AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

SYSTEMIC REGULATION, PRUDENTIAL MATTERS, RESOLUTION AUTHORITY, AND SECURITIZATION

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

OCTOBER 29, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–88

SYSTEMIC REGULATION, PRUDENTIAL MATTERS, RESOLUTION AUTHORITY, AND SECURITIZATION

SYSTEMIC REGULATION, PRUDENTIAL MATTERS, RESOLUTION AUTHORITY, AND SECURITIZATION

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

OCTOBER 29, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–88

U.S. GOVERNMENT PRINTING OFFICE

55–814 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
CHARLES A. WILSON, Ohio
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
BILL FOSTER, Illinois
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
STEVE DRIEHAUS, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan
DAN MAFFEI, New York

SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas
CHRISTOPHER LEE, New York
ERIK PAULSEN, Minnesota
LEONARD LANCE, New Jersey

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

CONTENTS

	Page
Hearing held on:	
October 29, 2009	1
Appendix:	
October 29, 2009	97

WITNESSES

THURSDAY, OCTOBER 29, 2009

Bair, Hon. Sheila C., Chairman, Federal Deposit Insurance Corporation	38
Baker, Hon. Richard H., President and Chief Executive Officer, Managed Funds Association (MFA)	66
Bowman, John E., Acting Director, Office of Thrift Supervision (OTS)	42
D'Arista, Jane, Americans for Financial Reform	76
Dugan, Hon. John C., Comptroller, Office of the Comptroller of the Currency (OCC)	39
Geithner, Hon. Timothy F., Secretary, U.S. Department of the Treasury	8
Kandarian, Steven A., Executive Vice President and Chief Investment Officer, MetLife, Inc.	71
Menzies, R. Michael S., Sr., President and Chief Executive Officer, Easton Bank and Trust, Co., on behalf of the Independent Community Bankers of America (ICBA)	73
Ryan, T. Timothy, Jr., President and Chief Executive Officer, Securities Industry and Financial Markets Association (SIFMA)	79
Sullivan, Hon. Thomas R., Insurance Commissioner of the State of Connecticut, on behalf of the National Association of Insurance Commissioners (NAIC)	43
Swagel, Hon. Phillip L., Visiting Professor, McDonough School of Business, Georgetown University	67
Talbott, Scott, Senior Vice President, Government Affairs, the Financial Services Roundtable	69
Tarullo, Hon. Daniel K., Governor, Board of Governors of the Federal Reserve System	41
Trumka, Richard L., President, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)	64
Wallison, Peter J., Arthur F. Burns Fellow in Financial Policy Studies, the American Enterprise Institute	74
Yingling, Edward L., President and Chief Executive Officer, American Bankers Association (ABA)	77

APPENDIX

Prepared statements:	
Garrett, Hon. Scott	98
Bair, Hon. Sheila C.	99
Baker, Hon. Richard	117
Bowman, John E.	127
D'Arista, Jane	138
Geithner, Hon. Timothy F.	150
Kandarian, Steven A.	155
Menzies, R. Michael S., Sr.	166
Ryan, T. Timothy, Jr.	188
Sullivan, Hon. Thomas R.	219
Swagel, Hon. Phillip L.	229
Talbott, Scott	236

Page

Prepared statements—Continued
Tarullo, Hon. Daniel K. 291
Trumka, Richard L. 308
Wallison, Peter J. 312
Yingling, Edward L. 321

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Frank, Hon. Barney:
Written statement of Andrew W. Lo 335
Written statement of the Property Casualty Insurers Association of America (PCI) 346
Garrett, Hon. Scott:
Excerpt from the Congressional Record, dated October 3, 2008 371
Dear Colleague letter from Representative Brad Sherman, dated October 29, 2009 374
Paulsen, Hon. Erik:
Written statement of the Commercial Mortgage Securities Association (CMSA) 376
Letter to Chairman Barney Frank and Ranking Member Spencer Bachus from the American Land Title Association, et al., dated October 28, 2009 383
D'Arista, Jane:
Addendum to written testimony 385
Swagel, Hon. Phillip:
Additional information provided for the record in response to a question posed by Representative Watt during the hearing 386

SYSTEMIC REGULATION, PRUDENTIAL MATTERS, RESOLUTION AUTHORITY, AND SECURITIZATION

Thursday, October 29, 2009

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

The committee met, pursuant to notice, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Watt, Sherman, Meeks, Moore of Kansas, Hinojosa, Clay, McCarthy of New York, Baca, Miller of North Carolina, Scott, Green, Cleaver, Ellison, Klein, Perlmutter, Donnelly, Foster, Carson, Speier, Minnick, Adler, Driehaus, Kosmas, Himes, Peters, Maffei; Bachus, Royce, Paul, Manzullo, Biggert, Capito, Hensarling, Garrett, Neugebauer, McHenry, Putnam, Bachmann, Marchant, McCotter, Posey, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order. I apologize. I was delayed a few minutes and I regret that. We will have 10 minutes on each side for opening statements and the gentleman from Illinois is recognized for 3 minutes.

Mr. GUTIERREZ. Thank you, Mr. Chairman. First of all, I would like to thank the Secretary for coming here today; and, while I support most of the legislation, I am apprehensive about the way we propose to create a fund to pay for the costs associated with the resolution of a failed, systematically significant financial institution. It seems to me that behavior that was reckless, dangerous, and risky in the past has generated huge profits and gains and allowed Wall Street executives to line their pockets with hundreds of millions of dollars, if not become billionaires in this process; that greed, that avarice, should it ever raise its ugly head once again, there should be an insurance fund paid for them. These are good times.

We read all about how good the Wall Street giants are doing once again and how their profitability is there. They should set aside some of that money. Most of us don't die and then buy a life insurance policy. Most of us say, in case something happens to Luis, let me make sure if I owe people money and if I have responsibilities, that I leave my family and all of those to whom I have a responsibility, that I set aside some money and I buy some insurance. It would be wonderful that one day I would just wake up cold and

that all my debtors and everybody would say, oh, let's go take the life insurance policy on Luis.

That's not the way it works. The way it works, and Wall Street has to learn, because I read in the paper this morning, Mr. Secretary, they're complaining. Record profits on Wall Street, and they're complaining that the Congress of the United States might require them to set aside some of those billions of dollars in earnings so that in the eventuality that they might become systematically risky to us and fail, that there be money set aside for that.

No more American taxpayer money should be set aside in case we have the kind of tragedy and economic failure that we saw in the last couple of years. So my basic premise today is, look, they were greedy. They should pay for future insurance policy payouts. The fund should be set up just in case their behavior, their reckless and dangerous and risky behavior, raises its ugly head again. And I look forward not only today but to the process of designing legislation that makes sure that those risky institutions are paying into a fund now, today—not after the fact.

Thank you very much, Mr. Chairman.

The CHAIRMAN. The gentleman from Alabama is recognized for 5 minutes.

Mr. BACHUS. Mr. Chairman, as you know from the letter you received from the House Financial Services Committee Republicans yesterday, the process for considering the most far-reaching reforms of our financial system since the Great Depression should be deliberative and not hurried.

The draft legislation that was supposed to be the subject of this hearing was not received until Tuesday afternoon. I doubt that any of today's witnesses, with the possible exception of Secretary Geithner, have had an opportunity to fully comprehend the legislation in its entirety or to arrive at informed views on its merits. Under the rules of this committee, the witnesses' written testimony was due 2 days before this hearing, which is to say it was due before the draft bill was released.

The written testimony, therefore, cannot and does not address in any meaningful way the legislation we are marking up early next week. Although we have had the draft bill for less than 48 hours, even a cursory reading shows that the Administration has chosen to continue its failed policy of costly taxpayer bailouts orchestrated behind closed doors by officials of the Treasury and the Federal Reserve.

The Democrats' talking points that their new proposal ends the era of "too-big-to-fail" are just that—talk. Their proposal places taxpayers first in line to bear the losses when the government invokes its resolution authority; and, for those who believe that those taxpayer losses will subsequently be recouped from surviving firms, I would direct their attention to the recent examples of GM, Chrysler, Fannie Mae, Freddie Mac, and AIG, and the even more recent example of GMAC, where the prospects for full taxpayer reimbursement are fanciful.

In fact, in testimony before this committee last month, former Federal Reserve Chairman Paul Volcker warned that a resolution authority with the power to lend or provide money would encourage the "too-big-to-fail" syndrome. Although he advises the Obama

Administration, his caution has been rejected in this draft. And in an attempt to naming the institutions it deems "too-big-to-fail," the Administration's legislative proposal foregoes the transparency and full disclosure that are the hallmark of America's capital markets. In the place of an open process, it substitutes a regulatory regime built around a secret list of "too-big-to-fail" institutions.

It is foolish to assume such a list will be kept secret. Are we so gullible as to believe that the regulatory authorities for eight government agencies will be able to impose increased capital requirements and a host of other regulatory constraints on the so-called identified firms without market participants quickly figuring out which firms are on the list? Are companies expected to treat this information as immaterial for purposes of filing reports with the SEC?

Until these questions are answered, it's simply irresponsible for this committee to accept such a foundation on premise and move forward with this legislation. The Administration's desire to get something, anything done to satisfy some arbitrary deadline imposed on the chairman will result in this committee passing a product that has not received the careful deliberation necessary to ensure sound legislation.

Mr. Chairman, is it too much to ask the members of this committee and the people they represent that they have enough time to read and understand the far-reaching implications of this legislation?

In conclusion, this committee's haste also stands in marked contrast to the views expressed by Federal Reserve Vice Chairman Donald Kohn, who said: "I hope we build a regulatory structure that's good for a couple of decades and it's worth taking our time to get it right. The economy is fragile, and we learned this morning that it continues to lose jobs. We need to promote job creation and growth—not more uncertainty."

I share Vice Chairman Kohn's hope that we fulfill our obligation to do this in a deliberative manner, not the haste that we are witnessing this morning. I yield back the balance of my time.

The CHAIRMAN. The gentleman from Pennsylvania is recognized for 2 minutes.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, I understand that we are under pressure to get some things done, and unfortunately we have not had a great deal of time to spend in analyzing this proposition. I wanted to address my remarks simply to the Secretary that in his presentation can help us out.

I discern that there is a great interest in America for us to have this type of power at the Federal level to prevent future disasters of the kind we have experienced within the last year; but, I also feel that the American people are speaking to this Congress and very broadly to the world that they cannot understand how we just support the safety mechanisms for the bailout and cannot put caps or limitations on the huge conglomerations of money that we are causing by our own very bailout.

It seems to me that if Treasury was able to come up with proposals like this, they also should have the burden and at this time use this offer as a balancing act to come up with the mechanism

in place so that we can act to start limiting the unlimited power of the Goldman Sachs of the world and other huge conglomerations of money. And that may sound strange. It may sound revolutionary, but we are almost in revolutionary times. But, clearly, if Treasury and the Executive Branch have come to the conclusion that the danger to our system was so great that we have to use the Interstate Commerce Clause to create tremendous executive authority without much restraint.

I just read the chairman's letter and I think he makes some good points in his letter. If we are going to have that kind of a transfer of authority, it seems to me it is the obligation of Treasury to come forth and say how we are going to prevent this, so this never happens again in the future, by really curtailing and tailoring down the size of the institutions, particularly the financial institutions of this country so that we do not have systemic risk.

The CHAIRMAN. The gentleman's time has expired. I am going to go to a couple of members on the Republican side, because we have just a spattering of people. The gentleman from Texas, Mr. Neugebauer, for 1 minute.

Mr. NEUGEBAUER. Thank you.

I thank Secretary Geithner and Chairman Frank for their work on this new draft. While they have addressed some of the concerns raised from prior proposals, the overall concept doesn't seem to have changed much. This draft will still allow regulators to identify firms that are "too-big-to-fail," although those firms will now be kept secret. This version still keeps the government in the bailout business while a line of credit for the taxpayers will be used, and may or may not be paid back.

These two ideas for me are non-starters. Rather than an arbitrary, government-run resolution, we need a stronger bankruptcy process that holds firms and creditors to the rule of law. Rather than picking winners and losers behind closed doors, the council should require regulators to look at risks across financial entities and review capital requirements to ensure that all firms are holding the necessary capital for the risk that they are taking.

We need a reform plan that puts the taxpayers and the economies first rather than making bailouts permanent. And, like the ranking member, I think this process needs to be slowed down some, because these are probably some of the more important things that we'll do on this committee in the next few months, and we need to get it right. I yield back.

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

Mr. ROYCE. Thank you, Mr. Chairman. Apparently, the "too- big-to-fail" model is "too-hard-to-kill." I thought we would have learned our lesson from Fannie Mae and Freddie Mac. Prior to their failure, it was widely perceived that the government would be there to bail them out when they ran into trouble. That implicit guarantee translated into real advantages for the GSEs in terms of lower cost of capital which facilitated their dominance in the marketplace.

The explicit backstop already provided to the largest of our financial institutions is having an eerily similar effect. A recent study by the Center of Economic and Policy Research found that the "too-big-to-fail" doctrine has translated into a tangible subsidy for the

18 largest bank holding companies worth $34 billion per year with a 78 basis points lower cost of capital when compared to their smaller competitors. Instead of granting permanent bailout authority and institutionalized in the "too-big-to-fail" doctrine which this legislation does, we should set up a structure that will allow for an orderly liquidation of an institution through an enhanced bankruptcy without the use of government funds. I yield back.

The CHAIRMAN. The gentlewoman from Illinois, Ms. Biggert, for 1 minute.

Mrs. BIGGERT. Thank you, Mr. Chairman. My initial review of the chairman and Secretary's financial stability plan is that it would do the complete opposite: create further financial instability; and facilitate risky behavior in financial firms. And while the headlines have said that a deal has been reached, I would argue that this is no deal for the American people and especially the taxpayers.

While I support a strong council of regulators, including Federal and State regulators at the table, and I support stronger and smarter regulation, I don't think that the resolution authority under this proposal is the right answer. It is my hope that instead of supporting more proposals to increase the power of the Federal Government, the Administration will strongly consider a new chapter to the Bankruptcy Code.

In addition, it is my hope that we can also consider proposals addressing two of the biggest financial failures of our time: Fannie Mae and Freddie Mac. Never again can we allow regulators to fall asleep at the wheel or another bailout, or the government picking winners and losers of private businesses. I yield back.

The CHAIRMAN. I will yield myself 5 minutes.

We are in a difficult situation. History has apparently been somewhat rewritten. All of the bailouts that the gentleman from Alabama referred to, where we are not going to get money back, were the result of an absence of policies to deal with this set of situations; and, every one of those bailouts was of course requested by the Bush Administration, by Secretary Paulson and Chairman Bernanke.

Now, as of April 2008, Secretary Paulson said we needed to do some things to keep this from happening. It happened very quickly, and we were unable to avoid those. The question of simply allowing bankruptcy to be the way to deal with it, there's nothing theoretical about that.

That's the Lehman Brothers situation. The Lehman Brothers went bankrupt and the Bush Administration officials had two responses: first, to use Federal Reserve authority without any congressional approval, and even prior notification, to begin the process of providing funds to pay off the creditors of AIG. That was done by the Federal Reserve last September under the Bush Administration with no congressional involvement other than to be told after the fact.

Second, they came and asked us for authority to spend some money to provide some forms of cash so other institutions didn't go under. Congress agreed with some conditions, I think, and avoided worse dangers. It could have been administered better.

Our whole purpose today was to change that situation and to prevent it. Yes, it is true that we had these previous problems. That's because we didn't have a set of rules. What we do today is to begin deliberation on a proposal that does. There are two problems that were raised with regard to the bailouts: one, the use of taxpayer money; and this is a set of proposals that will prevent taxpayer money from being used.

Members say, "Oh, this requirement that it come from the financial industry, that won't work. Congress will do it instead." They have a very different Congress in mind than the one I have served in. I do not believe there is any remote chance that Congress would come to the rescue of the financial industry that this bill will have required and said substitute taxpayer money. If that's their intention, they can try.

I think they will be outvoted if they feel that's what has to happen. Secondly, there is the moral argument. There is the argument that once people know that certain institutions are of a certain size, they'll be protected. That's why many of us protected the notion that there will be a list published beforehand. What we have here is this. A group of regulators that will be monitoring institutional behavior, both cumulative institutional behavior, like subprime loans, and the behavior of a large, irresponsible institution like AIG.

There will be no notification to the public or privately that a particular institution is in that category without simultaneous restrictions on the institution. There will be no prior notification, so the institution will then be free to attract investment, because it will be shown to be so big. It will become manifested. This institution is covered. The day that the regulator says you must significantly increase your capital, you must reduce your activity. We will be adding to this. It's in here—an ability to take the kind of restrictions that existed under Glass-Steagall nationwide and impose them institution by institution.

Now, there is a threshold question. Is it possible to go forward in this situation without any funds ever being used to prevent the kind of cataclysm of failure leading to failure leading to failure that the Bush Administration felt very much we had to avoid. We, I think, minimized this in a couple of ways. First of all, the penalty for being such an institution will be very severe. There will be death panels enacted by Congress this year, I hope, but they will be for those large institutions, which will be put out of business, whose shareholders will be wiped out, whose executors will be fired, whose boards of directors will be replaced.

There will also be no guarantee in any case that the creditors are going to receive 100 cents on a dollar. Classes of creditors will be allowed to be exempted entirely from any repayment. Other creditors will have it reduced. You can't do that under bankruptcy. General bankruptcy makes it harder to have that kind of thoughtful selection. We are using the constitutional power of bankruptcy, but in a way that is more thoughtful.

Finally, I would say this: This is not the only piece. We are regulating derivatives over the objection of my Republican colleagues. I hope we will be imposing some restrictions on your ability to securitize 100 percent of the loan. We are doing other things. We

are requiring other people to register. There will be other restrictions that will keep us from getting to that situation.

And, now, I recognize the gentleman from Texas, Mr. Hensarling, for 1 minute.

Mr. HENSARLING. Thank you, Mr. Chairman.

I find it somewhat curious that we are having a hearing on systemic regulation, and nowhere do I see the Director of the FHFA, the regulator of Fannie and Freddie, the same Fannie and Freddie that were compelled to buy the lion's share of poorly underwritten loans in this Nation; the same Fannie and Freddie that have now cost the taxpayer over $1 trillion.

The Administration has now submitted to us legislation to regulate pawnshops and grocery stores, but no legislation dealing with the greatest systemic risk within the system: Fannie and Freddie. The bill we are considering today will simply institutionalize "too-big-to-fail," paving the way for more Fannies and Freddies in perpetual taxpayer bailouts. According to the Wall Street Journal, the Administration is not done with taxpayer funded bailouts, as apparently GMAC is now in for their third multi-billion-dollar bailout.

To borrow from a title of the song from the Commodores: "Once, Twice, Three Times a bailout;" enough is enough. I yield back.

The CHAIRMAN. The gentleman from New Jersey, Mr. Garrett, for 1 minute.

Mr. GARRETT. Mr. Chairman, I seek unanimous consent to enter into the record the statement by Congressman Brad Sherman regarding, "Let's Not Adopt TARP On Steroids," an appropriate analysis of exactly what this legislation stands for.

The CHAIRMAN. Without objection, it is so ordered.

Mr. GARRETT. Okay. Thank you. And secondly, I wish to enter into this record the "Congressional Record" from the day in which the TARP legislation was passed by this House of Congress and indicate in that day of the "Congressional Record" that the chairman was the manager of that legislation as it passed through a Democratic Congress, without objection.

The CHAIRMAN. Without objection, it is so ordered.

Mr. GARRETT. There you go. Thank you.

Mr. Chairman, do I begin my time now?

The CHAIRMAN. Start the minute now.

Mr. GARRETT. Thank you. Mr. Chairman, I find this legislation draft proposal, which is a continuation of bailout legislation, absolutely incredible. Over the last several months, it was my impression that there was a developing consensus that the Federal Reserve should be given less power and not more. But in reading over this discussion draft in the very limited time that we have had to review probably the most important legislation the members of this committee will ever consider in our lifetimes, I am just struck by how much power the Federal Reserve is given.

Although it is not singled out as a systemic uber-regulator in name, don't anyone be fooled. This Fed is given primary supervision over systemic firms and can override lesser regulators that don't comply with its wishes. In the name of mitigating systemic risk, the Fed is given almost unlimited authority to systemically

dismantle a private company. This is a lot more than imposing capital standards.

I for one, given the extraordinary government intervention into private firms we have already seen with the trampling of the rule of law in order to benefit some political favorites in the auto industry, for instance, I am very uncomfortable with giving this sweeping, unchecked power to the same entity that failed to effectively mitigate many of the large bank holding companies already under its purview. Thank you.

The CHAIRMAN. The Secretary of the Treasury is now recognized for his statement.

STATEMENT OF THE HONORABLE TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Thank you, Mr. Chairman. It's a pleasure to be here again.

I want to begin with a few comments on the economy. Today, we learned that our economy is growing again. In the third quarter of this year, the economy grew at an annual rate of 3.5 percent, the first time we have seen positive growth in a year, and the strongest growth in 2 years. Business and consumer confidence has improved substantially since the end of last year. House prices are rising. The value of American savings has increased substantially. Americans are now saving more and we are borrowing much less from the rest of the world.

Consumers are just starting to spend again. Businesses are starting to see orders increase. Exports are expanding. And these improvements are the direct result of the tax cuts and investments that were part of the Recovery Act and the actions we have taken to stabilize the financial system and unfreeze credit markets. But, this is just the beginning.

Unemployment remains unacceptably high. For every person out of work, for every family facing foreclosure, for every small business facing a credit crunch, the recession remains alive and acute. Growth will bring jobs, but we need to continue working together to strengthen the recovery and create the conditions where businesses will invest again and all Americans will have the confidence that they can provide for their families, send their kids to college, feel secure in retirement. And we have a responsibility as part of that to create a financial system that is more fair and more stable, one that provides protections for consumers and investors, and gives businesses access to the capital they need to grow.

That brings me to the topic at hand. This committee has made enormous progress in the past several weeks. In the face of a substantial opposition, you have acted swiftly to lay the foundation for far-reaching reforms that would better protect consumers and investors from unfair, fraudulent investment lending practices to regulate the derivatives market, to improve investor protection, to reform credit rating agencies, to improve the securitization markets, and to bring basic oversight to hedge funds and other unregulated activities. Today, you carry this momentum forward.

One of the most searing lessons of last fall is that no financial system can work if institutions and investors assume that the government will protect them from the consequences of failure. Never

again should taxpayers be put in the position of having to pay for the losses of private institutions. We need to build a system in which individual firms, no matter how large or important, can fail without risking catastrophic damage to the economy.

Last June, we outlined a comprehensive set of proposals to achieve this goal. There has been a lot of work by this committee and many others since then. The chairman has introduced new legislation to accomplish that. We believe any effective set of reforms has to have five key elements. I am going to outline those very, very quickly, but I want to say that the legislation, in our judgment, meets that test.

The first test is the government has to have the ability to resolve failing major financial institutions in an orderly manner with losses absorbed not by taxpayers, but by equity holders and by unsecured creditors. In all but the rarest cases, bankruptcy will remain the dominant tool for handling financial failure, but as the collapse of Lehman Brothers demonstrates, the Bankruptcy Code is not an effective tool for resolving the failure of complicated global financial institutions in times of severe stress.

Under the proposals we provided, which are very similar to what already exists for banks and thrifts, a failing firm will be placed into an FDIC-managed receivership so they can be unwound, dismantled, sold or liquidated in an orderly way. Stakeholders of the firm would absorb losses. Managers responsible for failure would be replaced.

A second key element of reform: any individual firm that puts itself in the position where it cannot survive without special assistance from the government must face the consequences of that failure. That's why this proposed resolution authority would be limited to facilitating the orderly demise of the failing firm, not ensuring its survival. It's not about redemption for the firm that makes mistakes. It's about unwinding them in a way that doesn't cause catastrophic damage to the economy.

Third key point: Taxpayers must not be on the hook for losses resulting from failure and subsequent resolution of a large financial firm. The government should have the authority, as it now does, when we resolve small banks and thrifts. The government should have the authority to recoup any losses by assessing a fee on other financial institutions. These assessments should be stretched out over time as necessary to avoid amplifying adding to the pressures you face in crisis.

Fourth key point, and I want to emphasize this: The emergency authorities now granted to the Federal Reserve and the FDIC, should be limited so that they are subject to appropriate checks and balances and can be only used to protect the system as a whole.

Final element: The government has to have stronger supervisory and regulatory authority over these major firms. They need to be empowered with explicit authority to force major institutions to reduce their size or restrict the scope of their activities, where that is necessary to reduce risks to the system. And this is a critically important tool we do not have at present.

Regulators must be able to impose tougher requirements, most critically, stronger capital rules, more stringent liquidity require-

ments that would reduce the probability that major financial institutions in the future would take on a scale of size and leverage that could threaten the stability of the financial system. This would provide strong incentives for firms to shrink simply to reduce leverage.

We have to close loopholes, reduce the possibilities for gaming the system, for avoiding these strong standards. So monitoring threats to stability will fall to the responsibility of this new financial services oversight council. The council would have the obligation and the authority to identify any firm whose size and leverage and complexity creates a risk to the system as a whole and needs to be subject to heightened, stronger standards, stronger constraints on leverage.

The Federal Reserve under this model would oversee individual financial firms so that there's a clear, inescapable, single point of accountability. The Fed already provides this role for major banks, bank holding companies, but it needs to provide the role for any firm that creates that potential risk to the system as a whole. The rules in place today are inadequate and they are outdated. We have all seen what happens, when in a crisis the government is left with inadequate tools to respond to data damage.

That is a searing lesson of last fall. In today's markets, capital moves at unimaginable speeds. When the system was created more than 90 years ago, and today's economy given these risks requires we bring that framework into the 21st Century. The bill before the committee does that. It's the comprehensive, coordinated answer to the moral hazard problem we are also concerned about.

What it does not do is provide a government guarantee for troubled financial firms. It does not create a fixed list of systemically important firms. It does not create permanent TARP authority; and, it does not give the government broad discretion to step in and rescue insolvent firms. We are looking forward. We are looking to make sure we provide future Administrations and future Congresses with better options than existed last year. This is still an extremely sensitive moment in the financial system.

Investors across the country and around the world are watching very carefully your deliberations, our debate, our discussions; and, I want to make sure they understand that these reforms we're proposing are about preventing the crises of the future, while we work to repair the damage still caused by the current crisis.

The American people are counting on us to get this right and to get this done. I want to compliment you again for the enormous progress you made already and I look forward to continuing to work with you to produce a strong package of reforms.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Geithner can be found on page 150 of the appendix.]

The CHAIRMAN. I want to begin and use my 5 minutes essentially to make some points. I know there will be no dearth of questions, Mr. Secretary. So while I will not be asking you any questions, I do not think you will feel ignored by the end of this morning.

First, let me address the timing issue. The ideas that we are talking about here really were first formulated for major public debate by former Treasury Secretary Paulson in April of 2008, and

they have been under serious discussion since then. Various versions have gone forward. This particular draft, reflecting a lot of conversations a lot of people have had was recently released. We won't get to mark it up until next week, and probably not until Wednesday now, because we have a couple of things to finish up from Tuesday.

The argument that we should wait, we are more open to the criticism that we haven't moved quickly enough rather than we are moving too quickly in this. There was a paralysis in the financial system, but that is happily ending. And we don't want to get behind that curve. Second, I want to address the question of Fannie Mae and Freddie Mac. I am astounded by the notion that we have to regulate them. We did.

