nature of the changes that will be necessary.

Any reform must offer the prospect of a substantial improvement in outcomes relative to potential costs. And those trade-offs will have to be evaluated against, among other things, the potential distortions created by differential treatment across regulated and unregulated entities, the magnitude of the tax imposed on the overall level of financial intermediation, and the extent of the safety net and the potential for moral hazard.

I would like to offer some observations, from my perspective at the Federal Reserve Bank of New York, on some of the broad considerations that should guide this process.

Changes to the Structure of the U.S. Financial System

It is useful to start with a brief review of the changes in the structure of the financial system that should motivate reform.

Our system was once organized around banks – defined narrowly as institutions that take deposits and make loans. Over time there has been a gradual but pronounced decline in the share of financial assets originated and held by banks, and a corresponding

increase in the share of financial assets held across a variety of non-bank financial institutions, funds, and complex financial structures.

The lines between banks, investment banks, and other institutions have eroded over time, as have the lines between institutions and markets. Loans made by both banks and non-banks were increasingly sold by the originating institution and packaged into securities. And these securities were repackaged into even more complex instruments and products, many of which resided off the balance sheets of the major financial institutions.

Innovations in credit derivatives over this period made it easier to trade and hedge credit risk. Access to credit was extended on a dramatic scale to less creditworthy borrowers, without a commensurate increase in the risk premiums on the securities that embedded this more risky credit. Risk accumulated in institutions that operated at the margin of the explicit safety net, such as mortgage affiliates of thrifts, structured investment vehicles, and the GSEs.

These changes within U.S. financial markets were complemented by a rise in global financial integration as technology and deregulation made it easier for savings to flow across international borders.

As a consequence of this basic evolution of our financial system, a large share of financial assets ended up in institutions and vehicles with substantial leverage, and in many cases these assets were being funded with short-term obligations. And just as banks are vulnerable to a sudden withdrawal of deposits, these non-banks and funding vehicles are vulnerable to an erosion in market liquidity when confidence deteriorates and concerns about default risk increase.

These changes in the structure of the financial system were probably not the only causes of the financial boom that preceded this crisis, but they may have amplified the dimension of the boom and they were important to how the crisis unfolded and to how policy has responded.

In many respects, financial innovation over this period outpaced the system's capacity to measure and limit risk, to manage the incentive problems in the securitization process, and to provide for an appropriate degree of transparency through meaningful disclosure. Once the performance of the underlying assets began to deteriorate, these weaknesses in the system magnified the uncertainty about the scale of potential losses and added to the intensity of pressures that accompanied the crisis.

The growth in leverage and liquidity risk outside of banks made the system vulnerable to a sharp erosion in liquidity, but without the protections established to limit the risk of classic bank runs. The large share of financial assets held in institutions without direct access to the Fed's traditional lending facilities complicated the ability of our traditional policy instruments to contain the damage to the financial system and the economy.

This crisis provides a stark illustration of how hard it is for a supervisory and regulatory framework designed principally around banks to contain the impact of financial shocks in a manner that mitigates the risks to the broader economy.

Elements of Reform

What broad principles and objectives should guide reform?

I would like to outline some of the key elements of a stronger framework of regulation and oversight, and identify some of the harder questions we will need to answer to implement this framework. These questions are more fundamental than questions of the allocation of responsibility across supervisors, market regulators, and central banks and thus must be resolved before turning to those questions. I focus here on the issues related to financial stability, and do not try to address the equally important areas of consumer and investor protection, market integrity, or the role of the government-sponsored entities in housing.

I believe the most important imperative is to build a financial system that is more robust to very bad outcomes and more resilient to shocks. This means (1) a system in which the major institutions are less vulnerable to shocks; (2) a system that is less vulnerable to margin spirals and a generalized pull-back in liquidity and funding; and (3) a system that is more able to withstand the effects of failure of a major financial institution.

Looking past the immediate crisis, a more resilient system must be built on stronger and better designed shock absorbers, both in the major institutions and in the infrastructure of the financial system.