In 2007, as chairman of this committee, I made as our first major order of business adopting the regulation of Fannie Mae and Freddie Mac that the Bush Administration wanted. We did that in the House. We did not get prompt action in the Senate, surprisingly, and when the first stimulus bill came up in January of 2008, I urged that they take our Fannie/Freddie reform, which was approved by the Bush Administration, and make it part of the bill.

They weren't able to get agreement with themselves to do it. The Senate did act on our reform in 2008—too late to stall off the crisis—but the fact is that the Fannie and Freddie that exist today are already the ones that were strictly regulated. Now, they have collapsed. They are not acting as they did before. It is important for us going forward to totally revise the functions of the secondary market and whether or not the subsidy should be a part of that.

That certainly will be on our agenda next year. But, Fannie and Freddie are not out there doing what they did before: (A) they are subject to regulation; and (B) there is a collapse. It is not a case that they are two unregulated entities working out. I think part of this debate suffers from serious cultural lag with a little partisan motivation.

Next, I want to talk about the comparison between this year and last year. In the events leading up to the collapse of last year, there was no regulation of subprime lending, a major contributing factor. We adopted legislation to control subprime lending in the House. It didn't get enacted in the Senate. The Fed is still active. We have that as part of this bill. We will not have the unrestricted, unregulated, irresponsible subprime lending that led in part to the collapse because so many of the securities that fell apart were of that sort.

We had no regulation of derivatives. AIG was engaged in wild speculation and these things all interact. You had bad subprime mortgages that shouldn't have been issued. Then you had AIG without any restriction ensuring against the default of these bad subprime mortgages. That again will be corrected by the time we go forward. We will have hedge fund registration, private equity registration, much more data collection than we had before.

We, as I said, have Fannie and Freddie playing a very different role. You had an unregulated Fannie and Freddie before this House began the process of regulating for 2007. You had unregulated subprime mortgages. You had unregulated derivatives. All those things are now incorporated, so yes, we want to avoid the "too-big-

to-fail." Part of it is that we have restrictions here that will keep these institutions: (A) from getting too big; (B) from being likely to fail; and (C) having fewer consequences when they do.

So the comparison of today to before, as I said, is serious cultural lag. We will have severely restricted the kind of irresponsible activity in derivatives in subprime lending; and another piece that I mentioned, in securitization. I myself think one of the biggest causes that happened here was that 30 years ago people who lent money to other people were the people who were expected to be paid back.

Once they were able to get rid of all of those loans, the discipline of the lender-borrower relationship diminished, so we are severely—we are going to reform securitization with some risk retention. We are restricting irresponsible subprime loans. We are regulating derivatives. There will be no unregistered, large financial enterprises going forward. We will have the ability to significantly increase capital requirements, more than proportionally, so all of those things are there.

Yes, in the absence of all of those, we had greater problems. We are talking about a regime that puts all those in a place and then in the end says, for all of that, somebody fails. We step in and we hammer them pretty hard and we protect the taxpayers.

The gentleman from Alabama.

Mr. BACHUS. Secretary Geithner, this list of companies is to be kept secret? Is that correct?

Secretary GEITHNER. Congressman, the central imperative is to make sure that institutions that could threaten the stability of the system are held to tougher constraints on leverage and risk-taking.

Mr. BACHUS. And capital and prudential—

Secretary GEITHNER. Capital and liquidity—

Mr. BACHUS. Yes—

Secretary GEITHNER. And risk-taking generally.

Mr. BACHUS. Right.

Secretary GEITHNER. That's the central lesson of this crisis, the central imperative of reform. To do that, they have to know who they are.

There should not be a fixed list. It may change over time, because the system changes over time. But the central imperative is, if you take on or could risk the stability of the system as a whole—

Mr. BACHUS. But you have to designate, it has to come on a list, or it has to be designated, if you're going to increase capital on them, or prudential regulations, or—

Secretary GEITHNER. Exactly. And in some ways—

Mr. BACHUS. So you will have a list. There will be these companies that you know of.

Secretary GEITHNER. What I state is this—and this is the system that exists today, although it didn't work as well as it needs to—right now—

Mr. BACHUS. I'm not talking about that, I'm just saying—

Secretary GEITHNER. No, but this is important. Right now, if you were a globally active bank, the capital requirements you are held to are different from and tougher than if you were a regional or community bank.

So that's the system we have today. Now those banks know who they are, they exist, and they're designated as globally active banks.

Mr. BACHUS. I understand. But for instance, the SEC, these companies have to file with the SEC. They would have to make a material disclosure as to that they were—

Secretary GEITHNER. Yes. And it won't be a secret that they're held to tougher standards. It's very important that they are held to the tougher standards, and you know that they are held to the tougher standards.

Mr. BACHUS. So it will not be a secret?

Secretary GEITHNER. No, it can't be. Because again, they have to be—the purpose of it is so that they're held to tougher standards.

Mr. BACHUS. So if it is not a secret, then people will know. I think it's a given that people can figure out quite quickly, when you raise capital restraints, require more capital, that will be disclosed.

Secretary GEITHNER. If they weren't held to higher capital requirements, we would be making a mistake. If they were held to it, but nobody knew it, it wouldn't do any good.

Mr. BACHUS. You say in this legislation that you can increase the capital requirements.

Secretary GEITHNER. Of course, exactly. And that's why I think it's designed this way, and it's very appropriate.

Mr. BACHUS. And the market and the investors or shareholders, they'll know that in fact the companies would have to disclose that—

Secretary GEITHNER. Absolutely. Again, for the capital requirements, they have to exist to be tougher.

Mr. BACHUS. Right.

Secretary GEITHNER. And the market will have to know they're held to tougher standards.

Mr. BACHUS. So the public would almost immediately realize who these companies were.

Secretary GEITHNER. True. But Congressman, I think we're missing the key point. What you don't want to do is by identifying a list of companies that are going to be held to tougher standards, create an expectation that government will step in and protect them, if they screw up.

Mr. BACHUS. Well—

Secretary GEITHNER. It's a difficult balance. That's the balance you have to strike.

Mr. BACHUS. I know that you won't release—it says that there will not be a release of the companies on a list. Okay?

But by putting new requirements on them, people will realize quite quickly, in fact those companies will have to disclose to investors and to the market, and to the SEC and other regulators that they're under those constraints.

Secretary GEITHNER. I don't think we're disagreeing, Congressman. I think, if I understand you correctly, you're in favor of making sure that these firms can be held to higher standards. This is a way of doing that. And—

Mr. BACHUS. No, and let me say this, I'm not in favor of them being held to higher standards. But if we are to hold them to higher standards, I think the market is going to have to know.

Secretary GEITHNER. But you would not impose tougher standards on the largest, most risky institutions, than apply to a community bank or a regional bank?

Mr. BACHUS. All right. Let me ask you this. I'm not, because what you then do, you say that you can loan these companies money.

Secretary GEITHNER. No. I think that's a mischaracterization of this. What this does is makes sure, if in the future, they get themselves in the position where they can't survive on their own—

Mr. BACHUS. Right—

Secretary GEITHNER. Then the only authority we would have is to manage their failure without causing the economy to go through what this economy went in this crisis. That's the basic—

Mr. BACHUS. But under 1109, even a solvent company, you can have capital injections, you can invest in those institutions, you can buy their assets.

Secretary GEITHNER. Again, Congressman, the important thing to recognize is—and it's just worth going back to what it was like last fall—without the ability for the government to step in and manage the failure of a large firm, and contain the risk of the fire spreading, we'll be consigned to repeat the experience of last fall.

It's a stark simple thing. And I know of no person who has stood in my seat—this is true for Secretary Paulson—in any central bank in any major country, who would say the country should be run with no authority to step in and act in that case.

Mr. BACHUS. Let me ask you—

Secretary GEITHNER. I don't think there's any credible—

Mr. BACHUS. Let me ask you this, Secretary—this will be my last question. You impose a tax on large and medium-sized financial institutions to—

Secretary GEITHNER. Only if, as part of protecting the system from their failure, the government is exposed to losses. In that case and only to that extent, would there be a fee assessed on the institutions to cover it.

Mr. BACHUS. But that's a tax on their competitors, is it not?

Secretary GEITHNER. But that's again—Mr. Kanjorski, can I borrow my time?

Mr. KANJORSKI. [presiding] A second, to finish.

Secretary GEITHNER. Okay.

Mr. KANJORSKI. But no further questions.

Secretary GEITHNER. Okay.

This is a very important key thing. The system Congress designed for small banks and thrifts today works in a similar way. It's different because it's part of an explicit insurance regime. But in that case, if the government has to step in—and the FDIC does this every week, step in and manage the failure of a bank—if in that case, the government assumes any risk of loss, it has to put a fee on institutions to recoup that loss over time, so the taxpayer is protected.

What we are doing is a very simple thing. We're taking that basic framework, and we're adapting it to the system we have today. We should have done that 10 years ago, but we didn't do it.

But it's a very simple thing. If the government is exposed to loss when it acts to protect the system—any risk of loss—it should assess a fee on banks over time to recoup that loss. That's to make sure the taxpayer is not in the position of absorbing those losses. That's the basic premise.

Mr. BACHUS. Of course, I think we all know that what they do now is—

Mr. KANJORSKI. The gentleman's time has expired.

Mr. BACHUS. A fee on the insured deposit is what it is—

Mr. KANJORSKI. The gentleman's—

Secretary GEITHNER. No, it goes beyond that.

Mr. KANJORSKI. Look, time has expired, and the Chair is going to ask for cooperation here.

Mr. BACHUS. Okay. Thank you.

Mr. KANJORSKI. All right.

And now the Chair is going to take its time, 10 minutes, right? No, I'm serious.

[laughter]

Mr. KANJORSKI. I am going to follow up on the questions that the ranking members asked. If I listened to what he was saying—and I that your answers were off the point, Mr. Secretary—he is asking you on what authority is this extraordinary centralization of executive authority contained?

Do you have some particular provision of the Constitution that says that this Congress has a right to transfer this amount of authority to the Executive Branch of Government?

And that should be a pertinent question that we all address. There are a lot of things in this country we would like to do, should do, or could do to protect the people. But there is a little document that they executed some 233 years ago or 223 years ago, that does not allow us to do that.

Now what is the basis for your authority?

Secretary GEITHNER. It's—you can just look at the system today, and I think there's—I'm not a lawyer, and of course our lawyers would love a chance to study this very carefully—but Congressman, right now, the Congress grants to a series of agencies created by the Congress the authority to set capital requirements on banks.

Mr. KANJORSKI. Yes.

Secretary GEITHNER. And right now, the Congress has given the Executive Branch the authority for banks and thrifts—

Mr. KANJORSKI. Mr. Secretary, I agree with that.

Secretary GEITHNER. Yes.

Mr. KANJORSKI. But that is because those institutions exercise the right of being insured under statutes that this Congress has passed.

Secretary GEITHNER. No, it's not solely because of that, because the protections that exist today that Congress has given the Executive Branch the authority or the responsibility for executing go beyond simply the explicit insurance of deposits.

Mr. KANJORSKI. Mr. Secretary, I am not a man who fears this Administration or you. But I do fear the accumulation of power exercised by someone in the future that can be extraordinary.

Now you and I know that in this last disaster, Treasury was able to determine that General Motors and the auto industry were banks, financial institutions, so they could have access to TARP.

I am not sure I agree with that. But at the time, it was certainly essential, if we were going to save those institutions.

But what we are doing is allowing a board or council, or organization to make determinations in a time of extremity—no question about that—that some of us may not agree that authority rests in those entities, or was constituted, or we even had the authority in this Congress to give that type of authority.

Secretary GEITHNER. You get to choose now what mix of authorities and limits and executive power are going to be appropriate for the future. That's the choice you're going to be debating and making.

Now, then, what we propose, though, has a very carefully designed set of checks and balances, and it does limit very substantially the authority of the Executive Branch.

But again, that's the choice you'll have to make in that case. But we're using a model that exists today, building on that model.

Mr. KANJORSKI. Okay. I am going to make the assumption you have the authority, your lawyers have said you have the authority, you have a good constitutional basis.

If you do, what is our excuse for not exercising that same type of authority to stop these "too-big-to-fail" organizations from occurring and existing? Why can you not in this legislation say, "No, this bank is just too large, it has to cut up and split up," with authority?

Why should the American people have to sit out there and see us creating mammoth organizations that nobody says we have the authority to control or limit, but we have the authority to help them when they get into trouble?

Secretary GEITHNER. I agree with you, and that's why this bill would provide authority to not just impose higher capital requirements on them, constraints and leverage; it would have the authority to limit the scope of their activities, to compel them to shrink and separate.

That is a very important thing, and I agree with you about, and I think the chairman does too.

Mr. KANJORSKI. You believe we have the authority, or you will under this bill have the authority to preemptively seize these corporations, and take them under the control of Federal authority, with no judgment, no due process, or no thought on their part?

Secretary GEITHNER. No. I think you need to separate two different things. One is about prevention, and it's what about what you do in the event of a severe crisis. On the prevention front, what this does is make it clear that regulators would have the responsibility and the authority to limit risk-taking, limit the scale and scope of activities, size if necessary, if that's necessary to protect the system.

That's a very important thing. We did not have that in this crisis for a large part of the financial system. That fixes that.

Mr. KANJORSKI. So let me understand. You are interpreting this statute to give Treasury the authority to look at an organization that is not in difficulty or extreme, but is huge; and potentially it is not determined to be monopolistic at this point, but it is huge and could have systemic risk characteristics to it that you have the right to summarily seize that organization—

Secretary GEITHNER. No, no—

Mr. KANJORSKI. Disband the assets of that organization—

Secretary GEITHNER. No, no, no, no. That—you're slightly conflating two different things. It gives the responsible regulatory authority—

Mr. KANJORSKI. There are some organizations that have no regulators. General Motors did not have a regulator until you came in and interpreted that it was a bank.

Secretary GEITHNER. That wasn't my judgment, that was my predecessor's judgment—

Mr. KANJORSKI. I understand. But then do you sustain what judgment was made there, that in fact, it was a bank and subject to Federal Government regulation?

Secretary GEITHNER. Congressman, again, I don't think that's quite the right way to think about that. Again, that was a judgment made by my predecessor under authority given to him by the Congress, under the Emergency Economic Stabilization Act.

I think he made the right judgment there, but that was his judgment, in that context.

Mr. KANJORSKI. Okay.

Secretary GEITHNER. But I don't think that's what this bill is about.

Mr. KANJORSKI. I wish we had more time, Mr. Secretary. We don't—

Secretary GEITHNER. We will—

Mr. KANJORSKI. But we certainly should engage in the future. And if I could make a recommendation that we perhaps break down into sections with this committee on both sides, so some of these questions, fundamental questions, should be answered.

Mr. Neugebauer, you are recognized for 5 minutes.

Mr. NEUGEBAUER. Yes. Thank you, Mr. Chairman.

I want to go back to a little bit of what the ranking member was talking about, Mr. Secretary, because I'm a little confused now.

On page 11, Confidentiality, "The Committee of the Congress, receiving Council's report, shall maintain the confidentiality of the identity of the companies described in accordance with paragraph A3, the information relating to dispute resolutions described in accordance with paragraph"—

Then I'll go over to page, I believe it is 17, and it says, "The Council and the Board"—which is the Fed—"may not publicly release a list of companies identified under this section."

And what they're talking about is the identification of financial companies for heightened prudential standards for financial stability purposes.

So what are those companies? The determination for those companies would be their capital structure, number one. And those would be categorized into well-capitalized, which we hope all companies are well-capitalized—but then we have undercapitalized,

significantly uncapitalized, and critically undercapitalized companies.

And the council is going to make, I guess along with their prudential regulator, make that decision of what categories they fall into.

And you're telling me that you're going to disclose that information? The bill says you can't disclose that information. And I'm a little concerned about what is the answer to the question? Yes or no?

Secretary GEITHNER. I guess we can start with a simple thing. It does make sense to the system in which community banks and regional banks are held to the same standards that are necessary to protect the system from the risk posed by large complicated financial institutions.

You need to have a different regime, tougher set of constraints applied to them, because they pose more risk—

Mr. KANJORSKI. Mr. Secretary, with the different regimes, I just want to know, are going to disclose the companies or not? And are you going to disclose the—

Secretary GEITHNER. But you have to start with this thing. They need to be subject to a different set of constraints. I have heard nobody suggest that what's appropriate for a community bank is appropriate for a major global firm. Now, if that's true—

Mr. KANJORSKI. Leave the banks out of it. Let's just talk about the large banks.

Secretary GEITHNER. If that's true, then they have to subject to higher standards, and I am sure, for the reasons many of you have said, they will be disclosing the regime they're operating under to their creditors, their equity holders. Analysts will know. And it will be clear how much capital they're holding.

And I think that's the best way to get the balance right.

Again, what you want to avoid, I think—as many of you said in the past—is you want to have the sense there's a fixed list of companies out there, that are going to benefit from special support.

We want to avoid that risk. And that's why the chairman tried to strike the balance in the draft the way it's done.

Mr. NEUGEBAUER. I want to reclaim my time, because there will have to be a list, this bill calls for a list to be determined, because that's the council's responsibility.

Secretary GEITHNER. Would you prefer it be a public list?

Mr. NEUGEBAUER. I think we have to decide, because I don't know how you can keep it secret, because these companies—if I'm a creditor or a shareholder of a company, and it's not disclosed to me that I'm investing in a company that's critically undercapitalized—does the government have some fiduciary responsibility that—

Secretary GEITHNER. I think—

Mr. NEUGEBAUER. You're withholding information from—

Secretary GEITHNER. I'm not sure we're disagreeing. I think that the company will be held to tougher standards. It will have to disclose how much capital it holds. The analysts that cover it, its creditors, its equity holders will understand that. And that's probably the right way to get the balance.

Mr. NEUGEBAUER. Where I'm headed with this is that the resolution now that is proposed under this bill basically doesn't necessarily—and we haven't in some of the resolution of these entities followed what would be the rule of law—and in the sense that certain creditors were given preferences in, for example, GM. Or they were intimidated into taking a position that they didn't necessarily want to take.

Secretary GEITHNER. Now GM was managed under the established bankruptcy procedures of the laws of the land. The Congress recognized many, many years ago that those procedures do not work for banks, because banks borrow short, they take on leverage, they cannot function effectively under that kind of regime.

Thus, a different regime, very much modeled on the Bankruptcy Code, that establishes clear priorities for creditors. But again, that system exists today for banks and thrifts.

Mr. NEUGEBAUER. Why not—

Secretary GEITHNER. Now—

Mr. NEUGEBAUER. Why not just go ahead and use the Bankruptcy Code as a Republican alternative, and set up a special—

Secretary GEITHNER. But if you—again, I don't think this is complicated.

Look what happened to Lehman, in the wake of Lehman. Bankruptcy Code was the only option available in that context. It caused catastrophic damage.

That's why in the wake of the S&L crisis—and actually well before that—Congress recognized that for banks, and they operate like banks, they need to have a special set of protections to allow for the equivalent of bankruptcy.

Mr. NEUGEBAUER. But had we had a different provision in the Bankruptcy Code for a Lehman-like or financial institution, we could have done that and made sure that—

Secretary GEITHNER. That is effectively what this does. That is effectively what this is designed to do.

Mr. KANJORSKI. The gentleman's time has expired.

And now we will recognize the gentlelady from California, Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman.

Let me ask Mr. Geithner, do you have a list of systematically significant organizations that are basically in the definition of "too-big-to-fail?" Do you have a defined list?

Secretary GEITHNER. I do not have a defined list today. But I want to come back to one thing. Right now the way the—

Ms. WATERS. Excuse me, please. I just want to know that.

Secondly, in this legislation, where you're asking for broad authority, do you have authority to bail out, to rescue—

Secretary GEITHNER. In this proposal?

Ms. WATERS. Yes.

Secretary GEITHNER. What this proposal does—

Ms. WATERS. Just, do you have the authority to spend money to bail out any of these systemically significant organizations after they get in trouble? Not just resolution authority to break them up and to assign the management of their failed assets, etc., etc. Do you have the authority to spend the taxpayers' money to bail them out if you deem that to be a good way of handling that situation?

Secretary GEITHNER. No.

Ms. WATERS. Describe what authority you have to resolve them, if you don't have bailout authority.

Secretary GEITHNER. What you have is the authority to wind them down, to separate the bad from the good. To sell the good businesses, to put them out of existence in a way that doesn't cause catastrophic damage to the economy.

And if in that process, the taxpayer is exposed to any losses, then we propose to recoup those losses, as we do now for banks and thrifts, by imposing a fee on banks—

Ms. WATERS. Okay. I think I have the answer. You're not asking for any monetary bailout authority, as you do the resolving of any of these systemically significant institutions. That's what you're saying.

Secretary GEITHNER. We want the ability to let them fail, without the taxpayer being exposed to losses.

Ms. WATERS. You're not asking for the authority to bail them out. Okay, I got that.

Have you suggested to any of these systemically significant organizations that they should be winding down the size of their organizations? We know that AIG, for example, started to sell off, started to wind down.

You have to some systemically significant organizations that are in trouble now. Citi is in trouble. What are you suggesting they do?

Secretary GEITHNER. I would be happy to go into detail as to what I think the Chairman of the Fed—and go through exactly the conditions that have been put on a range of institutions to make sure they emerge from this safe, and not relying on the taxpayers' money.

But I want to emphasize one very important thing. Since I came into office, we have had $70 billion of capital taken back out of the financial system, replaced with private capital. The financial system has changed very dramatically.

Those major institutions are smaller, they have less leverage today, they are beginning to run more safely. The riskier part of their business has been wound down very dramatically, and it's a very important—

Ms. WATERS. All right. I want to take back my time. But the question really is this, if you know who they are, and there is a possibility they could cause the same kind of meltdown that we have experienced in this economy, have you suggested, before they get into trouble again, that they should be downsizing, they should be selling off—

Secretary GEITHNER. Exactly, of course—

Ms. WATERS. They should be reducing their size?

Secretary GEITHNER. Of course, absolutely.

The CHAIRMAN. Will the gentlewoman yield to me for 10 seconds?

Ms. WATERS. Yes.

The CHAIRMAN. I do want to say precisely the purpose of this bill is to give them powers to do more of that than they now have. They do not have the powers in a binding way to do exactly what the gentlewoman is suggesting. And this bill would give them more powers to make those not just as suggestions, but as binding orders.

Secretary GEITHNER. Before they need money from the government.

Ms. WATERS. Let me just finish. As we take a look at what has happened in the past, with the bailout that we have supported, and we have found that these institutions that we bailed out, froze the credit, didn't make credit available, they increased interest rates, they did all of that, perhaps we had the power to put some mandates on them, some dictates on them about what they should do in exchange for getting the bailout.

For example, our small regional community banks don't have capital now. And you say to them, "You have to go out and you have to get capital, or we're going to close you down." Or FDIC or somebody says that. And we have bailed out some of these big banks, who are now richer. Goldman Sachs is a lot richer, because we bailed them out.

Banks lend money to each other, but they're not lending money to the small community banks and regional banks and minority banks.

What can you do, or what have you done to make that happen?

Secretary GEITHNER. Congresswoman, this is a very important issue. Small businesses are much more reliant on credit from banks, including small banks. For again, to get that credit, banks have to have the capital they need to lend. The President proposed last week two important new initiatives to make sure small banks can get that capital, as well as community development and finance institutions as well.

And I think Congress needs to work with us to help make those banks more comfortable, coming to get capital from the government. If they do that, then they'll have a better capacity to provide credit to small businesses. And we think that's a very important thing to do.

The Congress also passed in the Recovery Act some important changes to help encourage small business lending by the SBA. Lending by the SBA since those actions were taken has increased very dramatically.

But I think you're absolutely right that for many small businesses across the country, they're still not getting the credit they need to grow and expand. And we need to work with you to try to fix that problem.

The CHAIRMAN. This is obviously a very important question; let me just reinforce what the gentlewoman said. Absent the addressing of this, I think we will have a great deal of problems going forward in any broad way.

The gentleman from California, I believe, is next.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Geithner, I asked you about a provision in your White Paper earlier this year, and I would come back to that. And that's this idea of providing direct funding to an operating institution to keep it from failing.

Such authority of course, we would be markedly different from a resolution authority that would entail an orderly unwinding of a failed firm.

Some have compared this idea that's in the White Paper to the open bank assistance authority at the FDIC. It appears as though

you've maintained this idea in the discussion draft that was issued earlier this week.

And I would ask, is it your belief, should this legislation become law, that the government should have the authority to prop up an operating institution with Federal dollars, without ever unwinding it?

Secretary GEITHNER. And my answer to that is no. But let me—it's a little more complicated than that.

You need two authorities we don't have today. One is for a large institution that is courting failure and whose failure could cause catastrophic damage, you need to be able to act and unwind them with less damage to the economy, without the taxpayers being exposed to loss.

We don't have that authority today; thus the traumatic damaging experience of last fall.

You also need to make sure that you can protect solvent, liquid institutions in the rest of the system from losing their capacity to operate and fund. In classic financial panics, what happens is the weakness of one spreads to the strong.

You need to arrest that to contain panics to fix panics. And that's why in this bill there is some authority reserved for the Fed and the FDIC to contain the risk of panic spreading to healthy institutions.

We propose to limit that authority, relative to what exists today. But you need to have both those provisions for it to work.

Mr. ROYCE. But under that interpretation, the government would have the authority to prop up that operating institution with Federal dollars, without unwinding it, because of your presumption at some point that you're eventually going to be able to restabilize it.

I think—

Secretary GEITHNER. No, I wouldn't—that's not quite right. Think of a world in which you have one bank that is large and complicated and can no longer survive without government assistance. And you have the rest of the system that is still relatively strong and healthy.

What you want to do is take that one institution that managed itself to the edge of the abyss, and you want to put it out of the existence safely.

Now you can't flip a switch and do that. It's a complicated task. In Continental Illinois, it took 10 years. But you have to have the capacity to do that as quickly as you can and safely.

But you need to make sure the rest of the system does not suffer a calamitous loss of funding—

Mr. ROYCE. But there's—

Secretary GEITHNER. And you need that basic—it's like a firebreak kind of—

Mr. ROYCE. Right, I understand your argument on that. Part of the problem here are the unintended consequences. And unless we set very clear parameters on this authority, we run the risk of the market really interpreting the worst here.

Let me give you an example, and this has to do with moral hazard. It was often stated by several individuals, including members of this committee, that the government would not bail out Fannie Mae and Freddie Mac when they ran into trouble.

But because there was a level of ambiguity, the market perceived these institutions as government-backed. At times, we asserted they were not, but the market perceived that they were, which, by the way, turned out to be the case. Economists pointed this out at the time.

With respect to the chairman's comments, it's true that several members often raise the example of Fannie and Freddie. We do this not simply because the GSEs were at the center of the mortgage market meltdown—and I feel they were. When you put a mandate from Congress that one half of your portfolio has to be either Alt-A or subprime, when you manage to bully the system into a way where you have zero downpayment loans and so forth, and when it ends up being 85 percent of the losses of these institutions, I think you can see how some of us would believe that played a large role in the market turning into a bubble.

I think that many in the Fed believed it did too. And I think, going back to what happened over on the Senate side, the fact that Senate Democrats blocked the real reforms that passed the Senate Banking Committee, on a party-line vote, and I think the fact that Fannie's and Freddie's political pull prevented real reforms during the years—because I certainly saw them up here, lobbying against the reforms that would be necessary to deleverage these institutions until it was too late—I think we can see out of that how we ended up with moral hazard in the system. And creating more GSEs would compound that problem.

The CHAIRMAN. A brief response, if you wish?

Secretary GEITHNER. I believe I agree with you. You cannot allow a system to be created again where institutions exist and operate with the expectation there will be government support if they mismanage themselves to the extent they can't survive with that.

That's the central lesson of this crisis, and the central responsibility that we have to make sure that doesn't happen. And that requires us to make sure we have strong constraints on risk-taking and leverage, and we limit dramatically any expectation of government support.

The CHAIRMAN. The gentleman from Illinois.

Mr. GUTIERREZ. Thank you, Mr. Chairman.

First of all, Secretary Geithner and Chairman Frank, I think the proposal is really a step in the right direction in terms of imposing the tougher standards, in terms of the constraints, in terms of allowing us to create a system that will prevent to the extent humanly possible the kind of calamity that we have suffered already.

And to that extent, let's move forward, let's get that job done. That's the last piece that we need to get done. We have done a lot of work here, and we really need to this last piece done.

It's really not my issue here this morning or with the proposal. The main issue with the proposal is that we have this reckless and dangerous and risky behavior, which we have no evidence is going to cease to exist. So we should assume that Wall Street and those on Wall Street, the Goldman Sachs of the world, are going to continue to conduct themselves and behave as they have in the past.

And so therefore, we have these new powers and this new regime to constrain them. But we also know that they were great at getting around those constraints in the past.

We also know that, with all due respect to you, that in the past, we had one CEO of Goldman Sachs after the another in your job. How do we know the next Secretary of the Treasury won't be the former CEO of Goldman Sachs, as they have been in the past?

They seem to be interwoven. And that's what the American public sees. They see this interconnectedness in terms of their power, their influence, and always to their benefit.

So as we see American workers' dreams of retirement being delayed and postponed, and vanquished, and we see them losing their homes, as we see them losing their small businesses, we see record profits over at Goldman Sachs.

And so I think we have a responsibility here to say, if indeed in the future, after we have used all of our power, all of our intelligence, every power that we have, to make sure that doesn't happen, that they be the ones paying for this.

So my proposal is very simple: No more TARP. No more bailouts. Let them create the fund, the systemic risk fund that will guarantee that the American taxpayer will no longer have to be involved, should they cause such a crisis ever again.

You said to us here this morning—I think we're headed in the right direction—you said to us here this morning that you would like there to be a resolution of a systemically risky financial institution, much in the same way that the FDIC deals with banks.

Good. We have an FDIC insurance corporation. They pay into the fund. Let's create the fund, just like the FDIC, so that when you need to resolve it, it stands. Your argument is, "Oh, but Luis, moral hazard. If the fund exists, they'll ask risky." I don't see banks racing to the precipice of destruction and bankruptcy because the FDIC exists. Nor do I go to an insurance company and take out a life insurance policy on myself and the next day decide, "Wow, maybe I'll just start smoking. Maybe I'll start drinking. Maybe I'll start driving my car in a crazy manner. Maybe I really don't care whether or not I live or die. I have life insurance. What the hell if I die? Everything's taken care of."

No, that's not the way it works. And if that is the way it works, then you should use your new power to say, "You will not drive, you will not smoke, you will not exist, because we will not allow that kind of behavior to incur a debt to the insurance fund."

So I think you can use your new power to make sure that they don't behave recklessly any more. And at the same time, should they escape you—because that's why we take insurance—should they escape you and there is an accident, that the American taxpayer is not once again asked to repay.

So can we work to create the fund, like the FDIC fund, and make sure that those who engage in riskier behavior are the ones who pay more into the fund, and the greater your likelihood of creating a debt to the fund that you pay into the fund? Can we talk about that?

Secretary GEITHNER. I think we generally agree. But this is a very important issue. And the difference between doing a fund in advance versus assessing a fee on banks to cover any losses in the event is a very important thing. And this is not quite like an insurance.

Deposit insurance is explicit insurance. Explicit contract for insurance. In that case, it makes a lot of sense to establish a preexisting fund to help give depositors confidence there will be money there to protect their deposits.

We don't want to provide explicit insurance for creditors. If you create a fund in advance, there is a risk you're going to create more moral hazard. People will live the expectation, where the government will come in and protect them.

We don't want to create that expectation. That's why we think it's better to do it after the fact.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Texas?

Dr. PAUL. Mr. Secretary, more and more people today are looking critically at the Federal Reserve and wondering what's going on and of course, the people are asking more questions and they want to know exactly what role the Federal Reserve has played in our financial crisis.

In the past, the Federal Reserve was held in very high esteem; that they produced prosperity and full employment and stable prices. Today, they are viewed somewhat differently. And many economists are joining in this. Today the Congress is, by the number of 307, who are asking for more transparency of the Federal Reserve. But also, everybody agrees that we have a financial crisis and we're working very hard on regulations.

And I think, sometimes, we get misdirected in this because if indeed the source of our problem is coming from the Federal Reserve, then you're depending too much on regulations without looking at the real cause. We're treating symptoms rather than the cause. Just the idea that the Federal Reserve is the lender of last resort, contributes horrendously to moral hazard, especially when we're dealing with the reserve currency of the world. But everybody knows that, no matter what happens, the lender is going to be there to bail them out.

But, you had an interview this year and you were asked what you thought were the really, the causes of this crisis, and I was fascinated with your answer. Because, in a way, it seems like you might have agreed a little bit with what I'm saying. Because you listed as number one, you say, one, the monetary policy was too loose, too long, and that created this just huge boom in asset prices, money chasing risk, people trying to get a higher return. That was just overwhelmingly powerful. And I think that really makes my point and unless you deal with that, and the suggestion is, is that what we do is move in with more regulations and hope and pray that'll work.

But again, if this is true, that a monetary policy way too loose lasted too long, how can the solution be speeding it up? How can you say, this is the real problem, so we'll double the money supply. Interest rates were too low at 1 percent, let's make them ¼ percent. I can't reconcile this. How can you reconcile this on just common sense?

Secretary GEITHNER. Congressman, there is one part of that quote you omitted, which is, I said, monetary policy around the world was too loose, too long. But I think it's very, you're right to say that this crisis was not just about the judgment of individuals

to borrow too much or banks to lend too much. It wasn't just about failures in regulation supervision. It was partly because you had a set of policies pursued around the world that created a large credit boom, asset price boom.

And I think you're right to emphasis that getting those judgments better in the future is an important part of the solution.

Dr. PAUL. Okay. On the issue that it's worldwide and we don't have the full responsibility, there's a big issue when you are running and managing the reserve currency in the world and other countries are willing to take those dollars and use those as their asset and expand and monetize their own debt, so it's all, we're not locked in a narrow economy, it's a worldwide economy and it's our dollar policy and our spending habits and our debt that really generated this worldwide crisis. That's why it's not a national crisis; it's a worldwide crisis.

Secretary GEITHNER. And again, I'm not sure we disagree, but I would say it slightly differently, which is that a bunch of countries around the world made the choice to tie their currencies to ours and effectively adopt our monetary policy and that made monetary policy too loose in their countries.

But it also created this wave of investment and savings into U.S. financial assets, which pushed interest rates down here and pushed up asset prices here, but you're right to say, you have to look at the global mix of policies. We have responsibilities to get that right, but we can't do that on our own. And that's important to think about, not just about regulation.

Dr. PAUL. I do think we do have responsibility on our own, if we're managing the world reserve currency, we can deal with that, we can deal with our spending policies, our deficits, the pressure on the Fed to inflate, so I think if we do what's right, it will benefit the entire world.

Secretary GEITHNER. I agree with that.

Dr. PAUL. In your testimony, you also talk about a new international accord and that you're working on internationalizing regulations, which literally scares me. I think we have way too many already and they don't solve the problem.

But, in those negotiations, since this issue of a new reserve currency is being discussed in the ordinary media you hear reports. Just this morning, I read, U.N. planning a new reserve currency. In these accords, could you tell me, every time this conversation comes up, and what is being talked about, and how you relate to what the Chinese are saying, yes, they would like to see a new reserve currency, they would like to participate—

The CHAIRMAN. The gentleman's time has expired.

Dr. PAUL. And it seems like that would be some very important information for us.

Secretary GEITHNER. I would be happy to come and talk to you about that privately or in another context.

The CHAIRMAN. The gentleman's time has expired and I recognize myself for questions next. Secretary Geithner, I have started to review the draft, the discussion draft that has been introduced and just want to clarify for the record one thing, and I think I know the answer to this without you answering it, but I just want to get it in the record.

I noticed that in the council that is created, the financial services oversight council, there is not a designation of the consumer protection financial agency representative. I presume that is because no such agency currently exists, but as part of this whole reform process, if we create a consumer protection financial agency, am I correct in assuming that person, the director, would be on this council? Is that your intention?

Secretary GEITHNER. Yes.

The CHAIRMAN. Okay. I thought that was the case. It just doesn't exist yet.

Secretary GEITHNER. And you had the right explanation for why it's not explicitly named there.

The CHAIRMAN. All right. Let me kind of pose the question Mr. Gutierrez has posed in a slightly different way because one concern that has been raised by banks is the integrity of the FDIC, the insurance fund itself. I take it that resolution authority, this new resolution authority is different than what currently exists under the FDIC because there's already in place a mechanism for resolving banks that are regulated and insured under the FDIC.

It could involve the resolution of a non-bank. Is that correct?

Secretary GEITHNER. Yes. We're creating a system modeled on the existing system for banks and thrifts to make sure they could be used for a major bank holding company.

The CHAIRMAN. But it could be, theoretically, a non-bank entity that's causing systemic risk or acting out of control in some way. That's true, right?

Secretary GEITHNER. Yes, carefully constrained authority with a lot of checks and balances. That's correct.

The CHAIRMAN. So, one concern that has been raised is, what are the implications of that for the integrity of the FDIC fund, the insurance fund itself? Are we sending a message that we may be in someway endangering that because that has become an asset of the public, so, how do we clarify that? Is there a way to create an entity that, for bigger systemically risky entities or non-financial entities that may be systemically risky that makes it absolutely clear that the insurance fund itself is not going to be put at risk in any way?

Secretary GEITHNER. You're making a very important point. And the insurance fund cannot be used for this; it needs to be separate and completely protected.

The CHAIRMAN. Okay, so—

Secretary GEITHNER. The mechanism we're proposing for these large institutions would be completely separate.

The CHAIRMAN. So, how do you do that without creating some kind of separate fund that's separate from the FDIC fund, itself, or do you just say, we're going to take care of this, but there at least needs to be a guarantee in here that you're not using FDIC funds.

Secretary GEITHNER. I think that can be done very clearly and explicitly and therefore, create no risk that the fund, the existing fund, could be used for these other purposes. That would be an important to do. I would support that.

The CHAIRMAN. Where would you contemplate getting funds to do that outside the FDIC?

Secretary GEITHNER. Again, the way the FDIC framework works today, the FDIC does have the authority to go out and temporarily use resources that are not in the fund to do its job to manage the failure of banks. But, it has to recoup any losses that might produce by imposing a fee on banks in the future.

The CHAIRMAN. But, we don't want to impose that fee on banks in the future because they weren't responsible in this context, so—

Secretary GEITHNER. But again, we're really talking about what are effectively banks. They're just not small banks and thrifts. And I think the basis principle of fairness is the right one in this context, which is, if in the future, the government's exposed to any losses as it acts to protect the economy from the failure of those institutions, then I think that the taxpayer shouldn't bear the cost of that. And the cost of that should be imposed on the banks that benefitted from the action.

And what the bill proposes to do is to make sure that banks below, I believe, $10 billion is the threshold in the statute, would not be exposed to fees to cover any losses from this authority.

The CHAIRMAN. Okay. We need to keep talking about this, but my time has expired and we obviously can't do it right now.

Ms. Biggert is recognized.

Mrs. BIGGERT. Thank you, Mr. Chairman. Secretary Geithner, it seems to me that an ex post assessment proposal that you have been talking about to pay for the failure of a firm, that the government deems "too-interconnected-to-fail," could create perverse incentives. The firm that fails and their creditors don't have to pay the cost of clean up, but the survivors, those other firms, who had no control over the firm's risk taking, do. So, as a result, no individual firm, and none of the creditors, has an incentive to minimize the firm's risk-taking because the gains are internalized and yet, the losses are borne by others. More than that, knowing that the firms that act prudently will end up at a competitive disadvantage to those firms that are taking the risk, and be having to pay for the failure of those firms, undermines the incentives to manage risks.

Secretary GEITHNER. If the proposal did that, I would agree with you. But, that's not what it is designed to do. In fact, it's quite the opposite. We want to make it very clear and credible that again, if a firm manages itself to the point where it's at the edge of the abyss, can't survive without the government, then equity holders and creditors would be exposed to losses in that context. And that would happen before the taxpayer was exposed to any loss.

And if the taxpayer was exposed to any loss, then you would have to recoup that loss with a fee on the industry. And I think that, again, that's the model we have today for small banks and thrifts and it makes sense because other banks will benefit from the actions taken to protect them from the risks, that the panic spreads to them.

So, I think it's fair in that sense.

Mrs. BIGGERT. What happens, though, is that the taxpayer is the interim lender, aren't they?

Secretary GEITHNER. But again, this is taking a model that Congress designed for small banks and thrifts, and just adapting it to a system that has outgrown that framework. But that system ex-

ists today and I think it's the best way to do it. The alternative way, which is again, to create an ex-ante insurance fund that would create an expectation of explicit insurance, I think would create more moral hazard.

Mrs. BIGGERT. Wouldn't bankruptcy be faster? I think that this proposal, you have what, 60, I forget what it is, 60 months or something to settle this while bankruptcy—

Secretary GEITHNER. Bankruptcy just, again, I think Lehman makes this clear and compelling. And it's why Congress designed a bankruptcy-like system, but it's a different kind of system. We call it resolution authority for banks and thrifts because banks are different. And if they lose the capacity to fund, then they can cause enormous damage to the system as whole. So, you need a slightly different regime for banks because banks are different from regular companies.

Mrs. BIGGERT. Okay, if just, let's say, an institution the size of Citi or Bank of America failed, how many institutions would have to be assessed to cover the cost of that resolution?

Secretary GEITHNER. Again, the proposal we made is that banks above a certain size would have to pay a fee, because they would benefit indirectly and directly from the actions taken to contain the risk of panic. So, I think it's fair—

Mrs. BIGGERT. They would benefit because there's one less competitor? Is that what you're saying?

Secretary GEITHNER. No, no, no, no. Because in the absence of action to manage the failure in a way that's safer for the system, does convey some broader benefits. So, it's not like, and so again, they should bear some, now, the choices, which we don't think should—

Mrs. BIGGERT. What would be those benefits?

Secretary GEITHNER. Well again, the way financial panics work, is that viable institutions face the risk they lose their funding and therefore, have to collapse. That's what financial panic did to define the second half of the 19th Century, the first quarter of this century, help produce the Great Depression, led the Congress, this government to act in the Great Depression to set up some protections for that. What we didn't do is extend those protections to institutions that are very much like banks.

Again, the alternative approach, which we would not support, is to say, the taxpayer would be there in the front of the line absorbing the cost of that failure. That, we think, is not necessary and would be a mistake.

Mrs. BIGGERT. All right. Then, do you think that the government control and concentration of power and the increased unchecked powers to control both the consumers and businesses, as outlined in your plans, is the answer? Isn't this really a huge amount of power that's going to the Administration?

Secretary GEITHNER. Again, let's just step back. Right now, the Congress of the United States has given more than four Federal agencies and a whole number of other agencies the power to do consumer protection. They just did not do it well and we're proposing to consolidate that responsibility in one place so that it can be done better.

Now, outside of consumer and investor protection, what we're proposing to do is to make sure the government has the same tools to manage risk it now has in small banks and thrifts for institutions that now define our modern financial system and can bring the economy to the edge of collapse. That's a necessary function for governments to do because banks can pose enormous risk. If you don't constrain the risk-taking of banks, we'll be consigned to repeat the crisis we just went through.

Mrs. BIGGERT. I yield back.

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. Thank you. Mr. Secretary, you have submitted about 900 pages of proposed legislation. I strongly agree with well over 90 percent, I commend your work and that of your staff and the chairman and his staff. I hope my colleagues have gotten this "Dear Colleague" letter that I have distributed. If anybody doesn't have it, please ask me, I do have a few extra copies. And Mr. Garrett has already put it in the record.

Unfortunately, you have in here what I call "TARP on steroids." You have permanent, unlimited bail-out authority. This is the most unprecedented transfer of power to the Executive Branch to make decisions about both spending and taxes in history, all without congressional approval and in a sharp departure from our Constitutional values. And depending upon what some future executive chooses to do, it authorizes the greatest transfer of money from Treasury to Wall Street, ever.

The bill allows for the bailout of both solvent and insolvent financial institutions and Mr. Secretary, the last time you were here, I asked you to embrace a $1 trillion limit on this total bail-out power and I'm still waiting for that embrace.

Specifically, Section 1109 allows the Executive Branch to loan unlimited amounts to any solvent financial institution. When such a loan is made, the executives keep their jobs, the shareholders retain ownership of the company, and their shareholder and company value is dramatically enhanced.

Section 1604 allows for the bailout of troubled financial institutions with unlimited loans and unlimited investments in the equity of the troubled firm. Now, when the troubled institution gets bailed out, the chief beneficiaries are its creditors. This will cause creditors to lend money on favorable terms to the systemically important institutions. Because after all, if the institution fails, the creditor will probably get paid by the government.

However, the shareholders of the bailed-out institutions also stand to benefit handsomely. The taxpayer takes the enormous risk, perhaps investing in the entity or lending money to it. And if things go well, the taxpayers get their money back and the shareholders get a previously comatose and now revived giant institution that they reassume ownership of.

Now, Sections 1109 and 1604 provide a multi-step process for bailouts. The first step is that we transfer billions, perhaps over a trillion dollars to Wall Street. The second step is that the taxpayers are supposed to get their money back from a new tax imposed on large and medium-sized institutions. The proposed statute directions the Executive Branch to get our money back within 60

months and then specifies, or such longer amount of time as the Executive Branch decides. So, it could be 60 years.

I find it difficult to think how we would ever recoup from a single financial industry, particularly one in extremis, the hundreds of billions of dollars which might be necessary to repay the taxpayer from the next bailout.

Now, the Executive Branch is empowered, and look at this from a Constitutional perspective, the Executive Branch is empowered to write the new tax law. So, how much money is paid by a medium-sized financial institution in your district, whether it is $100,000 or $100 million, is totally at the whim of the Executive Branch and can go up or down by that factor, depending upon what the Executive Branch wants to do.

The law will allow those institutions that are systemically important to borrow at a lower cost. This will help the largest institutions get larger so that they become greater systemic risk. And by becoming a greater systemic risk, such an institution becomes even more bail-out eligible, further lowering its cost of funds.

Now, those institutions that are medium-sized are going to have to pay whatever tax the Executive Branch chooses to impose. However, they're not going to be able to get money at lower rates because savvy investors are not going to believe the local regional banks are going to get bailed out. So, the medium-sized institutions will fund the program, which benefits only their large competitors.

It's like being forced to pay insurance on your competitor's business while yours goes uninsured.

Now, this tax is sometimes referred to as "polluter pays," but it's hardly that. The financial institution that is the polluter, the one that took big risks and became insolvent, pays nothing. Instead the prudent financial institutions have to compete with the high fliers and then pay to bail them out in the bad times. I yield back.

The CHAIRMAN. The gentleman's time has expired. The gentlewoman from West Virginia, Ms. Capito.

Mrs. CAPITO. Thank you. Thank you, Mr. Secretary for being here today.

Secretary GEITHNER. Excuse me. Mr. Chairman, am I going to have a chance to respond to Congressman—

The CHAIRMAN. Yes, if there is no objection, we will take a minute to respond.

Secretary GEITHNER. I'll just say very briefly because—

The CHAIRMAN. Let me say to the Secretary, you will probably have many opportunities to respond.

Secretary GEITHNER. Can I just say one thing? I actually think, Congressman Sherman, we agree on much more than 90 percent. And what you were describing is something I would oppose. And it is not what we have proposed. And I share, very much, your basic concern that we not create a system that would create those risks. I would be against that. I would not support it. I would not want to have to live under it and administer it. And it's just not the proposal we're describing.

Mr. SHERMAN. If the Secretary wants to correct any of my statutory citations, I hope he does for the record. I yield back.

The CHAIRMAN. The gentlewoman from West Virginia.

Mrs. CAPITO. Thank you, Mr. Chairman. Thank you, Mr. Secretary. Quickly, I would like to ask, are you now imposing larger capital requirements on the systemically "too-big-to-fail" institutions at this moment?

Secretary GEITHNER. The current rules which are old and outdated and did not work do establish slightly different ones, but they're not conservative enough, they're not tough enough, and they weren't applied broadly enough.

Mrs. CAPITO. So, you are or you aren't? Requiring higher capital?

Secretary GEITHNER. They are somewhat different than what would apply to community and regional banks, but they're not different enough, they're not conservative enough, they're not tough enough, they're not designed well enough, they're not applied broadly enough.

Mrs. CAPITO. All right. Well then, let me go to GMAC, which announced yesterday the Treasury was looking seriously, I guess by November, to decide whether to do another infusion to them of taxpayer dollars for the third time. And they're under this regime of trying to raise more capital. Is that correct?

Secretary GEITHNER. I'm glad you raised that—

Mrs. CAPITO. How would this bill be different then, in terms of GMAC?

Secretary GEITHNER. This bill has nothing to do with GMAC.

Mrs. CAPITO. Okay, but let's put GMAC under this bill. Right now, today.

Secretary GEITHNER. It wouldn't fit, so let me explain and clarify this.

Mrs. CAPITO. But wait a minute, but I thought—

Secretary GEITHNER. But let me explain and clarify this. It's very important. My predecessor, the Secretary of the Treasury, made the judgment under the authority Congress gave him in the fall of last year, in the middle of the worst financial crisis in 3 generations, to lend money to 2 automobile industries and to 2 auto finance companies, including GMAC.

When I came in, we put the major institutions, including GMAC, through a very tough stress test forcing them to disclose what their losses might be, how much capital they would need, in the event of a worse recession. At that time, we disclosed to the market and to the world, including for GMAC, what their likely capital needs would be. And we committed in the event that they would be able to raise capital from the market, that the government would put that capital in.

Now, GMAC, at the time, there was no prospect, frankly, they were going to be able to raise that capital from the market. All the other institutions, in contrast, have been able to go out and raise that capital from the market. The only thing we're doing is making sure we follow through on that commitment and in fact, although I don't want to go into any detail here, in fact, we're likely to have to put in less capital than we expected.

Now, no government should be in the position of having to do this kind of thing again. And we want to make sure that our role in those institutions is limited, we're not in there a minute longer than necessary, we get the taxpayers' money back as quickly as possible, with interest, and that is what we are doing for the major

banks already where you've seen $70 billion in capital come out, more than $12 billion in returns to the taxpayer on those investments, and we're going to work very, very hard to unwind those positions as quickly as possible.

But, those initial judgments were not my judgments, although I support them, and we would like to make sure we get out of this as quickly as we can.

Mrs. CAPITO. The fact is, this is the third infusion of TARP funds, taxpayer dollars into GMAC. I don't know what category they would fall in and so I would say, I think that the adaptability issue that you talked about on the resolution, I would like to see an enhanced bankruptcy resolution that provides that partition from the government into the court systems. I think we can create an enhanced bankruptcy through our court system that could address these adaptability issues and the GMAC issue and other issues.

And even some of your fellow Presidents of the Federal Reserve have spoken in favor of this because, and I'll just take one quote, there's a widespread relief that public funds will soften the blow to private creditors.

And I think this is an option we need to look at as we're working this through.

My last comment, question, sort of, and clarification would be, the whole secrecy issue here. You even, in questioning the gentleman from Alabama, basically said, once everybody is required to have larger capital requirements, those will be out in the public realm.

There really is no secret in Washington, D.C., for long; they are not too easy to keep, so I think we think that there will be, in the public domain, knowledge of these institutions, and there will be, they will be in a separate class from our community bankers, our credit unions and our other financial institutions.

And I think that's problematic because I think that does bring about, whether it says it or not, brings about the "too-big-to-fail" concept that we have just seen over the last year.

Secretary GEITHNER. That's exactly what we're trying to prevent. But if you want the big banks to have different, tougher capital requirements than small banks, you want them to have different standards because they create more risk, then you have to hold them to tougher standards. And if you hold them to tougher standards, they will disclose how much capital they hold and that's a good thing, not a bad thing.

Mrs. CAPITO. No, disclosure's great. Transparency—

The CHAIRMAN. The time has expired. What I want to do is, I think we can get two more questions in. We have several votes. We're then going to have to excuse the Secretary. We'll come back to the panel of regulators. So, we can go to the gentleman from New York, the gentleman from Texas, if we hold right to the 5 minutes on the first vote. The gentleman from New York.

Mr. MEEKS. Thank you, Mr. Chairman. And thank you for the hard work you have been doing on this committee. Thank you, Mr. Secretary. Mr. Secretary, I would like you to consider, for the sake of this question, that we pass this bill. Say if had we passed this bill as currently drafted 5 years ago, and if that had been the case,

I would like to know, one, do you think that Lehman bankruptcy would have still occurred, or would it have been averted? Two, if it had occurred, could you please walk us through how it would have played out differently than it actually did, specifically how and why the system as a whole would have been better able to withstand the shock, and what would have been the consequences or the sequence of events from the moment the precarious state of the firm was identified to when the resolution plan for the firm would have been implemented and finally, how long, in your opinion, would the resolution of such firm have taken place and how much would it have cost the taxpayers?

Secretary GEITHNER. Excellent questions, complicated questions and I won't be able to do them justice this quickly, but, let me make a quick attempt. If this set of authority and constraints had been in place ahead of this crisis, then you would have not have had AIG, you would not have had the world's largest investment banks, you would not have had firms like Countrywide and a bunch of other thrifts across the country, take on a level of risk that they could not manage.

That would have been preventable. You would not have allowed a bunch of insurance companies to write a whole bunch of commitments in derivatives they did not have capital to support. That would have been enormously effective in limiting the risk, the build-up of pressures, that helped produce this crisis.

You would not have let this terrible set of practices in mortgage underwriting, separate and lending in a bunch of other areas, get to the point they did. They would have been arrested more quickly. People would have been held to a level playing field with tougher requirements to constrain risk-taking.

Now, firms will still make mistakes, even within a regime designed well like that. But if they do, then what this regime would allow for is us to take a firm, like Lehman, and have that put them out of existence, have the good businesses sold off, have them resolved, in a situation that would have caused less risk of broad panic and not put the position where you had millions of Americans, millions of investors, people who held pension funds, municipalities, counties across the country who invested money in money market funds that had funded Lehman. They would not have been exposed to that scale of losses and you would not have the extent of the panic you saw last fall, which did threaten the viability of a whole range of other institutions.

In that case, what happened is, because the authority didn't exist, the government had to come in and do much more dramatic things, that created much greater risk of moral hazard, provided much greater protections to firms that should not have been exposed to those protections. And that's the basic rationale for this framework and that's what it would have provided.

But, we will have firms in the future that make mistakes, we just don't want those mistakes to come at the expense of well-managed institutions and at the expense of the taxpayer.