At the level of the financial institution, the key financial shock absorbers are capital and reserves, margin and collateral, liquidity, and the risk management and control regime. Financial stability starts with ensuring that individual institutions in periods of expansion and relative stability hold adequate resources against the losses and liquidity pressures that can emerge in economic contraction or instability.

For the infrastructure of the financial system, these shock absorbers include the resources held against the risk of default by a major market participant across the set of private sector and cooperative arrangements for the funding, trading, clearing and settlement of financial transactions.

Simplifying and consolidating the regulatory architecture will be instrumental to these efforts by establishing a common framework of rules, clear responsibility and authority, and by reducing opportunities for arbitrage. Through close coordination across central banks, supervisors, and market regulators, we need to adopt an integrated approach to the design and enforcement of capital standards and other prudential regulations critical to systemic stability. In this context, prudential supervisors, working with those responsible for setting accounting standards and capital market regulations, need to systematically examine the interaction among capital, accounting, tax, and disclosure requirements to assess their effects on the overall levels of leverage and risk across the financial system.

As we change the framework of regulation and oversight, we need to find ways to strengthen market discipline over financial institutions, and to limit the moral hazard that is present in a range of different forms in any regulated financial system.

The liquidity tools of central banks and the emergency powers of other public authorities were created in recognition of the fact that individual institutions, including those central to payments and funding mechanisms, cannot protect themselves fully from an abrupt evaporation of access to liquidity or ability to liquidate assets. The existence of these tools and their use in crises, however appropriate, creates moral hazard by encouraging market participants to engage in riskier behavior than they would have in the

absence of the central bank's backstop. To mitigate this effect on risk-taking, strong supervisory authority is required over the consolidated financial entities that are critical to a well-functioning financial system.

A more resilient financial system will also require a framework for dealing with the failure of financial institutions. For entities that take deposits, we have a formal resolution framework in place. As Secretary of the Treasury Henry M. Paulson, Jr., Federal Reserve Chairman Ben S. Bernanke, and others have stated, we need a companion framework for facilitating the orderly unwinding of other types of regulated financial institutions where failure may pose risks to the stability of the financial system.

The elements I just outlined need to be accompanied by a clearer structure of responsibility and authority over the payments system. Payment and settlement systems and central counterparties play a critical role in financial stability. Our current system is overseen by a patchwork of authorities, with responsibilities diffused across several agencies in a manner that leaves significant gaps. We need a more formal and integrated framework of oversight, one that establishes and enforces standards and continuously monitors the conditions in these markets.

And finally, as we adapt the U.S. framework, we have to work to bring about a consensus among the major economies on a complementary global framework. Given the level of financial integration globally, we cannot achieve a reasonable balance at home between efficiency and stability, without a complementary framework of supervision and regulation across the other major financial centers.

To make it operational, the framework I just laid out will require a complicated set of choices.

- What level of conservatism should be built into future prudential regulations over capital and liquidity?
- Which types of institutions should be subject to these requirements?
- Can direct regulation over a limited set of institutions effectively protect the system from distress among the unregulated?
- How should responsibility for different dimensions of financial regulation be allocated, and how centralized or decentralized?
- What institutions should have access to central bank liquidity under what conditions?

The Role of the Federal Reserve

The Congress gave the Federal Reserve broad authority to address risks to financial stability. Because the financial landscape has changed so substantially, many observers have pointed out the need to revisit the scope and nature of Federal Reserve's authority. Secretary Paulson has outlined a number of important proposals for reform, many of which would broaden the responsibility and the authority of the Federal Reserve. I want to identify some issues that are critical to our current responsibilities and will be important in defining an appropriate role in the future, with the most effective mix of responsibility and authority. There is more continuity than change in these suggestions, and they assume, as is the case today, that we will have to work closely with other functional supervisors to make the system work.

First, the Fed has a very important role today, working in cooperation with bank supervisors and the SEC, in establishing the capital and other prudential safeguards that are applied on a consolidated basis to the institutions that are critical to the proper functioning of financial markets.