Mr. MEEKS. Let me, and I want to go to the, in the short time that I have, there are two other things that I'm concerned about, of course. One of the major challenges in dealing with systemic risk going forward will also be the international coordinate and what

will be necessary to handle systemic risk posed by financial firms with a global footprint.

Could you please clarify for me how this plan before us today would manage the systemic risk posed by firms for which we are the home country, i.e., the firms that are headquartered in the United States but have major operations internationally, and for those where we are the host country from financial firms headquartered abroad but have major interests or major operations in the United States.

Secretary GEITHNER. Again, a very complicated but excellent question. Two quick responses. These constraints on capital, on funding, on leverage, on risk-taking, they have to be negotiated and applied internationally so there's a level playing field. So, you want to make sure that other major institutions that compete with U.S. institutions but are Swiss or German or are British, are held to the same standards.

Now, in the event, again, they manage themselves to the edge of failure, you make sure that in each of these major financial centers, you have the types of authorities that we're proposing to Congress establish in law today.

If you have that authority to better manage failure, then you can better manage the unwinding dismantlement of these major globally active firms. Now, we're going to have to, once we have these national authorities in place, we're going to have to do a better job of coordinating than was possible in the Lehman case, for example. But the real problem in the Lehman case was the absence of resolution authority, both here and in the U.K., frankly.

So, establishing at the national level first is probably the most important thing to do to achieve the objective that we both share.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman. Mr. Secretary, welcome. Chairman Frank and I will continue to debate the effectiveness of the GSE legislation that he brought to the Congress. What the facts are today, we have essentially 80 percent government control of Fannie and Freddie, their conforming loan limits have increased, increasing their exposure. Their market share has increased precipitously. Taxpayers, between the Treasury and the Federal Reserve now have roughly $1 trillion exposure out of a potential of $2 trillion.

Does the Administration plan to offer GSE reform legislation before year's end?

Secretary GEITHNER. No.

Mr. HENSARLING. Thank you. But if not, when?

Secretary GEITHNER. But I am looking forward to that discussion with you because you're absolutely right, that the system we have in place we cannot live with going forward and that's why we have committed—

Mr. HENSARLING. Is there a timetable for the Administration to propose GSE reform legislation?

Secretary GEITHNER. What we have said is, that we believe early in the year, we're going to outline at least our initial ideas on options for having to do that, so we need to begin that process soon. I agree with you and I look forward to it.

Mr. HENSARLING. Thank you, Mr. Secretary. I understand, I believe the Administration is endorsing the chairman's bill that we are discussing today. Did I understand that from your testimony?

Secretary GEITHNER. We worked very closely with the chairman on the bill and as I said, we think it needs the critical test of the strong package of reforms.

Mr. HENSARLING. Initially, under this bill then, taxpayers would shoulder the initial burden of "too-big-to-fail," then I believe that we hope that the institution may be resuscitated, they may be able to pay, eventually, if that doesn't happen, competitors may end up having to foot the bill.

Secretary GEITHNER. No, I wouldn't say that.

Mr. HENSARLING. This is not your understanding?

Secretary GEITHNER. Resuscitated is the wrong word, exactly the wrong word. As I said in my statement, the chairman said this, too. You don't want the government in that context to act with the objective of saving the institution to allowing it to live for another day. That would be a mistake. What you want to do is to make sure they live with the consequences of their failure and they can be unwound and sold and disassembled.

Mr. HENSARLING. I heard the chairman use the phrase "death panels" again in his opening statement, but as I have been able to read the 253 page bill, I do not believe that type of resolution is required. It certainly is permitted. I did not see where it was required. Perhaps I have missed that in the bill. That is the ultimate goal.

Secretary GEITHNER. That's our objective, and I think it's a very important objective.

Mr. HENSARLING. I agree. Let me ask you this question, Mr. Secretary. In thinking through this idea that firms that are in the marketplace will be able to either repay money or their competitors will, do you believe, what portion of the $128 billion that AIG has received, do you believe, ultimately, they will be able to pay back?

Secretary GEITHNER. We are in the process now, as required by law, to provide a comprehensive evaluation of the range of actions the government was forced to take in this crisis, both my predecessor and me, and we're going to be putting out that report in mid-December.

Mr. HENSARLING. Do you have a range now of what you expect the taxpayer to recover?

Secretary GEITHNER. I can't give you a range now, but will be able to give it to you soon.

Mr. HENSARLING. Okay. How about with respect to General Motors and the roughly $63 billion?

Secretary GEITHNER. It is in the same case.

Mr. HENSARLING. Same category?

Secretary GEITHNER. So, we're going to provide a set of independent assessments of what the range of potential losses and gains are across those programs.

Mr. HENSARLING. Mr. Secretary, we have had this discussion before about what was written into the ESSE statute. The bottom line is, that GM and Chrysler, de facto, have been considered financial institutions under the TARP statute, have received extensive government funding or were designated essentially systemic firms.

To many of us, that suggests that ultimately the number of perhaps Fortune 50, Fortune 100, companies that ultimate could receive government bail-out assistance, is not, unfortunately, a limited universe. And when I think about this regime where one's competitors pay to essentially clean up your mess, if WalMart were to become insolvent, how smart or how fair is it to impose that cost upon Target and Costco?

Secretary GEITHNER. Right now, Congressman, who bears the cost when firms screw up? What happens now is, is that companies, families, businesses, taxpayers, community banks, bear that cost. We're proposing to change that. For the simple reason, it's not fair. And what is fair, we believe, is that in the end, because banks are special and risky, if they manage themselves to the point where they're imperiling the system, then if the government—

Mr. HENSARLING. Should Ford bear the cost of compensating the taxpayer for what happened to GM and Chrysler?

Secretary GEITHNER. Look, I think you're making a good point, but you have to look at the alternatives. The alternatives to what we are proposing, which is based on the existing framework for banks and thrifts, we're under the existing framework for banks and thrifts, under the laws of the land established by Congress. What happens is, if the government has to act to close an institution and it's exposed to any loss, it imposes a fee on banks. It's just, it's very simple, it's compelling and it's better than the alternatives.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Alabama has a brief request.

Mr. BACHUS. Thank you. As a unanimous consent request, I would like to submit for the record a series of questions to Secretary Geithner on various aspects of this highly—

The CHAIRMAN. Without objection, let me say that same right will be extended to any member who wants to submit questions.

Mr. BACHUS. And to get the answers, if possible, and or implore the Treasury Department to answer some of these questions and make them available for us.

The CHAIRMAN. I would say, implicit in the request for questions would be a request for answers.

Mr. BACHUS. That's right.

The CHAIRMAN. But if there's a need to make it explicit, we will do that.

Mr. BACHUS. Thank you.

The CHAIRMAN. We are in recess.

[recess]

The CHAIRMAN. The committee will reconvene, and the next panel will take their seats. I don't know whether "panel" is a singular or collective verb, but the members of the panel will each take their seats, so each take his or her seat. And we have had all the opening statements, and we have everyone here, I guess. Yes, we have Commissioner Sullivan.

This is a panel of the Federal regulators plus a representative of the National Association of Insurance Commissioners. I just would note that throughout this process, we have stayed in close contact with the State bank supervisors and with the National Association of Insurance Commissioners, who are very much a part of this operation.

We are going to start the process now. I have to leave for a quick session. It is my plan, let me tell my friend from Kansas, who as the ranking subcommittee chairman here will be presiding, our intention would be to start with him and go down the list. That is, members who already asked questions of Secretary Geithner on our side will not ask again. So he will begin with himself, and go down the list in seniority, so that we do not have that duplication.

And with that, I am going to turn this over to the gentleman from Kansas as we begin our opening statements with the Chairman of the Federal Deposit Insurance Corporation.

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Chairman Frank, Ranking Member Bachus, Congressman Moore, and members of the committee, I appreciate the opportunity to testify today regarding proposed improvements to our financial regulatory system. The proposals being considered by the committee cover an array of critical issues affecting the banking industry and financial markets. There is an urgent need for Congress to address the root causes of the financial crisis, particularly with regard to resolution authority.

In the past week, this committee passed a bill to create a Consumer Financial Protection Agency, a standard-setting consumer watchdog that offers real protection from abusive financial products offered by both banks and non-banks. The committee is also considering other important legislation affecting derivatives and securitization markets.

However, today, I will focus on two issues that are of particular importance to the FDIC. First, a critical need exists to create a comprehensive resolution mechanism to impose discipline on large interconnected firms and end "too-big-to-fail." I truly appreciate the efforts of the committee in moving forward with legislation to address this crucial matter.

Second, changes need to be made to the existing supervisory system to plug regulatory gaps and effectively identify and address issues that pose risks to the financial system. One of the lessons of the past few years is that regulation alone is not enough to control imprudent risk-taking within our dynamic and complex financial system. So at the top of the must-do list is a need to ban bailouts and impose market discipline.

The discussion draft proposes a statutory mechanism to resolve large interconnected institutions in an orderly fashion that is similar to what we have for depository institutions. While our process can be painful for shareholders and creditors, it is necessary and it works. Unfortunately, measures taken by the government during the past year, while necessary to stabilize credit markets, have only reinforced the doctrine that some financial firms are simply "too-big-to-fail."

The discussion draft includes important powers to provide system-wide liquidity support in extraordinary circumstances, but we must move decisively to end any prospect for a bailout of failing firms. For this reason, we would suggest changes that take away the power to appoint a conservator for a troubled firm and eliminate provisions that could be interpreted to allow firm-specific sup-

port for open institutions. Ending "too-big-to-fail" and the moral hazard it brings requires meaningful restraints on all types of government assistance, whatever its source. Any support should be subject at a minimum to the safeguards existing today in the systemic risk procedures.

To protect taxpayers, working capital for this new resolution process should be pre-funded through industry assessments. We believe that a pre-funded reserve has significant advantages over an ex-post fund. All large firms, not just the survivors, would pay risk-based assessments into the fund. This approach would also avoid assessing firms in a crisis. The assessment base should encompass only activities outside insured depository institutions to avoid double counting.

The crisis has clearly revealed regulatory gaps that can encourage regulatory arbitrage. Therefore, we need a better regulatory framework that proactively identifies and addresses gaps or weaknesses before they threaten the financial system. I believe a strong oversight council should closely monitor the entire system for such problems as excessive leverage, inadequate capital, and overreliance on short-term funding. A strong oversight council should have authority to set minimum standards and require their implementation. That would provide an important check to assure that primary supervisors are fulfilling their responsibilities.

To be sure, there is much to be done if we are to prevent another financial crisis. But at a minimum, we need to establish a comprehensive resolution mechanism that will do away with "too-big-to-fail" and set up a strong oversight council and supervisory structure to keep close tabs on the entire system. The discussion draft is an important step forward in this process, and I look forward to working with you on these proposals.

Thank you.

[The prepared statement of Chairman Bair can be found on page 99 of the appendix.]

Mr. MOORE OF KANSAS. [presiding] Mr. Comptroller?

STATEMENT OF THE HONORABLE JOHN C. DUGAN, COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)

Mr. DUGAN. Mr. Moore, Mr. Bachus, and members of the committee, thank you for the opportunity to discuss the discussion draft of the Financial Stability and Improvement Act.

We support many of its key initiatives but also have significant concerns about certain provisions; and we are continuing to review the draft in detail to provide additional comments to the committee. Let me briefly comment here on four key parts of the draft. First, we believe the Financial Services Oversight Council established by the draft has appropriate roles and responsibilities. The Council would be well-positioned to monitor and address developments that threaten the financial system, identify regulatory gaps in arbitrage opportunities, and make formal recommendations to individual regulators.

The Council would also have the responsibility, which is appropriate, for identifying those financial companies and financial ac-

tivities that require heightened prudential supervision and stricter prudential standards.

Second, the discussion draft expands the role of the Federal Reserve in two fundamental ways: as consolidated supervisor and standard-setter for all systemically significant financial firms; and as the standard-setter for financial activities that pose systemic risk. We support extending the Federal Reserve's consolidated supervisor authority beyond bank holding companies to any other type of financial company that the council identifies as posing systemic risk. The lack of such authority over such non-banking companies as AIG, Bear Stearns, and Lehman Brothers was a key contributor to the financial crisis, and is imperative to eliminate this supervisory gap.

In terms of setting and implementing standards for these companies, the discussion draft is an improvement over the Administration's bill in terms of the role played by primary supervisors in the process. While the Federal Reserve would have authority to establish such standards for holding companies and their subsidiaries, the primary supervisors of regulated banks, if they disagreed with such standards, they would have the authority not to impose them if they explained in writing why they believed imposing them would be inappropriate.

As a practical matter, this will provide banking supervisors with the opportunity to provide meaningful input into the design of the standards. This is appropriate given that in many cases, primary supervisors will have more expertise with respect to the impact of particular standards on the firms they directly supervise than will the Federal Reserve.

We are very concerned, however, about the separate authority provided to the Federal Reserve to establish standards for any financial activity that the council deems to present systemic risk. There, the Board's authority is much broader in that the banking supervisor could in essence be compelled to apply the standard to the bank even if it objected in writing. As a practical matter, this would significantly diminish the banking supervisor's ability to provide that meaningful input to the standards. We believe this expansion of authority is too broad. And, more generally, we believe that there should be a meaningful consultation requirement with all primary supervisors before the Federal Reserve adopts any heightened standard for identified financial firms that meaningfully affects institutions regulated by primary supervisors.

We also have concerns about Fed authority to act on divestitures or acquisitions affecting the bank and about continuing gaps in supervision of non-bank holding company affiliates.

Third, we support the agency consolidation provisions of the discussion draft. These would transfer the bulk of the functions of the Office of Thrift Supervision to the OCC, while providing a framework in which the Federal Thrift Charter is preserved. The mechanics of the proposed transfer appear to be sensible and workable, and fair and equitable to employees of both agencies.

There are, however, important technical areas, including assessments, transfer of property and personnel, and clarification of the agency's independence where we will have additional comments.

Finally, the discussion draft includes important new measures to address the so-called "too-big-to-fail" problem. It would establish a new regime primarily administered by the FDIC to facilitate the orderly resolution of failing systemically important financial firms. As it has with failing banks, the FDIC would have the authority to operate the financial firm, enforce or repudiate its contracts, and pay its claims. It could also provide the firm with emergency assistance in the form of loans, guarantees or asset purchases but only with the concurrence of the Secretary and only after determining such assistance is necessary to preserve financial stability. And in doing so, however, there would be a strong presumption that the FDIC as receiver would remove senior management.

Even more important, shareholders, subordinated creditors, and any other provider of regulatory capital to the firm could never be protected. Instead, they would always absorb first losses in the resolution to the same extent as such stakeholders would in an ordinary bankruptcy. This mandatory exposure to first loss by shareholders and creditors is a substantial change from the Administration's original proposal. We believe it is an appropriate and effective way to maintain market discipline and address the "too-big-to-fail" problem while protecting systemic stability.

Thank you very much.

Mr. MOORE OF KANSAS. Thank you very much, Mr. Dugan.

Governor Tarullo, please.

STATEMENT OF THE HONORABLE DANIEL K. TARULLO, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the committee.

We have three panels, lots of witnesses today, so let me be brief. Systemic crises typically reveal failures across the financial system, and that has certainly been the case with the crisis that has beset our country in the last few years. There were profound failures of risk management in many private institutions. There were supervisory shortcomings at each of our financial regulatory agencies. Supervisory changes need to be and are being made. But we also need changes in legislative authority and instructions under which the regulatory agencies operate.

In this regard, the discussion draft put forward by the chairman today provides a strong framework for achieving a safer, more stable financial system. The draft contains the key elements of an effective legislative response to systemic risk and "too-big-to-fail" problems. It reflects the need for multiple tools in containing these problems: stronger regulation; more effective supervision; and improved market discipline. In particular, creation of the kind of resolution mechanism contemplated in the discussion draft will give the country a third alternative to the current, often unwelcome, options of either a bailout or disorderly bankruptcy.

As a complement to the regulatory and other changes in the legislation, it will give the government a means for letting even a very large institution fail while still safeguarding the financial system. This mechanism will move us away from a situation in which severe financial distress for large financial firms has led to a risk of

loss being borne by taxpayers in order to safeguard the system to one in which in losses are borne by shareholders, creditors, managers and, if necessary, other large financial institutions.

As always, Mr. Chairman, we would be pleased to work with the committee on any issues that arise as you move this legislation forward. Thank you very much.

[The prepared statement of Governor Tarullo can be found on page 291 of the appendix.]

Mr. MOORE OF KANSAS. Thank you, sir. Mr. Bowman, you are recognized for 5 minutes, sir.

STATEMENT OF JOHN E. BOWMAN, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION (OTS)

Mr. BOWMAN. Good afternoon, Congressman Moore, Ranking Member Bachus, and members of the committee. Thank you for the opportunity to present the views of the Office of Thrift Supervision on the Financial Stability Improvement Act of 2009.

As Acting Director of OTS, I have testified several times about various aspects of financial regulatory reform, including OTS' strong support for maintaining a thrift charter, supervising systemically important financial firms, establishing resolution authority over systemically important financial firms, establishing a strong Financial Services Oversight Council, establishing a Consumer Protection Agency with rule-making authority over all entities offering financial products, and addressing real problems that caused this financial crisis and could cause the next one.

I have also testified about OTS' opposition to consolidating bank and thrift regulatory agencies, believing that such an action would not have prevented the current crisis, and that the existence of charter choice was not a cause of the crisis.

During this time, I have told OTS employees that based on a review of the Administration's initial proposal, they could take some comfort in assurances that whatever happened, they would be protected, treated fairly, and valued equally with their counterparts at other agencies. After reviewing the draft bill, I can only conclude that this is no longer the case. We know that major changes were made to this portion of the bill recently. Instead of abolishing both OTS and the Office of the Comptroller of the Currency and establishing a new agency called the National Bank Supervisor, the bill would merge the OTS into the OCC. What we do not know is why these changes were made.

If Congress concludes that merging agencies would accomplish an important public policy goal, then we believe Congress should build a Federal bank supervisory framework for the 21st Century by establishing a strong, new agency with a name that is recognizable to consumers and accurately reflects its mission.

If this bill were to pass as currently drafted, OTS employees would be unfairly singled out and cast under a shadow. The impact of this approach would be particularly onerous for the one third of all OTS employees who are not examiners and who would not work in the OCC's proposed new Division of Thrift Supervision. Instead of having an equal opportunity to obtain a position in the reconstituted agency based on merit and on-the-job performance, they would be folded into current divisions of the OCC. I believe that

if all employees had an equal opportunity to compete for positions, then the resulting agency would be more cohesive and would benefit from the most qualified and capable workforce and leadership.

It is also critical that the bill include strong protections for all employees of the reconstituted agency, most importantly the same 5-year protection from a reduction in force that is contained in the bill to establish the Consumer Financial Protection Agency.

I am concerned that OTS employees could regard the current bill as punitive, and that such an approach would send the wrong signal, not only to the OTS workforce but to all Federal employees about how they would be treated in a similar situation. The timing of such a signal could hardly be worse when a large percentage of Federal employees are nearing retirement age and Federal agencies are redoubling their efforts to attract the workforce of the future to respond to the call of Federal service.

In conclusion, Congressman Moore and members of the committee, I strongly urge you to affirm that Congress values the service of all Federal employees and to ensure that this bill would promote a fair, even-handed approach that would result in a harmonious agency with employees hopeful about the future of their agency and their role in it.

Thank you, and I would be happy to respond to questions.

[The prepared statement of Acting Director Bowman can be found on page 127 of the appendix.]

Mr. MOORE OF KANSAS. Thank you, Mr. Bowman. The Chair next recognizes Commissioner Sullivan for 5 minutes.

STATEMENT OF THE HONORABLE THOMAS R. SULLIVAN, INSURANCE COMMISSIONER OF THE STATE OF CONNECTICUT, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

Mr. SULLIVAN. Thank you, Mr. Moore, Ranking Member Bachus, and members of the committee for the opportunity to testify at today's hearing. My name is Thomas Sullivan. I am the insurance commissioner for the State of Connecticut. I am also a member of the National Association of Insurance Commissioners, serving as Chair of its Life Insurance and Annuities Committee. Today, I represent the views of my fellow regulators on behalf of the NAIC.

With respect to the proposals being considered by Congress to prevent or manage systemic risk, we continue to stress the following principles.

First, we believe that any new system must incorporate, but not displace, the State-based system of insurance regulation. State insurance regulators are on the front lines in resolving approximately 3 million consumer inquiries and complaints each year. And that daily attention to the needs of individuals and businesses must remain a cornerstone to any effort of reform. Our national solvency system is resilient and any group capital standards should supplement, but not supplant, the requirements of the functional regulators.

Second, Federal legislation should ensure effective coordination, collaboration, and communication among all relevant State and Federal financial regulators in the U.S. financial stability regulation as it relates to insurance can only be stronger with the added

expertise of the 13,000 people who currently work in our Nation's State and territorial insurance departments. As such, State insurance regulators must have a meaningful seat at the table of the proposed Financial Services Oversight Council. In order to provide a complete view of the financial system, regulators at the State and Federal level must also have appropriate authority to share information.

Third, group supervision of complex holding companies that includes functional regulators is necessary, but preemption of State regulators, if ever necessary, should result only after State efforts have been exhausted. There is a great benefit to having multiple sets of eyes looking at an institution such as what exists today with the current State-based insurance regulatory system. Preemption and putting a single regulator in charge would take away a crucial fail-safe of allowing real and potential oversights by one regulator to be spotted and corrected by another.

Additionally, we would also stress that systemic supervision should consider the unique expectations of consumers and that different regulatory structures for different entities within a holding company. The health of a well-regulated subsidiary must not be sacrificed to preserve another unregulated subsidiary.

To reiterate, systemic resolution authority must continue to allow State regulators to protect the assets of sound insurance entities from the plundering by unsound, poorly regulated subsidiaries or the broader holding company. State receivership authority prioritizes policyholders as creditors of failed insurers, and we have extensive experience in unwinding insurers.

In conclusion, we urge caution in pursuing any proposal that could impact our ability to adequately regulate the insurance market and protect insurance consumers. And we ask that our perspective be considered by this committee in the critical days and weeks ahead.

Thank you for the opportunity to testify at today's hearing, and I would be happy to answer any questions.

[The prepared statement of Commissioner Sullivan can be found on page 219 of the appendix.]

Mr. MOORE OF KANSAS. Thank you, Commissioner Sullivan. The Chair first recognizes himself for 5 minutes of questions. Chairman Bair, I believe we must end "too-big-to-fail." I appreciate the work Chairman Frank and the Treasury Department put into improving the systemic risk and resolution authority title. Taxpayers must be fully protected and creditors, shareholders, and management must be fully accountable before taxpayers step in, in my opinion. The discussion draft takes us in that direction, but the Systemic Risk Council and resolution process must be more accountable, efficient, and transparent.

Page 17 of the discussion draft states, "The Federal Government will not publicly release a list of firms that pose systemic risk." I understand the intent for a private list is to eliminate any competitive advantage for being an identified firm but does not the marketplace already know who most of these firms are? And the firms that will be put at a competitive disadvantage will be the ones near the borderline, not the obvious ones, like Goldman Sachs, Citigroup, and Bank of America.

Additionally, if the point of putting creditors and shareholders on notice is that they stand to be wiped out if a firm posing systemic risk fails, how will they know the value of their investments legal claims if the list of firms is not public? If the cost and burdens put on these firms are not great enough to offset any perceived advantage, I would prefer to increase those costs instead of trying to hide the list. Why not make the list public? Chairman Bair, do you have any thoughts on that? Or at least require identified firms to notify their shareholders?

Ms. BAIR. I think that it is probably unrealistic to think that a list like that is going to be kept secret. Everyone will already know the obvious firms. I understand the intent of that provision is to try to not make it look like these institutions are "too-big-to-fail," but I think you take care of that problem with a robust resolution mechanism. So, at the end of the day, I am not really sure it is realistic to try to keep those confidential. In any event, they may very well be required to be disclosed as material under the SEC rules. And we have always asked for institutions to fully comply with securities disclosures. So, my sense is it is perhaps not realistic to require that the list be confidential.

Mr. MOORE OF KANSAS. Would anybody else like to address that question? Yes, sir?

Mr. DUGAN. There is a fundamental conundrum between wanting to be able to impose higher requirements on companies that pose systemic risk and trying to keep that quiet or secret somehow. I think at some level, when you impose the requirement, you have to know who they are. And when you do this, if they are significant, people will understand who they are. So I think it is going to be hard not to disclose in some way, shape or form who they are.

Mr. MOORE OF KANSAS. Governor Tarullo, do you have a statement, sir?

Mr. TARULLO. I think, Mr. Chairman, that Comptroller Dugan has summed it up. Surely we can keep the list private if that is what the Congress wants us to do, but through some combination of self-mandatory disclosures to shareholders and, frankly, just financial analyst observation of their behavior, capital, set-asides and the like for the firms, it is likely that most, if not all, of the institutions so identified would eventually be known to the public. And I think, as someone suggested, you may have a bit of a problem if an incorrect inference is drawn. So while again, there is a reason to try to avoid an increase in moral hazard, we should probably be realistic here about what will and will not be known.

Mr. MOORE OF KANSAS. Thank you, sir. Mr. Bowman and Mr. Sullivan, any comments?

Mr. BOWMAN. I do not think I have anything to add to that, Congressman.

Mr. MOORE OF KANSAS. All right. Okay. Next question very quickly. Another issue I would like to discuss is the requirement for firms with assets over $10 billion to contribute to the systemic risk fund after a large firm fails and goes through the resolution process. Why not make only the firms that have been identified to pose a systemic risk pay for the clean-up? Would not this further incentivize firms to not become "too-big-to-fail?"

Additionally, instead of simply paying back the principal for the use of taxpayer funds to help wind down a failing firm, I would suggest adding that any interest paid to service the national debt and the use of these expenses should also be repaid. What are your views on this? Chairman Bair, do you have any thoughts on that?

Ms. BAIR. First and foremost, it is very important to make clear that the assessment base would only apply to activities outside of an insured depository institution. Given such an assessment base, smaller institutions would really not pay significantly because most of their assets and liabilities are inside the insured bank.

It is hard to know in advance which institutions might pose systemic risk. So the rationale behind the $10 billion threshold was to try to identify those we could say with confidence would not be systemic. However, clearly it is likely that they would be significantly higher in assets if they were systemically significant.

If you design the assessment base appropriately, the smaller regional institutions would not pay significantly. But I think there needs to be some cut-off. It is just very difficult to know completely in advance who would or who would not need to be put into this type of resolution authority.

Mr. MOORE OF KANSAS. Thank you, Chairman Bair. And my time has expired. If any of the other members of the panel have thoughts they would like to express, please put those in writing to us if you would.

The Chair next recognizes, for 5 minutes, Mr. Garrett.

Mr. GARRETT. I thank the Chair, and I thank members of the panel. First of all, I assume everyone here was listening to the last panel when the Secretary was here? Okay. Oh, you heard it before. You have heard him testify before on two occasions. I do not mean for this comment to be flippant, but he did say it twice when he said that when we do hear the regulators, I know some are regulators, some are not, that—he did not say this, I am paraphrasing, we should take it all with a grain of salt because they are all just protecting their turf. If that is the case, then I guess I should take everything he says with a grain of salt as well because he is probably just protecting his turf, so I do not know why we have any of these panels. But I do really appreciate the testimony that we have heard so far.

One of the questions is, and I am going to go up and down the row. Ms. Bair, do you think that we should be extending this overall program beyond depository institutions, first of all?

Ms. BAIR. Yes, I do think there is a need for this ability. We think the Systemic Risk Council should be able to decide if there are institutions that pose systemic risk that have not already been identified.

Mr. GARRETT. Yes. Now if you were listening to Secretary Geithner, he said something to Ms. Capito, which I do not understand, about the auto companies. First of all, he said he was not around back then, but he agreed with what they did. I would have asked him would he have done it again. Since he agreed with them, I assume he would have done it again. He also said that GMAC would not come under this legislation. Does anybody here understand why GMAC would not come under this legislation? No? So you all assume that it would?

Ms. BAIR. We would hope that this only applies to financial intermediaries, number one. And, number two, I do not comment on open operating institutions, so I would rather not opine on the second part of the question. I think it would be a determination for the council as to whether a non-bank entity would go under this legislation.

Mr. GARRETT. Here is the thing. When I read this—and I read the beginning and went three quarters, and then I went to the last page to see how it all ended. But if you are reading the definitions to find out who all the council is dealing with, it has a two part standard to define them. One, they must be a corporation registered here in the country, yada, yada, yada.

Two, they must be an institution that engages directly or indirectly in financial activity. That would be my dry cleaners who has to take a loan out in order to operate his business. That would be the Drudge Report, which has reported in a local paper as having an influence on the value of the dollar. That would be just about any corporation in this country. That may even be me if I am a candidate who has a corporation for my candidacy because we engage in financial activity. So just reading what they gave us, it is pretty broad as to who comes under the council's authority.

Does anybody have a reason to believe that it is not that broad by the language in here, not just by intent?

Ms. BAIR. Congressman, I was out of town yesterday, and I have been speed reading this myself. That did catch my attention, and we think it could be a little bit more narrow. We would be happy to work with the committee on that technical matter. It is a very broad definition. I would agree with you.

Mr. GARRETT. Anybody else? And that is a neat little comment. Who else had to be like I did speed reading this thing? I think that is a fair assumption, and I appreciate the candor. I did too. I am not a speed reader. It takes me a long time to read this stuff.

Ms. BAIR. We appreciate that the committee did consult with us on a lot of the pieces on resolution authority. I do not mean that as a criticism. I am just apologizing that I have not had a chance to read it all.

Mr. GARRETT. Yes, we all did and this is pretty darn complicated stuff. And that is why I wonder if the next portion, let's take the worst-case scenario that you actually, and I will get back to Ms. Bair on the other question, and the rest of you too can chime in as to whether it should be ex-anti or ex-post as far as the assessment, but it is ex-post in here. I read it to say that what happens is if something goes down, you need to collect money from other companies, institutions, financial institutions over $10 billion, right, again reading this, I could say that does not just apply to financial institutions as I would think of them, as banks and what have you, it could apply across-the-board.

It could apply to all the car companies. It could apply to all the biotech companies. It could apply to everyone in this—just about any corporation that is over $10 billion in size, that they would be responsible for, heaven forbid, that BOA has a problem. Did anybody else read it that this cannot go across-the-board as far where they get it from a $10 billion assessment?

Ms. BAIR. I do not think that is the intent of the discussion draft. Again, the language can be further refined. But I do not think that is anyone's intent, not as it has been explained to me.

Mr. GARRETT. Okay. I am just going by the language. Intent is one thing but the way that regulators effectively carry things out is not always as Congress intends.

The other question is, and I don't know if I have the time, the sell-off ability. Once you have an institution that you define, you might want to sell off its assets, it goes back to what Mr. Kanjorski was raising before, I do not see any due process elements in here. On page 19, mitigation of systemic risk section, if the Board determines, they can sell off assets at will.

Is there any due process in the language of the bill?

Mr. MOORE OF KANSAS. The gentleman's time has expired. And the witnesses will have an opportunity to present any responses they have in writing for the record.

Mr. GARRETT. Can I get a yes or no real quick?

Mr. MOORE OF KANSAS. If somebody has a quick yes or no?

Ms. BAIR. There is due process in the FDIC's procedures against which this has been patterned, and we can give you a more thorough answer in writing on that, yes.

Mr. GARRETT. Thanks. Thanks, Mr. Chairman.

Mr. MOORE OF KANSAS. Thank you. The Chair next recognizes the gentlelady from New York, Ms. McCarthy.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. It is interesting listening to the testimony, and I guess when we received this some time late last night, obviously why it is in this small print, I have no idea. At my age, I need it a little bit bigger. Forget about even speed reading. But with that being said, the whole idea about having these hearings and having the different witnesses come in front of us is so that we can go through this, can work through it and certainly make the adjustments that need to be done. We have done that with every piece of legislation as we have gone through this whole process in the last several months.

But I guess, Chairwoman Bair, one of the questions that we constantly hear, with the amount of authority that you are going to be having, and it is certainly extensive between the resolution authority and the supervising State charter thrifts, how do you respond to those critics that are saying that this is going to be too much, too far of a reach for you and your group to be able to do everything that they are supposed to do?

Ms. BAIR. I do not think the State-chartered thrifts will be a significant burden—there are 472 of them. They are primarily smaller institutions. We regulate nearly 5,200 institutions already. So I do not think that would be a significant resource demand.

On the resolution authority, obviously this is cyclical work. Somebody needs to do it. We are the best equipped of the agencies to do it. We set up a group to look at what the resource needs would be. We do not think resources would be significant on a start-up basis. We have a lot of contractors that we rely upon. That is the whole idea of the FDIC, to be able to expand quickly because of the cyclical nature of this work. Some agency has to do it, and we certainly have the infrastructure already that can be built out to assume more of this responsibility.

My hope is that this is not something that is going to have to be used a lot, if ever. The whole idea of having a robust resolution mechanism is to put better market discipline back into the system, especially to tame some of these larger institutions so that investors and creditors will be more demanding. We want them to understand what kind of risk the institutions are taking, whether they are well-managed, and whether they are transparent because investors and creditors know their money will be at risk if the institution gets into trouble.

The hope and expectation is that the new Systemic Risk Council combined with these resolution authorities will help take a lot of risk out of the system. But you will always have cycles, and you will always have instances where institutions get into trouble. So, some mechanism is needed. But, I think that the primary benefit of that is the strong signal it sends to the market that these are the rules. You will take losses if you fund or invest in high risk-taking institutions that get too big. If these institutions are going to be closed, you will take losses.

Mrs. MCCARTHY OF NEW YORK. I agree with you on that. I would like to throw it out to the rest of the panel. Being that obviously your staff has probably gone through each section that would affect each and every one of you as far as your interests, have you seen anything that you would want to add to the legislation as we go forward to either improve it or do you think—I have heard some complaints there that some parts, that you do not agree to, but what we are missing in this piece of legislation?

Mr. DUGAN. Mrs. McCarthy, as I indicated in my longer written statement, we have thought for some time that there is an unevenness that goes on right now inside of bank holding companies in the sense that banks are extensively regulated but holding company affiliates, even if they are engaged in the very same activity, are not subject to this same examination and supervision on a regular basis. We think we ought to level that playing field so that you do not have any potential for arbitrage between different parts of the holding company because we did see some of that in previous times.

Mrs. MCCARTHY OF NEW YORK. Governor?

Mr. TARULLO. Thank you. I think all of us would agree that there will be places where we can make suggestions and recommendations. A couple that come to my mind, first, I do not think we want, the Federal Reserve I do not think wants to be on the board of the FDIC. I do not think we bring a whole lot to that enterprise. So that would be one change.

I suspect that we will, working with many of you, see opportunities for perfecting a lot of the other areas as well. And we are not unsympathetic to what Mr. Dugan said at the outset about needing to make sure that the allocation of authorities among agencies preserves the strongly and effectively collegial relationship that we do have certainly in working with the OCC within the bank holding company context.

Mr. BOWMAN. In my opening statement, I made a couple of remarks regarding the proposed merger and some of the issues that are there. And we will be happy to provide written suggestions in that regard.

Another area we would like to look at is a loss of a fairly fundamental advantage for smaller institutions that have holding companies. That is the consolidated holding company approach where you have the same regulator for the holding company and the institution, as distinguished from larger institutions or entities that have multiple affiliates, perhaps as Comptroller Dugan talks about, where you need a different kind of regulator.

In a case of a single institution, perhaps smaller, with a holding company and not a lot of other activities, consolidated supervision of those two entities, the holding company and institution, are real advantages to the smaller community institutions.

Mr. MOORE OF KANSAS. I am sorry, the gentlelady's time has expired. And I would ask if Commissioner Sullivan, if you have additional comments, we would like to have those in writing for the record, please. And I apologize. But Mr. Manzullo, you are recognized, the gentleman from Illinois, for 5 minutes.

Mr. MANZULLO. Thank you. I have a couple of questions. Mr. Dugan, on page 5 of your testimony you state, dealing with Federal Reserve separate authority and impose heightened prudential standards and safeguards concerning certain financial activities and practices, and then you say, "Once the Council makes this identification, the Federal Reserve would have unilateral authority to establish a broad range of standards and safeguards for such activities and practices but without seeking public comment and without consulting with primary supervisors even where the primary supervisor has greater expertise and experience with respect to such activities." It is obvious you do not like that authority?

Mr. DUGAN. I think it could be adjusted, and I take the comments of Governor Tarullo to heart. I think there are some places where there needs to be more of a recognition of the respective roles that we have on different things. For example—

Mr. MANZULLO. I have a question that goes along with that.

Mr. DUGAN. Okay.

Mr. MANZULLO. And I did not mean to cut you off, but you made your point quite clear here, and I respect that. Have you been following all the debate on the Consumer Financial Protection Act?

Mr. DUGAN. Yes, I have.

Mr. MANZULLO. You realize that what this new piece of legislation attempts to do is exactly what the CFPA would do on safeguarding activities and practices? Maybe you do not realize that but it—

Mr. DUGAN. It is a different slice, it is more on the safety and soundness prudential side of things, and it is trying to get at a broader range of institutions where the CFPA is focused on consumer protection.

Mr. MANZULLO. Ostensibly, but if you read the CFPA Act, it is so broad. I can see a huge fight going on over who is going to do something, and then this bill says the Fed can move unilaterally without talking to the people who have authority on it.

The second question, Mr. Sullivan, I do not want you to fall asleep over there, no one has asked you any questions. Your testimony I think is very, very pointed. On page 5, you identify the blame that many in this town refuse to recognize.

When you start at—on page 5, line 3, "The insurance industry in general does not pose a systemic risk to the nation's financial markets to the extent we have seen in the bank and securities sectors. Rather, insurance companies are more often the recipients or conduits of risk. Mortgage and title insurance, for example, do not generate systemic risk. They simply facilitate underlying loan transactions." Is not the problem with the financial collapse that we have had in this country due to the fact that these subprime mortgages were allowed to take place with very little underwriting standard supervision?

Mr. SULLIVAN. And I would point to the area that we regulate, the dominion that we have authority over, insurance has very high capital standards. And as a consequence, we have not seen failures within the insurance industry. I can count on one hand over the last 3 years the insurance affiliates that have failed during the most significant upheavals in the financial market while we have seen hundreds of banks fail during the same time.

Mr. MANZULLO. Then some witnesses here want to pool the entire insurance industry.

Mr. SULLIVAN. And we are very skeptical about any grab of such authority when we have a proven system that works.

Mr. MANZULLO. That is my question—the only people around here who do not seem to be getting any recognition or any respect are the people who have been doing their jobs back home in the State insurance authorities, and then all of a sudden people say, let's bring it together.

The third question is open to everybody, actually to the Governor. The Feds already had the authority, it has had it for years, to set underwriting standards for mortgages. I am talking subprimes. And do ridiculous things, such as requiring written proof of a person's earnings. And yet the Fed never put those regulations into effect until October 1st of this year. So why should the Fed be given more authority under a brand new organization set up when it had that authority in the first place and simply failed to act? And the failure did not occur during Mr. Bernanke's term. By the time he got in, it was too late.

Mr. TARULLO. So, Congressman, before I was on the Board, I was actually quite critical in my former capacity as an academic of the failure of the Board, indeed of the government more generally, to move to do something about subprime lending problems, both directly in their consumer implications, and indirectly in their safety and soundness implications.

And, as you indicate, I think Chairman Bernanke came, when he became chairman, he took a look at those prudential and consumer regulatory issues and under his leadership, the Board, I think, has enacted a good set of mortgage related as well as credit card related regulations. So the short answer I guess to your question is that the Congress can give mandates to agencies and then give authority to agencies, but the decisions that the people leading those agencies make and the context in which they make them matter. And to that degree, I think we all just have to recognize that the policy orientations of appointees to these agencies are important things for you and your colleagues on the other side of the Hill to consider.

Mr. MANZULLO. Thank you.

Mr. MOORE OF KANSAS. Thank you, Mr. Manzullo. And next, the Chair recognizes the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank you and the ranking member for hosting the hearing. Mr. Bowman, I respect you for speaking up for and standing up for your employees. How many are we talking about? And I am going to ask that you answer as quickly as possible because I have a series of questions that are of concern. How many employees are we talking about?

Mr. BOWMAN. I believe as of tomorrow, it will be 1,040, approximately.

Mr. GREEN. And is it your opinion that under the current proposal, these employees will not receive a fair and equitable transition?

Mr. BOWMAN. Our brief review of the legislation we received the other evening would suggest that two-thirds of the employees, the examination workforce, who are specialized and trained, would probably make out quite well. For those who provide other services, there is a difficulty in terms of how they will be merged with the OCC.

Mr. GREEN. For additional edification, when you say "others," are we talking about clerks, are we talking about—tell me what the others consist of?

Mr. BOWMAN. We are talking about economists. We are talking about legal. We are talking about IT specialists. We are talking about compliance specialists who are not examiners, those who would not go to the CFPA.

Mr. GREEN. And have you examined any information or any document that would help someone such as myself, who is concerned, something that you have codified that might help me to help those employees, is there something available?

Mr. BOWMAN. There are two places to start, and we will get you the information if you would like. One is the merger of the old Federal Housing Finance Board and the Office of Federal Housing Enterprise Oversight where they took two agencies and merged them into one, even though they had different charters and different purposes.

We would suggest that the second starting point would be the Administration's original proposal. It started off by creating a new agency, and then having the OCC and the OTS come together on equal footing.

Mr. GREEN. I will be candid with you, that may be difficult at this point, but I would like to hear more about what you propose. And I will look to work with you and your office and to see what we can do.

Mr. BOWMAN. Thank you, and I look forward to that.

Mr. GREEN. Thank you. And I will come to you, Mr. Dugan. Let me ask one quick question because I have to make sure that I get this in, a comment first. "Too-big-to-fail," without question, is the right size to regulate. It is also the right size to eliminate. I am of the opinion that we absolutely want to prevent ever having "too-big-to-fail."

And the question becomes, can we allow institutions to grow so large that they can be resolved and not cost the taxpayers dollars. The paradigm that we are proposing provides for resolution. The question that the taxpayers are interested in is this. If we had in place what we are proposing, would we be able to wind down AIG and not use one penny of taxpayer money? Ms. Bair? And if you can, give me a yes or a no. I know everyone is tempted to give a long explanation.

Ms. BAIR. Yes.

Mr. GREEN. Your opinion is, yes, we could with the current proposal, all right. Mr. Dugan?

Mr. DUGAN. Yes, I think we could too, but it is hard to go backwards in time and see exactly. I think if you put all these proposals in place, the answer is yes.

Mr. GREEN. All right. Sir?

Mr. TARULLO. I think that is correct, Congressman. I do not think it would have cost the taxpayers a penny in the end.

Mr. GREEN. In the end, not a penny, current proposal in place?

Mr. TARULLO. Yes, the question would be would there have been any temporary liquidity support provided in the interim, but that could have been fully collateralized and repaid.

Mr. DUGAN. I would say yes, but of course, the devil is in the details.

Mr. SULLIVAN. And the only concern we have from a State regulator's perspective is protecting policyholders. So if the wall of the assets that protect policyholder liabilities, and so if the unwinding—

Mr. GREEN. I am going to take that as a yes.

Mr. SULLIVAN. As long as we protect policyholders, that is our—

Mr. GREEN. I have to move on. Final comment and then Mr. Dugan is this. Once that list is codified, my assumption is that it will become public knowledge. Once more than one person knows about it, in the world that we live in today, things just do not remain esoteric. And I think we should provide for the possibility that it will be public more than private.

Now, Mr. Dugan, your comment?

Mr. DUGAN. Yes, very quickly, Mr. Green. I just wanted to say that on the transfer of personnel and fairness issues, we absolutely want to work with you to make sure that we provide information to you as well as OTS to make sure that it is fair and orderly.

Mr. GREEN. Thank you. Thank you, Mr. Chairman.

Mr. MOORE OF KANSAS. Thank you. If any other witnesses care to respond to Mr. Green's question, you are welcome to do that for the record. The Chair next recognizes Mr. Paulsen for 5 minutes.

Mr. PAULSEN. Thank you, Mr. Chairman. Let me just follow up. We had some discussion earlier this morning about the repayment from the AIG loan and the GM bridge loan to nowhere as being far from certain that those payments are going to be repaid. And I think many of us here have had concerns that this Administration may be using the extension of TARP, for instance, as a continued ATM or walking around money and having those funds out there.

And Mr. Volcker recently testified before the committee here. He said that, "The proposed overhaul of financial rules would actually preserve the policy of 'too-big-to-fail' and could lead to future bank-

ing bailouts." I am just curious, Mr. Geithner has left now, but from your perspective, can you just comment, what in this plan really prevents or assures that we are not going to have those future bailouts occur after we heard that testimony from the former Chair of the Federal Reserve?

Ms. BAIR. We think there are areas where this proposal could be strengthened, but it prohibits any type of open bank assistance for an individual firm. That is number one. It prohibits capital investments of any kind. It does under extraordinary circumstances allow the government to provide some liquidity support for healthy institutions, but that needs to be done through a systemic risk process, which is a fairly extraordinary procedure.

It also says that if there are any losses, a tenet with any of this, that it would be borne by the industry through an industry assessment. There would be no more one-off bailouts under this. There would be a fund. Whether we think it should be pre-funded or funded after the fact, any cost or unexpected losses associated with the resolution activity would be borne by the industry.

It does not provide for a guarantee of liabilities. Such obligations should not be affirmed for individual firms. This is far different from the type of thing you saw with AIG. There would be no capital investments, for one thing. It would be a closed system.

Again, we do not expect significant losses, as this is a wind-down process. It is more akin to a bankruptcy process in terms of the losses being imposed on shareholders and creditors. You would not have bondholders being taken out at par the way you had with some of these bailouts, for instance. And shareholders would be completely wiped out whereas they might live to fight another day with some of the bailouts that had been done so far. So this is a profoundly different process from what you have seen in the past. And that is not a criticism, we did what we had to do. There were no tools available, but this will be very different going forward.

Mr. PAULSEN. And many of us I think would advocate for the bankruptcy process to recede, and we had discussions earlier even this morning about the moral hazard argument. What in the plan really encourages companies to not engage in risky behaviors, to actually grow larger to a size where they will be deemed systemically important or at risk?

Mr. TARULLO. So, Congressman, there, the question you just asked brings up the important point that we need to have mutually reinforcing pieces of this system. Chairman Bair has just described how market discipline can be brought to bear when you have a robust resolution mechanism. I would add to that, bringing into the parameter of companies that are regulated, firms like AIG and Bear Stearns, stops you from getting to a situation which is very high leverage in some unregulated firms.

In terms of the question of, does this provide an incentive to become big or a disincentive to become big, I think it is incumbent on all of us to make sure that the incentives in the system make—require firms to internalize the costs of their bigness and their interconnectedness. It requires the counterparties of those firms to internalize them when they enter into transactions. It requires the firms themselves because of the imposition of special liquidity and capital requirements to internalize them.

So when we put all three pieces together, regulation, supervision, and market discipline, we should make sure that each firm, small, medium or large, is able to provide financial services to the businesses and consumers of our country but only in such a way that their safety and soundness is assured.

Mr. PAULSEN. And before I just run out of time, Mr. Chairman, I want to ask Commissioner Sullivan, who is now on the end as well, do you have any concerns about Treasury, the Treasury Department or the Federal Government essentially obtaining authority to regulate insurance under the draft plan or concerns about Federal interference down the road as a State commissioner?

Mr. SULLIVAN. Indeed, with respect to any preemption what we do today, yes. So if capital requirements are set higher than what we set today in the State regulatory system, have at it. But do not undermine or preempt what we do today, as I stated in my comments, our record is proven and it speaks for itself.

We have not had any failures of insurance enterprises and that is because they are strictly regulated from a financial solvency perspective. So do not preempt us from a resolution authority perspective. Do not preempt us from a capital requirement perspective. Do not preempt us in any of those ways because our system works.

Mr. PAULSEN. Mr. Chairman, I just wanted to ask unanimous consent to submit two letters for the record, one from CMSAA and one from the American Land Title Association.

Mr. MOORE OF KANSAS. Certainly, they will be received for the record. Thank you, sir.

The Chair next recognizes the gentleman from North Carolina, Mr. Miller, for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. Ms. Bair, Mr. Garrett asked earlier whether if there was a resolution under these powers, a manufacturer who is just minding their own business might be surprised to get an invoice declaring that they were a financial company, and they had assets of more than $10 billion. And what would keep that from happening. And you said that you did not think that was intended by the legislation.

Page 165, 166 includes a definition of financial company, which is a bank holding company as defined in Section 2(a) of the Bank Holding Company Act. An identified financial holding company is defined in Section 2(5) of the Financial Stability Improvement Act, any company predominately engaged in activities that are financial nature, for purposes of Section 4(k) of Bank Holding Company Act or any subsidiaries of any of those. And all of those are defined statutory terms.

And with respect to the "predominately engaged in activities," there is a procedure for notice that the company is regarded as predominately financial and they have an opportunity to contest that. Does that support your argument that no manufacturer minding their own business is just going to get an invoice?

Ms. BAIR. It certainly attempts to. Again, my apologies, as I have not had a chance to read this entire bill. I think we all understand we want this confined to financial intermediaries. If there are further refinements in the language, we are happy to work with the committee. But, yes, I think that is clearly the intent. And, as it is drafted here, that is what is expressed. But, there are other pro-

visions I know my staff had concerns over, and I need a chance to read the entire bill before I can respond.

Mr. MILLER OF NORTH CAROLINA. Okay. All right. Thank you. There has been a substantial discussion about whether banks should not do certain things. Any systemically significant firm should not engage in some inherently risky procedures. We have had that comment from economists for several months now as part of this debate. Mervyn King, the Bank of England governor, said there should be—banks should be broken up into casino functions and utility functions.

And Paul Volcker, testifying here last month, said that much the same thing, and specifically gave the example of proprietary trading. Do you agree that there are some functions that systemically significant firms should not do, among other reasons, because it is almost entirely impossible for their board of directors or even their CEO to know what they are doing if they are engaged in all manner of complex activity, do you agree with that? And do you agree specifically with respect to proprietary trading?

Ms. BAIR. Right.

Mr. MILLER OF NORTH CAROLINA. And does this bill give sufficient authority to do that?

Ms. BAIR. I think he was saying that insured depository institutions should not do that.

Mr. MILLER OF NORTH CAROLINA. Right.

Ms. BAIR. Those that benefit from the deposit insurance. I do not think he was saying nobody should do that. I think his preference would be basically to do away with Gramm-Leach-Bliley so that you have banking operations that take deposits and make loans separate from securities and insurance activity. So, we have somewhat of a hybrid approach. We would like much more definitive walls of separation, both legally and functionally, between insured depository institutions and other affiliates in a bank holding company.

We also would agree with Comptroller Dugan that regulatory standards for the holding company activity should be higher. The capital standards should be at least as high for holding companies as they are for insured depository institutions. The quality of capital should be just as high.

If you are going to have an insured depository institution, you should be in a position of strength, not weakness. We would like some strict separation of proprietary trading and a lot of these complex securitizations, etc., should be outside the insured depository.

We also were very grateful that the bill does propose giving us some back-up authority for holding companies so that when a holding company affiliate is doing something that puts the insured institution at risk, we would have some back-up ability to come in there and work with the Federal Reserve, presuming the Federal Reserve is the holding company supervisor, to remediate that situation.

We do want greater walls of separation between the banks and other types of activities, but we would not say that they could not co-exist within a broader holding company structure.

Mr. MILLER OF NORTH CAROLINA. I am sorry. Say the last bit again?

Ms. BAIR. So we would like greater separation between the insured depository and the affiliates that do other types of higher risk activities, though we would not say that the insured institution has to be taken completely out of the holding company structure. They could co-exist in a holding company structure.

Mr. MILLER OF NORTH CAROLINA. Okay. Mr. Dugan?

Mr. DUGAN. The one thing that I would add is that there is a notion that you can stop financial companies from engaging in this risky activity, and that will solve the problem, but the problem is somebody will continue to do those activities.

Mr. MILLER OF NORTH CAROLINA. Right.

Mr. DUGAN. They will get systemically significant and big. That is what happened last year. We had companies that weren't banks that did that, and we ended up having to do something about it. So I guess the approach of this bill is you cannot ignore the fact that they can become systemically significant. And that being the case, you ought to have ways to go regulate them.

Mr. MILLER OF NORTH CAROLINA. And I support that approach.

Mr. MOORE OF KANSAS. The gentleman's time has expired. The Chair will next recognize the distinguished ranking member, Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman. One thing, the State regulators I know under the FFIEC, you all are voting members under that council. This is a council that presently exists, and I think I would agree with my colleagues who say that the States ought to have voting members there. It is kind of letting you serve on something and not giving you a vote or a voice is I do not think it is acceptable.

Mr. Green mentioned the OTS and the employees, and it definitely seems like they are receiving shabby treatment, as has Mr. Bowman. And you also have a concern that if the OTS is simply merged into another agency, and Republicans have proposed that as well as Democrats, so I am not casting any aspersions on anyone, but it obviously would have a net effect of diminishing the thrift charter. I know that everyone seems to be proposing that, but I appreciate your testimony. I think you outlined ways it can be done.

I know the American Bankers Association wants a strong thrift charter, but I do not know that you can have a strong thrift charter if you do not have an agency whose primary responsibility is to the thrift. And most of those are small, a lot of them are Main Street banks at a time when we are concerned about concentration and "too-big-to-fail." And it seems like that principle works against the purpose of the bill.

Mr. Tarullo, the Federal Reserve gains an awful lot of new authority under this draft. What role did the Federal Reserve have in drafting the text?

Mr. TARULLO. So far as I am aware, Mr. Bachus, we had no role in drafting the text. We did not do the drafting. We certainly, along the way, over the last 6 months, but more recently over the last few weeks, were asked our views, I think as my colleagues were, by people in the Administration and people on the committee staff

and elsewhere. But we were not involved in the drafting of the text itself.

Mr. BACHUS. Were you consulted throughout the process? Were you consulted during the writing of it?

Mr. TARULLO. There were certainly some consultations in the sense that we were asked by the Administration our views on certain things, and we had meetings, the President's Working Group and elsewhere, among many of us on that topic. But if you are asking whether there was some sort of particular, our particular role as opposed to that of our colleagues, I think the answer to that is no. We were all certainly talking to one another.

Mr. BACHUS. All right. Now, under this, you would pick up the power to force companies into bankruptcy or require them to divest segments of their company, would you not?