Second, the Fed, as the financial system's lender of last resort, should play an important role in the consolidated supervision of those institutions that have access to central bank liquidity and play a critical role in market functioning. Our ability to directly oversee the risk profile of these institutions is essential to our capacity to make the judgments necessary for using our lender of last resort tools, including critical judgments about liquidity and solvency for individual institutions and for the system as a whole. Those judgments require the knowledge that can only come from a direct, established role in supervision. And replacing our ongoing role as consolidated supervisor with stand-by, contingent authority to intervene would risk exacerbating moral hazard and adding to uncertainty about the rules of the game.

Third, the Federal Reserve should be granted explicit responsibility and clear authority over systemically important payment and settlement systems, and the ability to continue to encourage broader improvements in the over-the-counter derivatives markets.

Fourth, the Federal Reserve Board should have an important consultative role in judgments about official intervention where there is potential for systemic risk, as is currently the case for bank resolutions under FDICIA.

And, finally, the responsibilities for market and financial stability that are accorded the Fed in current and any future legislation will require that the Fed adopt a more comprehensive approach to financial supervision and market oversight. Given the

changes in the structure of the financial system, maintaining financial stability requires us to look beyond just the stability of individual banks. It requires us to look at market developments more broadly, at the infrastructure that is critical to market functioning, and at the role played by other leveraged financial institutions.

Over the past four years, the Federal Reserve has led a number of initiatives with our supervisory colleagues in the United States and in the other major financial centers to improve the OTC derivatives infrastructure, to strengthen the systemically important payment and settlement systems, to improve counterparty risk-management practices with respect to hedge funds, and to place greater emphasis on ensuring robustness to low probability, high severity instances of stress. This forward-looking, cross-institution approach, integrating prudential supervision with market oversight and payment system expertise, offers the best model of broad financial oversight focused on systemic risk

I want to emphasize in conclusion that we are working now, in close cooperation with the SEC, other U.S. bank supervisors, our international counterparts, and market participants to improve the capacity of the financial system to withstand stress. These initiatives include joint efforts with the SEC to bolster consolidated oversight of the investment banks, formalized in our recent Memorandum of Understanding. These institutions have made substantial changes over the past several months to bring down overall leverage and risk-weighted assets and to reduce liquidity risk. In addition, we have undertaken a broad based program of initiatives to build a more robust over-the-counter derivatives infrastructure through, among other measures, a central clearing house for credit default swaps; to strengthen the financial cushions held by central

counterparties against the risk of default by a participant; and to reduce vulnerabilities in secured funding markets.

These initiatives will take time, but we expect to see substantial progress over the next two quarters.

I look forward to your questions today and working with you as we move ahead in building a more effective financial regulatory framework for the United States.

Thank you.

Department of Energy
Washington, DC 20585

July 2, 2008

The Honorable Jack Kingston
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Kingston:

This is in response to your letter of May 28, 2008, which requests an estimate of what the impact on oil prices would be if an additional 1 million barrels per day of crude oil productive capacity were brought online today.

Your letter specifically asks that this estimate be based on the same methodology and set of circumstances and assumptions underlying my response to a question at a March 4, 2008, hearing of the Senate Energy and Natural Resources Committee regarding the impact on prices of adding oil to the Strategic Petroleum Reserve (SPR). At the hearing, I stated EIA staff had estimated that, holding other factors constant, an unanticipated generic fill program adding 100,000 barrels per day to the SPR over the first 10 months of 2008 could increase oil prices by about $2 per barrel over that same period.

Applying the same methodology to the hypothetical scenario of bringing 1 million barrels of crude oil productive capacity online today, prices could be expected to decline by up to $20 per barrel. This price drop reflects the significant price change needed to absorb increased supply in the short run. It should be noted that, while the immediate addition of 1 million barrels per day of unanticipated new productive capacity would significantly affect prices, an addition of this size typically involves years of planning and development activity. Also, it is assumed in the hypothetical scenario above that there would be no offsetting response in other OPEC or non-OPEC production or in other planned projects to add productive capacity and no changes in inventory levels.

I hope this information is of assistance to you. If you have further questions, please do not hesitate to contact me or your staff may contact Glen Sweetnam at 202-586-2188.

Sincerely,

Guy F. Caruso
Administrator
Energy Information Administration

Printed with soy ink on recycled paper