Mr. TARULLO. I believe there are provisions in the bill which would do those two things, yes, sir.

Mr. BACHUS. Okay, all right. It also gives you the ability to overrule your colleagues at other Federal banking agencies, are you aware of that?

Mr. TARULLO. Yes, and I think that is what Mr. Dugan was alluding to in his opening statement. And, as I said, I think there are a lot of things that went wrong in supervision and regulation over the last 10 years in this country, but one of the things that I found when I came to the Fed earlier this year that actually goes right is the cooperation between the OCC and the Fed and the regulation of holding companies that have national banks. And I do not think we want to undo that.

I think we want to have a collegial relationship, not one of trying to set up situations which are overruling one another. So we certainly want to come out with an accommodation that achieves the safety and soundness ends that I think the drafters intended to achieve on the one hand, while preserving that collegial relationship on the other.

Mr. BACHUS. And I think you will agree that some of the policies by the Fed leading up to the events of the last 2 years actually probably contributed to the overextension of credit.

Mr. TARULLO. So, Congressman, this may be my academic self speaking, but I can identify a lot of policies by a lot of entities who contributed to this, including the Fed.

Mr. BACHUS. Thank you. I appreciate that. Chairman Bair, Republicans have pretty much uniformly rejected the idea of a continuing permanent bailout mechanism, but I know Chairman Frank in this legislation sets up—funds two different basically bailout authorities. Can you explain or give us some of your concerns with a system that pays for failure after the fact or one that assesses surviving competitors of failing institutions as this plan does?

Ms. BAIR. We do think there are some areas where it could be strengthened and are happy to keep working with the committee. There is a suggestion of a conservatorship for failing institutions. We think the process should be a receivership with the goal to be a prompt wind-down of the firm or breaking it up and returning it to the private sector.

I think it is very positive that it prohibits capital investments of any kind. If there is truly a system-wide problem, such as an international destabilizing event, and there is a system-wide problem where even healthy institutions cannot get liquidity support, I think there should be some ability for the government to step in. But that should be only with the systemic risk procedures. We think that should apply, whether it is us giving the support or the Federal Reserve giving support.

The intent is a wind-down authority, not a bail-out authority. That is our understanding of the intent. And we are happy to keep working with the committee to effectuate that.

But you are certainly right, the whole purpose of doing this is to send a strong signal to investors and creditors that they will be the ones taking losses and to management that they will be replaced if they get themselves into trouble. It is very important that the bill sends that message.

Mr. BACHUS. And the ability to loan money to a failing corporation.

Mr. MOORE OF KANSAS. The gentleman's time has expired.

Ms. BAIR. No, we would not support that.

Mr. MOORE OF KANSAS. I would ask the gentleman and the Chairman to have any additional comments in writing please for the record. Next, Mr. Perlmutter from Colorado, is recognized for 5 minutes.

Mr. PERLMUTTER. Thank you, Mr. Chairman. I will try to keep it under 5 minutes. Many of you have appeared probably a dozen times, if not more than that, in the course of the last year before this committee. I just kind of have to go back to this time last year. And in any of your experiences, had you ever seen a banking system in such peril or the economy in such peril in September, October, November of last year? And I would say let the record reflect people are shaking their heads no.

Ms. BAIR. No.

Mr. TARULLO. Absolutely not.

Mr. PERLMUTTER. Okay. So now after all the times you have appeared, all of you have been thinking about how do we manage the system so that we can deflect the failures that we saw last fall from happening again, at least during our lifetimes. The next generation will do whatever it does.

And I know it is almost premature asking you this question, but in your commenting to the Treasury Department or in the time that you have had to kind of skim this bill, are we missing something to try to constrain and be able to respond to the free fall that we had last fall? And, Ms. Bair, it is an open-ended question, if you can kind of give me a quick answer, I would appreciate it.

Ms. BAIR. No, I think the things that we consider to be most important are in this bill. We would like to see a stronger council. I think one of the benefits of the council is the ability to identify and address regulatory gaps, as well as to serve as a check on all of us to make sure we do our job. We believe the council should have the ability to set its own rules, that it would increase standards if individual regulators are not doing what they are supposed to.

Mr. PERLMUTTER. And I appreciate your saying that because I did want to respond to Mr. Garrett. I kind of agreed with his point

about when Secretary Geithner did not think GMAC Finance would be part of this. And then his next point, but he thought his dry cleaner would be part of it. Just looking at page one, he did not get very far in the bill, because on page one, it defines the financial company as any incorporated, any organization incorporated in the United States, and it talks about banks. And then it says, "that is in whole or in part engaged in financial activities."

So that is a lot of companies. Then there is a limitation that I hope would get rid of his dry cleaner, and that is on page 13, where it says that the council determines is a material financial distress that could pose a threat to the financial stability of the economy. Now, I hope his dry cleaner is not so big that it would pose a financial threat to the economy. But it does seem to me, Ms. Bair, that you do have a very broad roof that you can—

Ms. BAIR. That is right. As I told Congressman Miller earlier, our staff were a little concerned about this in whole or in part, directly or indirectly. But you are right. It would have to be systemic for the council to get involved, so clearly the dry cleaner could not at all be subject to this. A large commercial entity, perhaps. This should be clarified because I think we all are talking about financial intermediaries. But, absolutely a dry cleaner could not be included in this.

Mr. PERLMUTTER. So General Electric, major manufacturer, major company but also has a major financing arm. I would expect it would be, in some facet or another, covered by this. And not to pick on them, I am just trying to figure out who is covered and who is not?

Ms. BAIR. Right, I think we're talking about institutions of significant size and complexity. Yes, that would be my assumption.

Mr. PERLMUTTER. That if they were to get into trouble, it could have a domino effect.

Ms. BAIR. That is right.

Mr. PERLMUTTER. Just starting with IndyMac, then Fannie Mae and Freddie Mac and then Merrill Lynch and AIG and Lehman and all that, it was dominoes.

Ms. BAIR. Right.

Mr. PERLMUTTER. And it was a painful experience. So, Mr. Dugan, I will ask you this, kind of changing the subject. There is a question, and there seems to be some debate, I am a bankruptcy lawyer, all right. That was 25 years I did Chapter 11's. And it bothers me a little bit that people are being so free and loose with the word "bankruptcy" because there are all sorts of bankruptcies. There are liquidating bankruptcies. There are reorganizing bankruptcies. There are different varieties. And we should not use it as one thing.

Do you think that there should be the ability to reorganize or do you think there should be an orderly liquidation of companies that potentially are systemically risky and are in the financial business? For the most part, we do orderly liquidations of it.

Mr. DUGAN. It is a good question, and I am not sure. I am not a bankruptcy lawyer, and I think there is a very important technical bankruptcy point in here about the reorganization question. I think what the draft gets at and what people have been so concerned about is, however you do it, the shareholders of the com-

pany and the subordinated creditors bear the losses, so even if it is reorganized, others senior in the chain might get there.

It has been viewed as somewhat impractical, I gather, historically, to do this in the financial institution context. I do not really understand why, but I think it is a perfectly legitimate question. And let us give it some more thought, and we will provide something for the record.

Mr. PERLMUTTER. Thank you.

Mr. MOORE OF KANSAS. The gentleman's time has expired. Votes have been called. We are going to have one more set of questions. Ms. Bachmann from Minnesota, please?

Mrs. BACHMANN. Mr. Chairman, thank you. Again, with the 253-page bill that just came out less than 48 hours ago and another several thousand page bill on the horizon with the healthcare, this is a lot to take in. And I think two adjectives that come to my mind are breathtaking and stunning when I look at the Resolution Authority. And I think on both sides of the aisle I think there is bipartisan concern about the unprecedented level of power that seems to be centralized under this.

So it seems to me prudent that we would exercise serious due diligence on the part of establishing what the chairman and the President have called a Resolution Authority to break up systematically risky institutions.

And here is my question. The proposal looks to me like we are codifying—and I am sure you have gotten this comment before of what our constituents were outraged about last year when Congress passed TARP, except under this proposal we, the Congress, wouldn't have to take a vote each time an institution needs a bailout; and the bill would give the FDIC the authority to extend credit on the backs of taxpayers whenever it wants.

Do you think that is an accurate characterization, or am I wrong? And that is for anyone on the panel.

Ms. BAIR. No. I don't think that is an accurate characterization. I think the bill carefully constrains what we can and can't do. And we clearly cannot provide any kind of assistance, nor can the Federal Reserve, I might add, on an individual basis, to an individual failing firm. There is a process for a systemic support if you had a major destabilizing event where the government needed to step in and stabilize a system, or even healthy institutions could not access liquidity.

But no, the whole point of this is to make sure that the shareholders and creditors are the ones that take losses, and there is an orderly wind-down. You may need to have some temporary liquidity support into a bridge financial institution as you break it up and sell it off.

But I think those short-term liabilities are already fully secured. So, that would not be imposing any losses on the receivership that wouldn't otherwise be obligated, whether as a bankruptcy practice or the statutory resolution process. Based on our experience with bridge banks, we think that those preserve value and minimize losses if you can maintain the short-term funding relationship.

This is not a bailout mechanism. This is a wind-down mechanism. We think it is very important that this be clear and understood.

Mrs. BACHMANN. Let me follow up then. With the Republican alternative that several of my colleagues are offering, it is clear that bankruptcy is the end game for those who make mistakes or the risky banks. And that is what our plan does, to strengthen market discipline by making it clear that a failing institution's creditors and counterparts would bear the cost of the financial mistakes, not the taxpayers.

And I know I heard Treasury Secretary Geithner say earlier that he didn't believe that this would fall on the back of the taxpayers. But there was a certain amount of incredulity on the part of us as Members of Congress, especially when we heard the $81 billion that has already been forwarded to the auto makers. We can expect that the taxpayers won't be paid back.

And I think that we are very concerned when we look at the wind-down authority and wondering, how is that a speedier resolution of a company than what we would find in bankruptcy?

Ms. BAIR. The bankruptcy process is what we have had, and it led to all of these bailouts.

Mrs. BACHMANN. But we haven't had, perhaps, a modification of that, that would anticipate—

Ms. BAIR. We don't differ profoundly in where we want to end up. We believe the claims priority that should apply to the receivership process, which is what we have now for insured banks, is much along the lines of what you have in bankruptcy.

Mrs. BACHMANN. I think that may be accurate, that we may not differ in where we want to end up other than authority. Who has that power? Who has the authority?

And I think that is the real concern here, is that taking away a power from the Congress and giving that over to the Executive Branch. And again, I think Mr. Kanjorski asked a very good question earlier of the Treasury Secretary when he said, where in the constitution would you find that authority?

Mr. Kanjorski said he didn't believe that Congress even had the authority to devolve to the Executive Branch of the taxpaying function, or the tax-assessing function. And I would agree with Mr. Kanjorski on that.

On an unrelated question—this would be for Chairman Bair—on October 7th, I sent you a letter requesting examination of the role of ACORN, what they play in helping banks satisfying their Community Reinvestment Act obligations. And as you know, ACORN has earned a reputation with the public for extremely poor systemic controls that have led to persistent unethical behavior, and repeated disregard for voter registration and other Federal and State laws.

So as chairman of the Federal Financial Institutions Examination Council, I requested that you and your fellow council members conduct a thorough examination of the issue and prohibit financial institutions from receiving CRA credit by donating to or partnering with ACORN.

Have you seen my letter? Are you willing to consider such an examination?

Ms. BAIR. I have seen your letter, and we are in the process of consulting with our fellow regulators and giving you a good response.

Mrs. BACHMANN. Do you have any idea when I would anticipate a reply?

Mr. MOORE OF KANSAS. The gentlelady's time has expired.

Ms. BAIR. We will try to do it as promptly as possible. We will give you a thoughtful response.

Mrs. BACHMANN. Thank you very much.

Mr. MOORE OF KANSAS. If the gentlelady has additional questions—

Mrs. BACHMANN. I thank the chairman.

Mr. MOORE OF KANSAS. —or comments from the panel, that is fine. We have Mr. Foster for 2 minutes, and then we are going to go for votes. Votes have been called.

Mr. Foster is recognized for 2 minutes, sir.

Mr. FOSTER. Thank you. My questions are in regard to subtitle (f) on risk retention during the asset-backed security process. And it is my reading of it that you have very wide authority to set it not just at 10 percent, but to eliminate it entirely or make it significantly higher.

My concerns are with the macroeconomic effects and possible politicization of this. It is obvious this could exert a very powerful, and possibly beneficial, damping influence on, for example, real estate price bubbles. If someone had said several years ago that, look, you are securitizing out of Las Vegas, you don't have to put 10 percent down but 25 percent down, it could have had a very beneficial macroeconomic effect.

And so my question is, how do you anticipate this will actually be exercised? Do you anticipate varying the risk retention by asset class? By industry sector? By geographical region, in the case of mortgage securitization? Governor Tarullo?

Mr. TARULLO. Thank you, Congressman. Obviously, it will depend on how you all write the bill in the end. But I think our preference would be for the capacity to do just what you suggest. That is, the variety of asset classes which can be subject to securitization, the variety of the credit circumstances under which they are so subject, and, importantly, the role of servicers as well as originators of securitized assets, are such as to make the retained risk a very useful instrument, but one that needs to be deployed in a fashion that takes account of the centers that vary across asset class.

Mr. FOSTER. So you contemplate using it in concert with monetary policy? For example, to cool off a real estate bubble?

Mr. TARULLO. I think that provision, as I read it, is intended to be a safety and soundness rather than macroeconomic provision. And unless instructed otherwise, I think that is the way we would read it, which is to say, how does risk retention ensure that the loans in question, when securitized, are themselves risk appropriate?

So I don't think we look at it as a monetary policy instrument as such, although I think your question—

Mr. FOSTER. It certainly would have an effect because even—

Mr. TARULLO. It would have an effect, and one would need to think about it. That is correct.

Mr. MOORE OF KANSAS. The gentleman's time has expired. I want to thank the second panel for your testimony and for your ap-

pearance here today before this committee. Votes have been called. After votes, we will resume with the third panel.

The committee stands in recess. Thank you all.

[recess]

The CHAIRMAN. We will reconvene. I apologize to everyone except Mr. Baker for this delay. He knew what he was getting into.

As for the rest of you, we apologize. We thank you for being here.

Let's get right to the statements, and we will begin. Mr. Trumka, I know you have some time constraints, so if at any point you have to leave, we understand. Mr. Baker, too.

Mr. TRUMKA. Thank you.

The CHAIRMAN. And actually, if you leave, it will be like the old days when we used to have pairing, one on each side. So you can leave together.

We will begin with Richard Trumka, President of the AFL-CIO.

STATEMENT OF RICHARD L. TRUMKA, PRESIDENT, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS (AFL-CIO)

Mr. TRUMKA. Thank you, Mr. Chairman. And thank you to Ranking Member Bachus. My name is Rich Trumka, and I am the president of the AFL-CIO.

The AFL-CIO is a federation of 57 unions representing 11½ million members. Our members were not invited to Wall Street's party, but we have paid for it with devastation to our pension funds, lost jobs, and public bailouts of private sector losses. Our goal is a financial system that is transparent, accountable, and stable, a system that is the servant of the real economy rather than its master.

The AFL-CIO is also a coalition member of Americans for Financial Reform, and we join that coalition in complimenting the committee for its work on the Consumer Financial Protection Agency, and we endorse the testimony of AFR's witness here today; however, we are concerned with the working draft, that the committee's work thus far on the fundamental issues of regulating shadow financial markets and institutions will allow in large part the very practices that led to the financial crisis to continue.

The loopholes in the derivatives bill and the failure to require any public disclosures by hedge funds and private equity funds fundamentally will leave the shadow markets in the shadows. And we urge the committee to work with the leadership to strengthen these bills before they come to the House Floor.

The subject of today's hearing, of course, is systemic risk. And the AFL-CIO strongly supports the concepts in the Treasury Department White Paper, that a systemic risk regulator must have the power to set capital requirements for all systematically significant financial institutions, and be able to place a failing institution in a resolution process run by the FDIC. We are glad to see that the committee bill actually does those things.

Although we have some concerns with the discussion draft that was made public earlier this week, we really haven't had a chance to go through it. And our understanding so far is that some of the intention of the committee, we may have read things at variance with that, and we think they can be worked out. But our concern

is that this bill gives pretty dramatic new powers to the Federal Reserve without reforming the governance by ending the banks' involvement in selecting the boards of the regional Fed banks, where the Fed's regulatory capacity is located.

The discussion draft would appear to give power to the Federal Reserve to preempt a wide range of rules regulating the capital market, power which could be used, unfortunately, to gut investor and consumer protections. If the committee wishes to give more power to the Federal Reserve, we think it should make clear that this power is only to strengthen safety and soundness regulation, and that it must simultaneously reform the Federal Reserve's governance. These powers must be given to a fully public body, and one that is able to benefit from the information and perspective of the routine regulators of the financial system.

We believe a new agency with a board made up of a mixture of the heads of the routine regulators and direct presidential appointees would be the best structure. However, if the Federal Reserve were made a fully public body, it would be an acceptable alternative. Unfortunately, it is reported today that the Fed has rejected Treasury Secretary Geithner's request for a study of the Fed's governance and structure.

We are also troubled by the provision in the discussion draft that would allow the Federal Government to provide taxpayer funds to failing banks and then bill other non-failing banks for the costs. We realize that it is not intended that this be a rescue, but rather a wind-down.

The incentive structure created by this system seems likely to increase systemic risk, from our point of view. We believe it would be more appropriate to require financial institutions to pay into an insurance fund on an ongoing basis. Financial institutions should be subject to progressively higher fee assessments and stricter capital requirements as they get larger, and we think this would actually discourage "too-big-to-fail."

Finally, the discussion draft appears to envision a regulatory process that is secretive and optional. In other words, the list of systemically significant institutions is not public, and the Federal Reserve could actually choose to take no steps to strengthen the safety and soundness regulation of those systemically significant institutions. We think that in these respects, the discussion draft appears to take some of the problematic and unpopular aspects of the TARP and make them a model for permanent legislation.

In closing, Mr. Chairman, I would say that instead of repeating some of the things we did in the bank bailout, Congress should be looking to create a transparent, fully public, accountable mechanism for regulating systemic risk and for acting to protect our economy in any future crises.

On behalf of the AFL-CIO, I want to thank you for the opportunity to testify today.

[The prepared statement of Mr. Trumka can be found on page 308 of the appendix.]

The CHAIRMAN. Next is Richard Baker, president and chief executive officer of the Managed Funds Association.

STATEMENT OF THE HONORABLE RICHARD H. BAKER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MANAGED FUNDS ASSOCIATION (MFA)

Mr. BAKER. Thank you, Mr. Chairman. It is a pleasure to be here today. I shall wait to the end of the proceedings to come to a resolution thereon.

MFA is the primary advocate for sound business practices in industry professionals in hedge funds, funds of funds, and managed futures, as well as industry service providers. MFA is committed to playing a constructive role in the regulatory reform discussion as it continues, as investors' funds have a shared interest with other market participants and policymakers in seeking to restore investor confidence and achieving a stable financial system.

In considering the topic of a Systemic Risk and Resolution Authority, it is important to understand the nature of our industry in taking action. With an estimated $1.5 trillion under management, the industry is significantly smaller than the U.S. mutual fund industry or the $13 trillion U.S. dollar banking industry. Because many hedge funds use little or no leverage, their losses have not contributed to the systemic risk that more highly-leveraged institutions contributed.

A recent study found that 26.9 percent of managers do not deploy leverage at all, while an FSA study in 2009 found that, on average over a 5-year period, leverage of funds was between 2 or 3 to 1, significantly below most public perception. The industry's relatively modest size and low leverage, coupled with the expertise of our members at managing financial risk, means we have not been a contributing cause to the current difficulties experienced by the average investor or the American taxpayer.

Although funds did not cause the problems in our markets, and though we certainly agree with recent statements by Chairman Bernanke that it is unlikely that any individual hedge fund is systemically relevant, we believe that the industry has a role in being a constructive participant as policymakers develop regulatory systems with the goal of restoring stability to the marketplace.

We believe the objectives of systemic risk can be met through a framework that addresses participant, product, and structural issues, which include: a central systemic regulator with oversight of the key elements of the entire system; confidential reporting by every institution, generally to its functional regulator, which would then make appropriate reports to the systemic regulator; prudential regulation of systemically relevant entities, products, and markets; and a clear, single mandate for the systemic risk regulator to take action if the failure of a relevant firm would jeopardize broad aspects of economic function.

We believe these authorities are consistent with the authorities contemplated by the discussion draft. We believe the objectives of systemic risk regulation are best met not by subjecting non-banks to the Bank Holding Company Act, but by developing a framework that adopts a tailored regulatory approach that addresses the different risk concerns of the business models, activities, and risks of the systemically significant firms.

For example, when firms post collateral when they borrow from counterparties, like hedge funds customarily do and as major mar-

ket participants will be required to do under the OTC bill recently passed by this committee, the potential systemic risks associated with that borrowing are greatly reduced, a factor that should mitigate in determining what prudential rules should apply to various market activities.

We believe that smart regulation, facilitated by the OTC, the Advisor Registration, and the Investor Protection bills recently passed by the committee also will greatly reduce the likelihood that a Resolution Authority framework will even need to be implemented.

To the extent that a regulator does need to implement such authority, however, we believe that it should be done in a manner to ensure that a firm's failure does not jeopardize the financial system. However, it should be explicitly stated that this authority should not be used to save firms from failing. It is unclear at the moment whether the authority granted by the proposal would enable assistance to be extended to a firm not leading to resolution of the entity being assisted.

There are other issues that have been raised by members' questions and the testimony earlier today that we would also address. But for the sake of time, I shall conclude by saying we believe that the Systemic Risk and Resolution Authority framework discussed above will address the concerns underlying the Systemic Risk and Resolution Authority bills, while minimizing unfair competitive advantages and moral hazards that can result from market participants having an implied government guarantee.

It is important this framework be implemented in a manner that allows investors, lenders, and counterparties to understand the relevant rules and have confidence those rules will be applied consistently in the future. When investors do not have that confidence, they are less likely to put their capital at risk. And when market function is impaired, we all pay a price.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Baker can be found on page 117 of the appendix.]

The CHAIRMAN. Next, Professor Phillip Swagel, visiting professor at Georgetown.

STATEMENT OF THE HONORABLE PHILLIP L. SWAGEL, VISITING PROFESSOR, McDONOUGH SCHOOL OF BUSINESS, GEORGETOWN UNIVERSITY

Mr. SWAGEL. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. Thank you for the opportunity to testify.

I am a visiting professor at the McDonough School of Business at Georgetown University, and a nonresident scholar at the American Enterprise Institute. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 until January of 2009. I will focus now briefly on the provisions in the legislation, the draft legislation, for enhanced Resolution Authority.

The critical steps that provide certainty to market participants and lead them to believe that costs will be imposed in a crisis will change risk-taking behavior and help make a future crisis less like-

ly. But the enhanced resolution authority in the draft bill does the opposite.

In the end, it provides complete discretion for the government. Put simply, this is a proposal for a permanent and supercharged TARP. The government could deploy public money without further authorization from the Congress, making this a permanent TARP. The government could repudiate contracts, making this a supercharged TARP.

This expansive new Resolution Authority does not provide the certainty that would help avoid future crises, and it would allow the Executive Branch to usurp Congress's prerogatives in this area. Let me mention briefly two specific concerns.

The first is moral hazard. Even though the resolution regime can impose losses on creditors, the fact that ultimately it gives complete flexibility to the government inevitably gives rise to moral hazard. There is a tradeoff between certainty and flexibility, but there should be no doubt that the legislation being discussed today falls squarely on the side of flexibility.

My second concern is that with flexibility to deploy public resources and change contracts outside of a judicial process, there comes a potential for enormous mischief—in the end, the temptation to use the new power in inappropriate ways, ways that were not contemplated when the power was granted.

This is not a theoretical concern. Enhanced resolution authority would allow the government to put money into a private firm and to change contracts. And both of these were done in the recent automobile bankruptcies. Contracts were changed, with the capital structure rearranged to favor junior creditors over senior ones. And the two firms were used as conduits to transfer resources to favored parties.

Now let me be clear at the very beginning. It is entirely legitimate for the President or others to propose the use of public funds to ensure that workers and retirees maintain access to health insurance. That is absolutely legitimate.

But the dedication of such resources should be done through a vote of the Congress, and not embedded in a financial rescue. Moreover, the reordering of the capital structure has the potential to lead to higher costs of financing for future projects, and thus less investment and slower economic growth and less job creation.

It would be difficult for any Administration to resist the temptation to transfer public resources through regulatory authority rather than new legislation. And yet the Administration did not resist this temptation. Even when it must have been clear, absolutely clear, that this action would have a direct negative implication for their own proposal to obtain non-bank resolution authority.

In the event of a future crisis, it would be preferable for Congress to decide to deploy fiscal resources. In the meantime, a better way to provide certainty would be to pursue an improved bankruptcy regime. H.R. 3310 includes such an approach.

My written statement touches upon other aspects of the legislative proposals.

Mr. Chairman and Ranking Member Bachus, thank you again for the opportunity to appear today.

[The prepared statement of Mr. Swagel can be found on page 229 of the appendix.]

The CHAIRMAN. Next, Mr. Scott Talbott, who is the senior vice president at the Financial Services Roundtable.

STATEMENT OF SCOTT TALBOTT, SENIOR VICE PRESIDENT OF GOVERNMENT AFFAIRS, THE FINANCIAL SERVICES ROUNDTABLE

Mr. TALBOTT. Chairman Frank, Ranking Member Bachus, and members of the committee, I am Scott Talbott, as the chairman said, senior vice president of government affairs for the Financial Services Roundtable. Thank you for the opportunity to allow us to appear before you today and address the committee draft on systemic risk, prudential standards, failure resolution, and securitization.

Steve Bartlett would have liked to have been here himself, he was looking forward to it, but he fell victim to H1N1 and felt it was better not to expose his fellow panelists to the flu.

The CHAIRMAN. Let me just say, you can tell Mr. Bartlett I have a general rule. No one need ever apologize for not coming here.

[laughter]

Mr. TALBOTT. I will let him know.

The Roundtable supports greater systemic risk oversight. We support creation of a resolution mechanism. We support more effective prudential supervision. And we agree with asking mortgage securitizers to retain some risk. As such, we commend the committee in addressing these necessary reforms through the creation of a financial services oversight council.

We oppose the idea of "too-big-to-fail," and believe that if a firm is going to fail, it should be allowed to fail. Creative destruction is part of the market system. The key here is to strengthen the regulatory framework to spot developing trends, and then if the firm does fail, to minimize the effects of its demise on the entire system.

Let me turn to the discussion draft and offer our perspectives on a few of the details. First of all, the draft allows for better coordination between prudential regulators. This is a very crucial step necessary to break down the silos that allow, in part, this crisis to develop as it was.

There are other ways, however, to increase the coordination and communication between the prudential regulators. One would be to have a Federal insurance regulator on the council. I know there are proposals working their way through Congress to create an FIO, and we believe that once it is created, like we heard earlier today with the CPA, they should be added to the council.

Additionally, we believe that the Financial Accounting Standards Board should be underneath the council's purview. Accounting standards are integral to protecting the investor, and we believe they should be part of the council.

Next, the discussion draft preserves thrift charters and grandfathers industrial loan charters and their lawful affiliations in commercial companies. However, the limits on cross-marking between the parents and ILCs would restrict activities and their abilities to meet their customers' needs. These standards would freeze the ILCs in time, and would force a company to choose between keep-

ing its ILC and satisfying the ever-changing demands of customers and the markets.

The discussion draft correctly focuses on the U.S. financial firms and does not extend beyond its borders. We should ensure that this regulation, as well as any others, are examined to ensure that they do not conflict or overlay with home country regulations. The G–20 is focusing on this area, and we think they are headed in the right direction.

The draft, unfortunately, focuses, we feel, too much on size and the complexity of the identified financial holding company, and we think that there is excessive authority that is focused, as I said, based solely on size or complexity. And these two factors are not necessarily an indicator of risk to safety and soundness, and we believe that other factors should be considered. And those include liquidity, assets, the quality of assets, and the strength of management.

The discussion draft also places an excessive focus on capital as the answer to safety and soundness concerns. While capital is important, it should not become the siren song, and could overpower economic growth. Any increase in capital, we believe, should be based on activities rather than the size of the institution, and should be applied across the industry regardless of size.

In addition to capital, we recommend a comprehensive approach that focuses not just on capital but activity restrictions where appropriate, prudential supervision, liquidity requirements, as well as prudential standards. We oppose the idea of requiring firms to issue contingent capital as a debt they can convert to equity if the company runs into trouble. This would greatly increase the costs of raising capital.

The standards used in the draft must be examined carefully as well to ensure that the power that is granted under this authority is not exercised unless there is an extreme emergency. You want to make them high enough that they aren't triggered unnecessarily.

On securitization, the draft proposes a 10 percent risk retention requirement for mortgage lenders as well as securitizers. We support the concept of risk retention, but believe that the risk retention provisions contained in H.R. 1728, which called for a 5 percent requirement, are the right one; 5 percent should be the ceiling and not the floor.

Furthermore, the 10 percent risk requirement is unstudied. There have been no hearings on the matter. And we believe that this is a crucial piece that should be discussed further, and should not apply to the FHFA, to Ginnie Mae, as well as the GSE standards. It could have the unintended consequence of significantly limiting securitization and subsequent the ability of a home mortgage finance company, and limit the ability of customers who are trying to seek to purchase a home.

The discussion draft would subject derivative transactions between the bank and its affiliates to a quantitative limit contained in Section 23(a), and we oppose this. We believe that the arm's length standard contained in 23(b) is sufficient.

Additional, the discussion draft would mandate haircuts for unsecured creditors, and we think this would raise the costs of capital going forward.

On the issue of costs, we have heard a lot of testimony today. We support having a post-event assessment. We believe that the $10 billion should be studied so it is not over-inclusive as well as under-inclusive. We believe it should be fair and equitable assessment, possibly on a sector-by-sector basis, or even limited to possible stakeholders.

Finally, the discussion draft should be one—going forward, we should focus on the concept of balance. We want to make sure that we regulate properly, but we don't hinder the ability of markets to serve consumers to promote and sustain economic growth.

I look forward to any questions you may have. Thank you.

[The prepared statement of Mr. Talbott can be found on page 236 of the appendix.]

The CHAIRMAN. Our next witness is Mr. Stephen Kandarian, who is executive vice president and chief investment officer of the Metropolitan Life Insurance Company.

STATEMENT OF STEVEN A. KANDARIAN, EXECUTIVE VICE PRESIDENT AND CHIEF INVESTMENT OFFICER, MetLife, INC.

Mr. KANDARIAN. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for inviting me to testify today. You have asked MetLife for its perspective on the proposals under discussion today. MetLife is the largest life insurer in the United States. We are also the only life insurer that is also a financial holding company.

Because of our financial holding company status, the Federal Reserve serves as the umbrella supervisor of our holding company, in addition to the various functional regulators that serve as the primary regulators of our insurance, banking, and securities businesses, including our State insurance regulators, the OCC, and the SEC.

While I'll comment on certain aspects of the Administration and congressional proposals, I can best contribute to the dialogue on systemic risk and resolution authority by providing some thoughts about the potential impact of the proposals being discussed. My written statement also includes some suggested guidelines that we believe are important to keep in mind as you consider how to improve the securitization process.

Let me start by saying that we support the efforts of Congress and the Administration to address the root causes of the recent financial crisis and to better monitor systemic risk within the financial system. We applaud your thoughtful and deliberate approach to these very complex issues.

The discussion draft proposes to establish a new regulatory structure to oversee systemic risk within the financial system, enhance prudential regulation, and authorize Federal regulators to assist or wind-down large financial companies whose failure could pose a threat to financial stability or economic conditions in the United States.

We recognize the need to identify, monitor and control systemic risk within the financial system, but we are concerned that creating a system under which companies will be subjected to differing requirements based on their size will result in an unlevel playing field and will create new problems.

As proposed, the concept of designating tier one financial holding companies and subjecting such companies to enhanced prudential standards and new resolution authority may address some of the problems we have seen in the financial markets, but it may also create new vulnerabilities, including the creation of an unleveled playing field if tier one status is assigned to only a small number of companies in industry.

Systemic threats can stem from a number of sources in addition to large financial institutions. For example, in 1998, the hedge fund Long-Term Capital Management was not particularly large, but it created a significant amount of potential systemic risk when it was at the brink of failure because of its leverage and the volatility in the financial markets.

Attempting to address systemic risk by focusing a higher level of regulation on a discrete group of companies under a tiered system could result in little or no oversight of those other sources of risk, leaving the financial system exposed to potentially significant problems.

We suggest that Congress consider regulating systemic risks by regulating the activities that contribute to systemic risk without regard to the type or size of institution that is conducting the activity. Linking regulatory requirements to the activity will help close existing loopholes and prevent new regulatory gaps that could be exploited by companies looking to operate under a more lenient regulatory regime.

The discussion draft also introduces a new resolution authority based on the premise that large institutions must be treated differently than smaller ones. While we are pleased that the drafters have excluded certain types of institutions from the enhanced resolution authority provisions, including insurance companies, we are concerned about the potential conflicts the new resolution system may create.

For example, what if the new Federal resolution authority decided to wind-down a financial holding company that also has a large insurance subsidiary? Given their different missions, the Federal resolution authority might seek one treatment of the insurance subsidiary that is in direct conflict to the desires of the State insurance regulators.

As a result, creditors, counterparties, and other stakeholders will likely find it difficult to assess their credit risks to these institutions. These large financial institutions will have to pay a higher-risk premium because of this uncertainty, placing them at a competitive disadvantage both domestically and globally and leading to higher costs that will ultimately be borne by consumers and shareholders.

We believe the current system of functional regulation has worked well in the insurance industry. In our experience, the Fed and the functional regulators have worked cooperatively, sharing information and insights that allow each regulator to perform its function.

In light of the issues outlined here and in my written statement, I will conclude by suggesting that Congress regulate activities that contribute to systemic risk rather than creating a system of regulation that uses size of the financial institution as a key criterion. We

believe that such a system can be more effective, easier to administer, and result in fewer unintended consequences then the proposed tiered structure. Thank you.

[The prepared statement of Mr. Kandarian can be found on page 155 of the appendix.]

The CHAIRMAN. Now, we will hear from Mr. Michael Menzies, who is the president and chief executive officer of Easton Bank and Trust, testifying on behalf of the Independent Community Bankers of America.

STATEMENT OF R. MICHAEL S. MENZIES, SR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, EASTON BANK AND TRUST, CO., ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. MENZIES. Chairman Frank, Ranking Member Bachus, and members of the committee, it's an honor to be with you again. And I'm especially proud to be the chairman of the Independent Community Bankers of America. We represent 5,000 community bank members throughout the Nation.

ICBA appreciates the opportunity to comment on the joint discussion draft that has just been released. Based on our early review, we believe the draft is a substantial improvement over earlier proposals, and we commend you, Mr. Chairman, and your committee for these efforts.

Just a year ago, due to the failure of our Nation's largest institutions to adequately manage their highly risky activities, key elements of the Nation's financial system nearly collapsed. Even though our system of locally-owned and controlled community banks were not in similar danger, the resulting recession and credit crunch have now impacted the financial cornerstone of our local economies, community banks. Accordingly, we recommend that Congress move quickly on this legislation.

We strongly support the provisions of the discussion draft that designate the Federal Reserve as the systemic risk regulator, and that appear to give it sufficient authority to carry out its responsibilities.

We also support the enhanced authority of the Financial Services Oversight Council over the Federal Reserve's decisions. While the Federal Reserve has the expertise and experience to deal effectively with these matters, they are so critical that other agencies must be involved as well.

ICBA is especially pleased that the discussion draft provides the Federal Reserve the authority to require a systemically risky holding company to sell assets or terminate activities if they pose a threat to the company's safety and soundness or the Nation's financial stability. This authority gets to the heart of many of the problems that led to the Nation's financial meltdown.

Some institutions have become so large that they cannot be effectively managed or regulated, and must simply be downsized. ICBA recommends that the legislation direct the Federal Reserve to intensely study each identified financial holding company to determine if it should be subject to this new authority.

The draft legislation appears to give the FDIC ample authority to responsibly resolve systemically risky holding companies. The

bill gives the Treasury Secretary the sole authority to appoint the FDIC as receiver for a failed holding company. This vests a politically appointed official with tremendous power over the Nation's economy.

We recommend that the legislation specifically empower the FDIC, as an independent agency, to recommend to the Secretary that he or she exercise his authority. Downsizing and resolving systemically risky institutions are key to eliminating "too-big-to-fail" from the financial system.

Another important part of the solution of the "too-big-to-fail" problem is contained in the Bank Accountability and Risk Assessment Act introduced by Representative Gutierrez. This bill would make the funding of deposit insurance more risk-based and equitable. We urge the committee to incorporate this measure into broader financial reform.

ICBA recommends that funding for the resolution process for systemically risky holding companies be provided by the largest institutions in advance, rather than after the fact. We believe that a pre-funded resolution process has many advantages. It avoids the initial call on taxpayer funds that would be likely if an institution were to fail unexpectedly, which of course is what happens. It places the cost on institutions that may later fail rather than only on institutions that haven't failed, providing an important equitable balance. And prefunding avoids procyclical effects, tapping the industry for modest, predictable contributions when the times are good.

We strongly support the revisions in the discussion draft that block the creation of additional industrial loan companies that may be owned by commercial firms. This is the last loophole that would allow the mixing of banking and commerce.

Even though the OTC would be merged into the OCC, ICBA is particularly pleased that the discussion draft retains the thrift charter; the vast majority of Federal thrifts have served their communities well.

In that vein, we appreciate continued support of the chairman and the Administration for the current regulatory system as it applies to community banks. It provides valuable checks and balances that would be lost to a single regulatory scheme. I want to convey our appreciation for your efforts and thank you for the opportunity to testify today.

[The prepared statement of Mr. Menzies can be found on page 166 of the appendix.]

The CHAIRMAN. Next is Mr. Peter Wallison, Arthur Burns fellow in financial policy studies at The American Enterprise Institute.

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, THE AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you very much, Mr. Chairman, and thank you, Ranking Member Bachus, for holding this hearing. The discussion draft of October 27th contains an extremely troubling set of proposals, which if adopted will turn over control of the financial system to the government, sap the strength and vitality of our economy, and stifle risk-taking and innovation.

Rather than ending "too-big-to-fail," the draft makes it national policy. By designating certain companies for special prudential regulation, the draft would signal to the markets that these firms are "too-big-to-fail," creating Fannies and Freddies in every sector of the economy where they are designated.

These large companies will have funding and other advantages over small ones, changing competitive conditions in every sector of the financial system. The draft suggests that the names of these companies can be kept secret. That can't happen. The securities laws alone will require them to disclose their special status.

For designated companies, new activities, innovations, and competitive initiatives will be subject to government approval. Companies engaged in activities that the regulators don't like will be forced to divest. That power will ensure that nothing will be done in New York that wasn't approved in Washington.

Commercial companies would be separated from financial activities even though these activities are never separated in the real world. All companies—retailers, manufacturers and suppliers—finance their sales. It's a puzzle how U.S. companies will compete with other foreign companies when they can't finance their own sales.

Another flawed idea in this draft is that there is some kind of discernable line between finance and commerce. That line is political, it's imaginary. For example, to protect the Realtors against competition from banks, Congress has stopped the Fed from declaring that real estate brokerage is a financial activity. Can anyone describe why securities brokerage is financial but real estate brokerage is not? Of course not.

Every industry will be asking for special treatment or exemption if this draft is adopted. The resolution authority is based on the faulty assumption that anyone can know in advance whether a company will—if it fails—cause a systemic breakdown. This is unknowable, but government officials are supposed to make this determination anyway.

With unfettered discretion, officials will follow a better-safe-than-sorry policy, taking over companies that would only create economic disruptions, not full-scale systemic breakdowns. General Motors and Chrysler are an example. They were not systemically important but they were politically important. Their failure would not have caused a systemic breakdown, but would have caused a loss of jobs and other economic disruption.

Companies like these will be rescued, while smaller ones with less political clout will be sent to bankruptcy. The markets will have to guess which will be saved and which will not, creating moral hazard and arbitrary gains and losses.

Worse than giving government officials this enormous discretionary authority is what the draft authorizes them to do with it. They can rescue some companies and liquidate others, pay off some creditors and not others, and using government funds keep failing companies operating for years and competing with healthy companies.

This will not only create uncertainty and moral hazard, but will again give large and powerful firms advantages over small ones. Those that seem likely to be taken over by the government will

have an easier access to credit at lower rates than those likely to be sent to bankruptcy.

In other words, the draft proposes a permanent TARP. It will use government money to bail out large or politically favored companies and then will tax the remaining healthy companies to reimburse the government for its cost of competing with them.

That concludes my testimony, Mr. Chairman.

[The prepared statement of Mr. Wallison can be found on page 312 of the appendix.]

The CHAIRMAN. The next witness is Jane D'Arista, from Americans for Financial Reform.

STATEMENT OF JANE D'ARISTA, AMERICANS FOR FINANCIAL REFORM

Ms. D'ARISTA. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee for inviting me. And I want to say that I'm representing a very large group of organizations that are consumer and non-financial or nonprofit and concerned with the issues of reform, not just consumer issues but the entire panoply.

I would say that President Trumka has laid out many of our concerns about this draft legislation today. I'm going to take the opportunity, if I may, to go into something else, which is to say that obviously it is important that we begin by dealing with crisis management, as you have done in this legislation.

But we must not forget that the important thing to do is not just manage these problems but to prevent them. And I find that the legislation so far comes up short in the preventive era. I would like to talk about two particular issues.

One of them is what I see as an equally important underlying cause of the crisis, and that's the combination of excessive leverage, proprietary trading, and the new funding strategies that go into the repurchase agreements, markets and the commercial paper markets, etc., for financial institutions.

We have here a situation in which leverage has, in effect, monetized debt, because assets are used as backing for new borrowing to add more assets. The evidence of this is that the financial sector has grown 50 percent in the decade from 1997 to 2007, rising to 114 percent of GDP. That is pretty shocking in and of itself.

Proprietary trading is an issue that must be addressed, and it is of concern for a lot of different reasons, one of which of course is that it erodes the fiduciary responsibility of intermediaries.

But equally important is the issue of the fact that what is at stake here is institutions trading for their own bottom line without any contribution to their customers or to the economy as a whole. What money goes in to the financial sector comes from our earnings and our savings, and they have skimmed it off to game it. It is our money that is at risk in this game.

The funding strategies that have been used in order to support leverage and proprietary trading have been the major contribution, in my view, to the interconnectedness of the financial sector. These institutions are borrowing from one another, not from, primarily, from the outside non-financial sector, as a result of which over half of those positions are supplied by other financial institutions. This

is the counterparty issue, this is what we were dealing with when we were dealing with Lehman, AIG, etc., and it is something that absolutely must be addressed.

Finally, briefly, about securitization. Securitization has changed the structure of the U.S. financial system. We have gone from a bank-based system to a market-based system with new rules of the game. We have eroded the bank-based rules that shielded the consumer and the household in this country since the 1930's. These new rules expose households to interest rate risks, market rate risk, etc., but they do so to institutions as well because of the mark to market phenomena they require. You cannot have a market without marking it to market.

But the chart drops against capital that we have seen here, and we have not fully evaluated, have turned capital of our financial institutions into a conduit to insolvency—not a cushion, but a conduit to insolvency.

So what I think is that this committee has a very large plate to deal with going into the future as a preventive set of resolutions. I would urge you to do so not in the direction you're going now, which is to give discretion to too many institutions that we know—the Federal Reserve in particular—but to actually craft the rules of the game that need to be followed in the future.

Thank you very much.

[The prepared statement of Ms. D'Arista can be found on page 138 of the appendix.]

The CHAIRMAN. Next, Mr. Edward Yingling, who is the president and chief executive officer of the American Bankers Association.

STATEMENT OF EDWARD L. YINGLING, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BANKERS ASSOCIATION (ABA)

Mr. YINGLING. Chairman Frank, Congressman Bachus, and members of the committee, thank you for inviting me to testify.

It has been over a year since I first testified before this committee in favor of broad financial reform. This week, the committee is considering legislation that addresses the critical issues that we identified in that testimony, and the ABA continues to support such reform.

The key issues addressed include the creation of a systemic oversight council, addressing key gaps in the regulation of non-banks, addressing "too-big-to-fail," and establishing a regulatory approach to the payment system.

My written testimony addresses these issues more fully, and I want to emphasize we appreciate the progress that has been made in these areas, the areas that are most critical to reform. One very important change in the draft from the original Administration proposal is that the draft maintains the thrift charter. The ABA wishes to thank Chairman Frank for his leadership on this important issue.

In my remaining time, I want to talk about a few areas that need further work, in our opinion. First, there is one glaring omission in the Administration's original proposal and in the draft, the failure to address accounting policy. A systemic risk oversight council

cannot possibly do its job if does not have oversight authority over accounting rule-making.

Accounting policies are increasingly influencing financial policy and the very structure of our financial system. Thus, accounting standards must now be part of a systemic risk calculation. We believe the Federal Accounting Standards Board should continue to function as it does today, but it should no longer report only to the SEC. The SEC's view is simply too narrow. Accounting policies contribution to this crisis has now been well-documented, and yet the SEC is not charged with considering systemic or structural effects. ABA has strongly supported H.R. 1349, introduced by Representatives Perlmutter and Lucas, in this area.

Second, I want to reiterate the ABA's strong opposition to using the FDIC directly for non-bank resolutions. Several weeks ago, the ABA provided a comprehensive approach to resolutions and to ending "too-big-to-fail." The draft, in many ways, mirrors that proposal. However, using the FDIC directly as opposed to indirectly is fraught with problems and is unnecessary.

Putting the FDIC directly in charge of such resolutions would greatly undermine public confidence in the FDIC's insurance for the public's deposits. This confidence is critical and it's the reason we have had no runs on banks for over 70 years, even during this very difficult period.

The importance of this public confidence should not be taken for granted. Witness the lines that formed in front of the British bank, Northern Rock, at the beginning of this crisis, where they did have classic runs. Yet our own research and polling shows that while consumers trust FDIC insurance, their understanding of how it works is not all that deep.

Headlines saying, "FDIC in charge of failed XYZ non-bank" would greatly undermine that trust. Just imagine if the FDIC were trying to address the AIG situation this year, dealing with AIG bonuses and that type of thing. We urge the Congress not to do anything that would confuse consumers or undermine confidence in the FDIC.

We also believe it's a mistake to use existing bank resolution policies in the case of non-bank creditors. Basic bankruptcy principles should be applied in those cases.

Finally, we want to work with the committee to achieve the right balance on securitization reform. We want to work with you to provide for skin in the game on securitization. We understand why there is interest in that, but we need to address the very thorny accounting and business issues involved in having skin in the game.

ABA has been a strong advocate for reform. A good deal of progress has been made through the constructive debate in this committee, and we really appreciate the consideration members have given to our views. Thank you.

[The prepared statement of Mr. Yingling can be found on page 321 of the appendix.]

The CHAIRMAN. I thank you, and we now have—our last witness is Mr. Timothy Ryan of the Securities Industry and Financial Markets Association.

STATEMENT OF T. TIMOTHY RYAN, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. RYAN. I want to thank the committee for this opportunity to appear today. We believe that systemic risk regulation and resolution authority are the two most important pieces of legislation focused on avoiding another financial crisis and solving the "too-big-to-fail" problem.

I testified in support of a systemic risk regulator before this committee nearly a year ago. It is vital to the taxpayers, the industry, and the overall economy that policymakers get this legislation right.

We believe that the revised discussion draft gets most aspects right. We support the general structure it sets up, but given its breadth and its complexity and the short time we have had to review it, we have already identified a number of provisions in the revised draft that we believe could actually increase systemic risk instead of reduce it.

We understand your need to act quickly, but please try to do no harm through the legislative process. My written testimony provides details on the proposals weaknesses. We urge the committee to take the time to correct them. We will work day and night to suggest constructive changes.

Just two examples. We support the idea of an oversight council. We think it should be chaired by the Secretary of the Treasury. We believe it will be beneficial to have input from a number of key financial regulatory agencies. We're also pleased to see that the Federal Reserve would be given a strong role in the regulation of systemically important financial companies.

But we are not sure of the size and composition of the council. We're concerned that the influence of agencies with the greatest experience and stake in systemic risk will be diluted and possibly undermined with a lesser stake. This structure must be reviewed carefully to ensure the council is designed to achieve its goal of identifying and minimizing systemic risk.

Second, resolution authority. We strongly support this new authority, essential to contain risk during a financial crisis and to solve the "too-big-to-fail" problem. The bank insolvency statute is the right model for certain aspects of this new authority.

A Federal agency should be in charge of the process. It should be able to act quickly to transfer selected assets and limit the liabilities to third party. It should have the option of setting up a temporary bridge company to hold assets and liabilities that cannot be transferred to a third party so that they can be unwound in an orderly fashion.

But the bank insolvency statute is the wrong model for claims processing and for rules dividing up the left-behind assets and liabilities of non-bank financial companies. The right model is the Bankruptcy Code. The Code contains a very transparent judicial claims process and neutral rules governing creditors rights that markets understand and rely upon.

By contrast, the bank insolvency statute, the Federal Deposit Insurance Act, contains a very opaque administrative claims process and creditor-unfriendly rules. These may be appropriate for banks,

where the FDIC as the insurer of bank deposits is typically the largest creditor. But the bank insolvency claims process and creditor-unfriendly rules are inappropriate for non-banks which fund themselves in the capital markets, not with deposits.

So there is a very important reason to preserve the bankruptcy model for claims processed for non-banks. If you don't, the new resolution authority will seriously disrupt and permanently harm the credit markets for non-banks, increasing systemic risk instead of reducing it.

We urge the committee to revise the resolution authority so that it takes the best parts of the bank insolvency model and the best parts of the bankruptcy model. That way it will reflect the strengths of both models without reflecting either of their weaknesses.

We and our insolvency experts stand ready to work with you immediately to improve the highly complex and technical resolution authority section.

Finally, we also question whether the FDIC has the necessary experience to exercise resolution authority over the large, complex, interconnected, and cross-border financial groups that are the targets of this legislation. We believe that adding the Federal Reserve to the FDIC board is a step in the right direction, but in order to ensure that the right experience is brought, we think we need a new primary Federal resolution authority.

And I thank you very much, Mr. Chairman, for your courtesy.

[The prepared statement of Mr. Ryan can be found on page 188 of the appendix.]

The CHAIRMAN. Mr. Trumka, I appreciate your staying. I know you had some schedule issues. Let me—one thing you point out, which has to be correcting in the drafting, any ambiguity on preemption of existing statutes would be cleared up. They will be allowed to do capital standards, etc., but no investor protection, no consumer protection. We will make it very clear that is not intended. As some of you have heard me say, I have a favorite phrase to put in the legislation, this bill does not do what this bill does not do. It will not do that.

Secondly, as to reforming the Federal Reserve structure, I had a study done; 90 percent of the dissents at the Federal Open Market Committee are from regional bank presidents and 90 percent of the 90 percent are for higher interest rates. Those are inappropriately placed private businessmen or women, occasionally, picked by other private businessmen and occasionally women, and they should not be setting public policy.

I don't care that the Fed rejected what the Treasury said. That may be a nice discussion among gentlemen. The Fed will not reject it when we, I promise you, next year take up legislatively the issue—and I think it's very clear—you should not have private citizens like the presidents of the regional banks voting on policy, and I guarantee you that won't happen.

So those are two things that we do very much intend to deal with, and I appreciate your calling them to our attention.

Let me just go to Mr. Ryan and—I have to say, you have actually strengthened my view, in one sense, as to how you do the resolu-

tion authority. You say that you don't like what we have picked because it is creditor unfriendly. Yes, that's what we want to be.

Here's the problem, the whole question of moral hazard is one that seemed too creditor-friendly. The argument for moral hazard is that once people think a particular bank is going to be involved in this, they put their money there, they become the creditors of that institution, because they think they are going to be protected.

So frankly, I wasn't quite sure about where the differences are. Yes, we want to be creditor-unfriendly because we want to generate the uncertainty here, because it is the lack of certainty and it is the sense that we are too creditor-friendly that causes the problem.

Now, we also want to address the question of the list. One of my favorite Marx Brothers movie quotes is between Chico and Groucho negotiating a contract, and they're going through each clause, and Chico doesn't like this clause and that clause, and they keep ripping it up, and finally, Chico says, "What's this?" He said, "That's the sanity clause." And Chico says, "You can't fool me. There ain't no sanity clause." Well, "There ain't no list, either."

There may have been a misinterpretation of what I said. Here's my view of this. I will insist that in this legislation, in order to get my support—which is helpful in getting it out of here, not enough, but it's necessary, albeit not sufficient—there will be no identification of a systemically important institution until the hammer falls on it. That is, there will be no two-step process—they're important, what do we do about it? They will know that there is concern about them the day they are given higher capital requirements or told to divest this entity.

Now that's not supposed to be secret. There may have been a misinterpretation. When I said I didn't want there to be a list, people said, we won't tell you what's going on. No, that will be made public. The draft has to be revised. Yes, the regulators will say that's a potentially troublesome institution. I believe that this will be a scarlet letter. I think it will be the opposite of moral hazard.

There will be no list, this is a systemically important institution. There will be a list of the institutions that were considered troubled, and therefore were given higher capital requirements or told they couldn't issue as many of this instrument, or may be broken up, because I want to put in here a kind of institution-by-institution Glass-Steagall that they can put in there.

So I did want to clear those up. Ms. D'Arista, let me just say, I agree in part. As to securitization, we are addressing it. Some people think we're being too tough on it. One other issue, though, that you raised that's intriguing, Paul Volcker has said it, the question of proprietary trading by banks, both risky and anti-competitive. I'm asking the bank to trade for me and they're trading for themselves. In a pinch, who gets the better deal?

And I appreciate it, but I tell you, I have become a little weary of people telling me to solve the problem. You help me solve the problem. You raised it, you say, make rules. Seriously, let me just ask you this, what would you have us do about proprietary trading? I mean that seriously. I think that's on the table. Should we ban proprietary trading by depository institutions or put limits on it? What would we do?

Ms. D'ARISTA. Certainly ban it by depository—

The CHAIRMAN. What's that?

Ms. D'ARISTA. Ban it by depository institutions, yes, because they are in conflict with their clients. But it is a very large problem. I think proprietary trading goes on globally.

The CHAIRMAN. All right, well then send us something in writing. I understand the large—

Ms. D'ARISTA. Okay, all right. The problems—

The CHAIRMAN. You do us no service when you tell us the problem—

Ms. D'ARISTA. Leverage will help, and if you were to extend the idea of the National Bank Act to limit lending to financial institutions, that would be very helpful.

The CHAIRMAN. Let me ask you to do that in writing, because I do think the issue of proprietary trading is one that we would like to work on. If you can send us that in the next week or so—

Ms. D'ARISTA. I would be happy to do that, thank you.

The CHAIRMAN. That would be helpful. Mr. Ryan, I am over my time, but I talked about you. So I will give you a few seconds.

Mr. RYAN. Thank you. Just on uncertainty, there is some uncertainty that we don't like. It's uncertainty that causes a pricing impact—

The CHAIRMAN. No, but here is what we have been told. When we get into—when we're talking about those that would be subject to resolution authority, we're told that there is a moral hazard there because people will now say, "Oh, they're going to be resolved. That means I should put the money there."

I want that to be less creditor-friendly. I want creditors—I want the uncertainty that says, "You know what? That institution is somewhat troubled. Maybe I won't deal with them because I want the institution to have an incentive to stop doing what's troubling people."

Mr. RYAN. May I just say—

The CHAIRMAN. Yes.

Mr. RYAN. —what I fear? What I fear is that uncertainty will cause significant disruptions in the intra-daily markets and—

The CHAIRMAN. Mr. Ryan, isn't it likely to cause—and I apologize, if I can go—isn't it likely to cause a transfer from one institution to another? After all, there will be some institutions that will be on this list and some that won't.

So, what I am trying to do is to convert the fear that being put on the list is a badge of honor into making it a scarlet letter. And I don't see how it would be disruptive, unless there are a whole lot of institutions there. But if only a few institutions are there, they can put their money elsewhere.

Mr. RYAN. We will try to come back to you with some ideas which will get to your—

The CHAIRMAN. All right, I appreciate it.

Mr. RYAN. Thank you.

The CHAIRMAN. I appreciate the indulgence. Let me just say that I want to put into the record an article on the feasibility of systemic risk management by Andrew Lo at MIT—because there is no point in pretending you can do any of this unless you can get the data and make sense of it, and he says you can—and also testi-

mony from the Property Casualty Insurance Association of America on this hearing.

So, I ask unanimous consent that they be put in the record.

The gentleman from Alabama is recognized.

Mr. BACHUS. Thank you, Mr. Chairman. Mr. Chairman, I would like to ask each of the panelists—and maybe just a yes or no, or a very brief response, have you had time since the discussion draft was issued to thoroughly analyze the bill, as far as strengths and weaknesses?

Mr. TRUMKA. No.

Mr. BAKER. No, sir, not enough.

Mr. SWAGEL. No.

Mr. TALBOTT. No.

Mr. KANDARIAN. No.

Mr. MENZIES. No.

Mr. WALLISON. Certainly not all, Mr. Chairman.

Ms. D'ARISTA. No.

Mr. YINGLING. No.

Mr. RYAN. No.

Mr. BACHUS. All right. We hadn't, either, so I appreciate that.

The chairman mentions creditors. I guess you can't have credit without creditors.

So, let me see. There are so many questions I would like to ask. Professor Swagel, you were at Treasury last year. You said that the enhanced resolution authority would create a permanent supercharged TARP?

Mr. SWAGEL. Yes.

Mr. BACHUS. Secretary Geithner and Chairman Frank have repeatedly said that the resolution authority does not provide for bailouts. But you disagree. Is that correct?

Mr. SWAGEL. I do disagree. I listened carefully to the Secretary's testimony, and I understand—his testimony was about what he would intend to do, and I believe him and respect him.

My concern is that the legislation allows much more. And I look at what happened with the TARP. I don't think anyone anticipated all the manifold activities that the TARP would get into. And that's essentially what the text of the legislation allows, as well.

Mr. BACHUS. Mr. Wallison, Secretary Geithner said that the chairman's discussion draft does not provide for the possibility of future bailouts. So what's your perspective on that?

Mr. WALLISON. I was very puzzled to hear the Secretary say that, because there is language in here that does permit things that anyone would consider to be a bailout. That means assistance to an institution that is failing, and then permitting that institution to be brought back to solvency.

Now, under any person's interpretation of what a bailout might be, that is a bailout, because government funds are then used to bring the institution back to solvency, and set it off again competing with others.

In my prepared testimony as well as in my oral testimony, I said that this doesn't seem like either an equitable or sensible thing to do. Because then the costs of the government in keeping that other institution alive, to compete with the existing healthy institutions,

are then taxed to the healthy institutions, which have just been weakened by that assistance.

So, I could not understand what the Secretary was saying, and I would be delighted for someone to interpret it.

Mr. BACHUS. Maybe they hadn't had sufficient time to read the bill.

Mr. WALLISON. Maybe not.

Mr. BACHUS. Mr. Kandarian, you said, and I have said this before, that I think a better approach would be to regulate activities, not institutions. Does anyone else on the panel agree with that, that it would be a better approach? Maybe start with Mr. Trumka.

And let me say this. When you decide that certain institutions will be bailed out and some will not, you make a decision not only that institutions are "too-big-to-fail," you make a determination that 99 percent of institutions—or 99.9—are "too-small-to-save." And that doesn't seem very fair. Mr. Trumka?

Mr. TRUMKA. Would you please repeat the first part of the question?

Mr. BACHUS. Yes. Do you have a problem with—I will just say the last part. Do you have a problem with "too-big-to-fail," as far as from a fairness standpoint?

Mr. TRUMKA. We have a problem with "too-big-to-fail." We would like to prevent people from becoming "too-big-to-fail." Because once they are there, you do not have a lot of choice but to bail them out. So, the goal should be to try to prevent that from happening.

Mr. BACHUS. All right.

Mr. TRUMKA. And make sure that systemic risk doesn't aggregate, even—

Mr. BACHUS. You believe that it's—that activities within an—it's an activity that creates the risk, and it's an institution—I guess I will just go to Mr. Baker, going down.

What do you think about the approach where you regulate activities, and not institutions, as a—

Mr. BAKER. Activities should be the focus, not necessarily assets under management.

Mr. BACHUS. All right, thank you.

Mr. SWAGEL. I would agree with that.

Mr. TALBOTT. I agree. It's not the size; it's the riskiness of the activities.

Mr. BACHUS. Thank you. Mr. Kandarian? We will just go on down the line.

Mr. KANDARIAN. Yes, those were my comments, so certainly I support—

Mr. BACHUS. Yes, you would support it.

Mr. MENZIES. I disagree. Our activities are unbelievably regulated right this minute. It's the size of the institutions.

Mr. BACHUS. What about subprime lending? Do you think it was regulated, or—

Mr. WATT. [presiding] I—

Mr. BACHUS. Can I get the rest of the answers—

Mr. WATT. I am trying to get the rest of your answers in—

Mr. BACHUS. All right, Mr. Wallison?

Mr. WATT. —but you can't—

Mr. BACHUS. You're right. I have—

Mr. WATT. —ask another question and then expect the rest of the—

Mr. BACHUS. You're right. Mr. Wallison?

Mr. WALLISON. As I have testified to this committee before, I don't think any institution can create systemic risk, no matter what its size, unless it is an insured commercial bank.

Ms. D'ARISTA. No, I think size is important. Yes, activities must be regulated. I have advocated that for many years. But management of a very large institution runs another problem that has to be addressed.

Mr. BACHUS. All right. Mr. Yingling?

Mr. YINGLING. I think we need more subtle approaches than just having a somewhat arbitrary list.

Mr. BACHUS. You mean of institutions or activities?

Mr. YINGLING. Of institutions.

Mr. BACHUS. Okay. Mr. Ryan?

Mr. RYAN. I agree with Ed's comments.

Mr. WATT. The gentleman's time has expired. And I will recognize myself for 5 minutes, just to say that every effort that we have tried to regulate as an activity, my colleagues have said they don't want to regulate either.

So, this is one of those situations where it seems to me we're damned if we do and damned if we don't. If we do it based on size, they oppose it. If we do it based on activities, we oppose it. I guess that's what the Minority is designed to do, just oppose something, as opposed to propose something that will solve a problem. But that's—I won't belabor that point.

Now, I know there are people on this panel who are unalterably—maybe they have moderated a little bit—but at least still opposed to the concept of a CFPA. I understand that. But assuming that there is a CFPA, is there anybody on this panel who thinks that the director of that agency shouldn't be on the council that is set up under this bill?

I am not looking for a speech about whether you like CFPA or not. I just want to know whether you think they ought not to be on the council. Yes, sir?

Mr. SWAGEL. Yes, I would not put the director of the CFPA on the systemic risk—

Mr. WATT. We need to do something about your microphone.

Mr. SWAGEL. Sorry about that. I would not put the director of the CFPA on the systemic risk council.

Mr. WATT. Okay. Anybody else who will agree with that?

[No response.]

Mr. WATT. Okay. I won't go into your reasons. Give me your reasons in writing.

Mr. SWAGEL. Okay.

Mr. WATT. I won't take the time to do that. Mr. Yingling, you raised an issue that I raised this morning with the Secretary about dividing the funds, the FDIC fund, which has a brand, obviously, that the public relies on from whatever fund gets created to—either after the fact or before the fact—to deal with this resolution of systemically risky institutions. I think some of the others of us are concerned about that.

You support setting up a fund in advance of a resolution or after the fact?

Mr. YINGLING. I would do it after the fact. I think your—

Mr. WATT. Okay, and who would you tax with the—with putting up the money to put into that fund?

Mr. YINGLING. I think, unfortunately, you end up with something similar. We would have some changes in what the Administration proposed, but some—

Mr. WATT. All right. I understand that. I'm asking you who you would tax. Would it be all financial institutions? Would it be some financial institutions? Would it be institutions above $10 billion? Would it be—who would you tax?

Mr. YINGLING. What we said in our proposal was very similar to what the Administration proposed. We didn't put a number on it.

Having said that, one thing we would like to see is a much stronger provision relating to the fact—and Chairman Bair mentioned this—that you get credit for the fact that you're already paying deposit insurance. So those—

Mr. WATT. Would it be set—

Mr. YINGLING. Those liability—

Mr. WATT. —up as a separate fund, I take it?

Mr. YINGLING. Oh, absolutely—

Mr. WATT. Totally separate from the FDIC?

Mr. YINGLING. Oh, absolutely, but—

Mr. WATT. Called something else? A resolution fund?

Mr. YINGLING. A resolution fund, and we think the agency should not be called the FDIC, it should be called the systemic resolution agency. That is what it is. And that the—

Mr. WATT. Anybody else on the panel—

Mr. YINGLING. You get credit for the fact that you are an—

Mr. WATT. —disagree with that?

Mr. YINGLING. —insured depository.

Mr. WATT. Mr. Menzies, you disagree with—

Mr. MENZIES. I—

Mr. WATT. —separating the funds?

Mr. MENZIES. I'm a victim of my experience as a community banker. We set aside reserves—

Mr. WATT. I don't want to provide a platform for you to give—

Mr. MENZIES. Okay.

Mr. WATT. —a speech about it. I understand you say that.

Mr. MENZIES. We should pre-fund—

Mr. WATT. But this is about the fund, Mr. Menzies.

Mr. MENZIES. We should pre-fund that.

Mr. WATT. You should pre-fund it?

Mr. MENZIES. Absolutely. We should—

Mr. WATT. What are the arguments in favor of pre-funding it, as opposed to doing it after the fact?

Mr. MENZIES. The same logic as applying loan loss reserves.

Mr. WATT. And who would contribute to that fund?

Mr. MENZIES. Those who present some form of systemic risk to our system.

Mr. WATT. And how would you designate those without knowing who they are in advance?

Mr. MENZIES. The industry is not going to be designating those. That's what Congress and the regulators need to do.

Mr. WATT. So we ought to just pick it out of the—Congress ought to make a decision about it and put them on a list? Okay.

We keep going around and around in a circle here. My time has expired. And, let's see, Mr. Royce is next.

Mr. TRUMKA. Mr. Chairman, I was supposed to be out of here—

Mr. WATT. Oh, I'm sorry. I was supposed to make apologies. Mr. Trumka had indicated beforehand that he had to leave, and I was supposed to announce that—

Mr. TRUMKA. At 2:30.

Mr. WATT. —so that it didn't look like he was running out on Mr. Royce. I hope nobody has any objection to that. He has to leave anyway, but you can put your objection in the record, so—

Mr. BACHUS. If he has to leave, he has to leave.

Mr. WATT. You are excused without objection, I believe. You are excused without objection.

Mr. TRUMKA. Thank you.

Mr. WATT. And don't take that out of Mr. Royce's time. Start his clock over.

Mr. ROYCE. Fair enough. Thank you, Mr. Chairman. I had a question for Mr. Wallison, and it went to memory of some of the hearings, and some of the comments.

Back when he was Chairman of the Federal Reserve, Alan Greenspan often mentioned that he believed deposit insurance had an effect of weakening market discipline. He noted that the benefits of deposit insurance are great. But he said, "Explicit safety nets weaken market discipline. It encourages institutions to take on excessive risk."

And I am not arguing here against the benefits of deposit insurance, obviously. But I am concerned that this legislation, by extension, would expand that perceived safety net throughout our financial system, that it wouldn't just be any longer a question of accounts covered by deposit insurance. Suddenly it becomes a problem that ripples throughout the entire financial system.

And I would like to hear your comments on that, or your thoughts on it.

Mr. WALLISON. Thank you very much, Congressman. I think it should be obvious that deposit insurance does enable the taking of risk, and reduces market discipline.

In fact, I think that's why banks are regulated, because once the government is backing their deposits, the only way for the government to protect itself against excessive risk-taking—because the creditors, then, and at least the depositors—have no significant incentive not to lend to an institution that is backed by the government. That is, of course, the whole reason why everyone is supposed to be concerned about "too-big-to-fail." And I was quite surprised by the chairman's comments about "too-big-to-fail."

But if we have a system in which any institution is looked upon as though when it fails, there will be no serious losses to people—and that's what this legislation does—we're in the same position as we are when we have institutions that are covered by deposit insurance—people will have much less concern about lending to them. They will get much more favorable terms.

And, unfortunately, that will enable them to take more risks. And eventually, we end up with failed institutions. Fannie Mae and Freddie Mac are the poster children for exactly that. That was systemic risk writ large, and the American people are now going to have to spend something like $200 billion to $400 billion to pay for the losses that are embedded in their balance sheets right now.

Mr. ROYCE. Now, the chairman's draft legislation would give regulators the ability to shield creditors from losses. Do you agree that making public funds available to soften the blow to private creditors would weaken market discipline, as deposit insurance does?

Mr. WALLISON. Of course. It's the same thing as deposit insurance, and it doesn't really matter very much that eventually the public funds made available to these institutions are then recouped from the rest of the industry or whoever is going to be required to pay these costs.

The important point is the fact that creditors know in advance that they have a much better chance of being paid politically or in some other way through a resolution system than they would have if the companies went into bankruptcy.

Mr. ROYCE. So political pull, or the importance of it, starts to replace market discipline or market forces. And I suspect we could see a lot more activity by those who suddenly begin to focus on that issue.

As the Richmond Federal Reserve has pointed out, roughly half of our financial system—at least in 1999—had some degree of government backing, whether it was explicit or implicit.

I think the critical question in this regulatory reform effort is whether or not our system will benefit from a government safety net covering what is likely today well over half of the liabilities in our credit markets. Considering the unintended consequences that have come about from these types of market distortions, I have a hard time believing this is a good development. And I think we should look to ways to scale back that safety net and enhance market discipline in the system.

And I would ask if you had any additional thoughts on that matter?

Mr. WALLISON. I agree. And one of the problems with the draft legislation is that it actually expands the safety net in very significant ways: reduces market discipline, and guarantees there will be more risk-taking by large institutions—it favors large over small.

And what will happen in the end is the same thing that happened with Fannie Mae and Freddie Mac. We will face huge losses in very large companies that have not been properly disciplined by the market.

Mr. ROYCE. Thank you. Thank you, Mr. Chairman. Thank you, Mr. Wallison.

Mr. WATT. The gentleman, Mr. Himes, is recognized.

Mr. HIMES. Thank you, Mr. Chairman. I have two kind of esoteric questions, which may or may not elicit a response. I hope they do.

The first is on the topic of securitizations. Securitization structured products, like so much of what we're talking about, are real double-edged swords, inasmuch as, used correctly, they increased credit and liquidity. Used incorrectly, or kept off balance sheet, or

poorly rated, they contributed to the place we find ourselves in today.

I am a big believer in the idea incorporated in this proposed legislation of retention, that you keep a piece of whatever it is that you create. I think it's very elegant. It prevents us or the regulators from having to try to sort through securities, because, really, the creator of a structured product, to some extent, will eat his or her own cooking.

I do have real concerns, though, about the stipulated level. The legislation says that you will hold 10 percent of a structured product, perhaps down to 5 percent, no lower than 5 percent. And my problem with that is that I think structured products can have wildly different credit characteristics. You could have a structured product full of agency and treasuries, you could have a structured product full of high-risk stuff.

So, I am really—and I am thinking about, is there some way to link the retention to the credit risk of the product, or to the fees associated with the product, which presumably are higher, if the product is more complex.

I am wondering if there is any comment on what is proposed, vis-a-vis the 5 to 10 percent retention, and whether these ideas I have thrown out maybe have any merit.

Mr. RYAN. Our view—and it has been consistent here—and I believe the chairman asked the same question about a year ago, did we support retention, and I said yes.

We have been working also in Brussels with the European Commission. They are basically at a 5 percent number. We hope they will also provide some flexibility.

Based on your esoteric question—because it really is different risks, depending on the assets that are held. So what we would like to see is 5 percent, not 10 percent, as the high—5, but the flexibility for this systemic council or some other regulator to determine a standard that could be used below that.

Mr. YINGLING. I would agree with your comment, that there needs to be flexibility.

The other problem we have is, particularly for smaller banks, you can only keep 5 percent, and it looks like you have 95 percent off your books. But for accounting and other reasons, you still treat it as though you have 100 percent. So that's the other issue.

Mr. HIMES. Yes, sir?

Mr. TALBOTT. Yes, H.R. 1728, which was, I think, approved by the House, started with 5 percent as the ceiling, and we think that's the right place to start. And I agree with the comments. Start with 5 percent, and then adjust the risk based on the riskiness of the underlying asset.

Mr. HIMES. I am sensing a general assent that maybe one of the guiding principles to retention ought to be the riskiness of the structured product itself. Is that maybe a place to start? Okay. I'm seeing lots of nods.

Mr. TALBOTT. Yes.

Mr. HIMES. Okay. One other esoteric question. Embedded finance companies—I happen to have GE and Pitney Bowes in my district. And, of course, there are other companies that have finance arms that have operated for a long time. Certainly, the way I think

about this project we're embarked on is that we look very hard at those entities that screwed up and contributed to the mess. We look a little less hard, but we look nonetheless at entities that maybe weren't involved, but could—hedge funds, others.

It does seem to me that these embedded companies really weren't part of the problem. And I am glad to see that, versus the original draft, we're not requiring separation. But I am concerned about some of the restrictions, cross marketing, that are in this draft.

So, again, I just would like a general comment on whether you think this threads that needle in a competent way. Yes, sir?

Mr. TALBOTT. Yes, we're pleased that the—it's grandfathered, but the provisions that you mentioned, like the cross marketing, as well as changing ownership, those essentially freeze them in time, and prevent the ILC from changing as the markets change. You risk, if you make a change, that the ILC goes away. And so you lose that flexibility, going forward, to be able to adapt as the markets change.

Mr. HIMES. Thank you. Yes, sir?

Mr. WALLISON. If I can just make a comment on this, the legislation assumes that it is possible to separate finance and commerce. I don't think they can be separated. This has been shown again and again when the Federal Reserve has been required to decide what is a financial activity and what is not a financial activity.

Here, what we are proposing is to take financial activities, whatever they are—and that's going to be a very heavily debated question right here in this committee and in the halls of Congress, generally—separate them from the operations of the company, and then impose restrictions on what that separate financial company can do to help the original parent. That is a very troubling thing to do.

Mr. HIMES. Thank you, Mr. Chairman.

The CHAIRMAN. Time has expired, but I am going to ask for 10 seconds just to say to Mr. Yingling—and you have mentioned this before—I am sympathetic here.

You have talked about the accounting impact. We would be glad to receive from you language that would allow securitization that would not have those broader accounting implications. We are not trying to interfere with accounting, but where we're creating something, we have a right to create it clean.

So, you're right, that should not—that's a serious impediment, and please give us language. We will try to clean that up.

Mr. YINGLING. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. Ms. D'Arista, before you raised the question of proprietary trading and the chairman followed up with it, I had asked the previous panel about that.

Ms. D'ARISTA. I heard you, sir.

Mr. MILLER OF NORTH CAROLINA. In part, because while Chairman Volcker had testified last month that proprietary trading by systemically significant firms should be prohibited, that perhaps customer trading should be allowed, but not proprietary trading.

And Ms. Bair seemed to agree, with respect to the depository institutions, but thought it would be okay in an affiliate within a holding company.

And then Mr. Dugan, not surprisingly, found a reason not to do it at all, and that was that if you required it to be by a separate entity, the entity would still grow to be so large that it would be systemically significant. It certainly occurred to me that there are still reasons to do it, even if all the different entities end up being really big.

One is the market discipline—to use the term that others have used today—that if you're dealing with a company that just does one thing, you focus on that, and do not assume that because they're so big they're going to be good for their debts. Who could imagine Citigroup not being good for their debts? Obviously, it could never ever happen—or Bank of America.

It's impossible to manage a company. Obviously, the CEOs, and certainly the boards of directors, had no idea what the different parts of their companies were doing, the ones that got into trouble.

And finally, it's impossible to regulate. Again, not surprisingly, we have had other discussions of Freddie and Fannie. Everybody seems to have agreed right along that the regulator for Freddie and Fannie was not up to the task, because Freddie and Fannie was so complex.

And they had derivatives in case interest rates went up, they had derivatives in case interest rates went down. And there were only a handful of people on the planet who could figure out what it all meant. And the more lines of business there are that are all complex and opaque, the harder it is to regulate.

Do you agree that even if the separate entities end up being really big, and probably systemically important, that proprietary trading should not be done at the same entity that's doing—that is a depository institution that's doing lending?

Ms. D'ARISTA. I would agree, and I would think that you need to limit proprietary trading across the entire financial system, not only within the conglomerate, but with other institutions.

Typically, this was the province of investment banks in the past, who have changed muchly, as we know.

Mr. MILLER OF NORTH CAROLINA. Right.

Ms. D'ARISTA. I think as I began to say—and I will submit some information about my thinking on this—we could go at this in a number of ways: limiting leverage; limiting counterparty exposure; etc. This will reduce the amount of counterparty trading, or proprietary trading, that is going on.

But you have to understand that the proprietary trading is what blew up, inflated into a balloon, our financial system. We are not Iceland, but we're getting there, if we don't do something about it. In other words, size is important Because of what it means in terms of gross domestic product, in the size of the financial institution itself, of the financial sector, etc.

Where does it get to the point where we don't produce enough in the economy to cover the exposure of our financial sector?

Mr. MILLER OF NORTH CAROLINA. All right. Mr. Yingling, should depository institutions do proprietary trading?

Mr. YINGLING. I don't think they should do it directly in the depository institution. I would agree with Ms. Bair's response to you earlier.

Mr. MILLER OF NORTH CAROLINA. That affiliates within the holding company should do proprietary trading, but—

Mr. YINGLING. Yes, with careful regulation and capital requirements and leverage limits.

Mr. MILLER OF NORTH CAROLINA. Mr. Ryan, you seem to want to be recognized. Were you raising your hand?

Mr. RYAN. I do. Thank you.

Mr. MILLER OF NORTH CAROLINA. Yes.

Mr. RYAN. That's why I came, to answer questions like this.

Mr. MILLER OF NORTH CAROLINA. Okay.

Mr. RYAN. And my view is, first of all, there are different types of proprietary trading. Some have excessive risk, some do not. And that's an important question.

What we have proposed—and I think that your bill proposes, or the Administration's bill proposes—is this type of activity would be in the domain of the systemic risk regulator. They would look to see, are they taking excessive risk? Or, more importantly, are they capable of managing the risks that they're taking?

That is the way I would approach it, because there is such a wide difference between excessive risk in proprietary trading, and some proprietary trading that is not that risky.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. Ms. D'Arista, you said we're not quite Iceland, but we're getting there. Are you suggesting we're going to lose McDonald's?

[laughter]

Ms. D'ARISTA. No, and I perhaps exaggerated for effect.

Mr. CLEAVER. I am—that's—yes. It came through clearly.

But I do have a serious—my kids would think that's serious. But I have an even more serious question. The World Bank president on Monday—Mr. Zoellick—made a speech. And it was a little surprising in the fact that he said that Treasury, rather than the Fed, should be given the authority to regulate systemic risk, because Treasury is an executive department, and that both Congress and the public would have more involvement in how this authority is used than if the Fed is given this authority.

Where do you come down on that?

Ms. D'ARISTA. As President Trumka said, if the Fed were a reform, we would not have a problem with the Fed having the responsibilities that they have been given. I think we do have a problem with the Treasury. The Federal Reserve is an agency of the Congress. And I think that the Congress needs to undertake greater responsibility for overseeing the Fed, both in terms of monetary policy and regulatory policy.

But the idea that the Treasury, the Administration, should assume such a large role is, in my view, a problem.

Mr. CLEAVER. So you are saying that it is de-politicized—I'm asking the question—it is de-politicized if the Fed has the responsibility and authority, as opposed to Treasury, which is appointed by the President and confirmed by the Senate?

Ms. D'ARISTA. Yes and no. I really—looking at the Constitution, and what—

Mr. CLEAVER. We don't do that in here.

Ms. D'ARISTA. Well—

[laughter]

Mr. CLEAVER. Go ahead.

Ms. D'ARISTA. You have the responsibility for creating money and maintaining its value. And that is a responsibility that you passed on to the Federal Reserve.

I don't think you have—I don't think this body has, in recent years, done the job it should have done with the Federal Reserve. But the Federal Reserve is an important institution, it is the central bank, and it has knowledge and reach, and it goes into the issues of external markets, etc.

I think it should be on the council, but not dominate the council. I want the council to have more responsibility, but I don't feel that it should be under the thumb of the Treasury.

Mr. CLEAVER. Mr. Baker, as a former Member of this August body, do you differ with Ms. D'Arista?

Mr. BAKER. Certainly, we feel that a council-like structure would be more appropriate in providing balance and perspective.

I understand the concerns Members have with regard to the Federal Reserve unilaterally engaging. There are certain questions with regard to monetary policy obligations and resolution of particular systemically significant entities, which could create issues. Go back to Mr. Volcker during the Mexican currency crisis, when it was advocated that banks extend credit, notwithstanding concerns about creditworthiness, which created considerable concerns about the integrity of monetary policy formulation and bank lending activity.

This is a very carefully constructed question that I think we should take time to examine. But certainly having a Presidential appointee unilaterally make the decision or have the Federal Reserve make the decision, both are fraught with inappropriate resolution ability.

Mr. CLEAVER. Are any of you aware of any other central bank that has the responsibility for supervising systemic banking risk and managing monetary policy? Any other central bank that does—yes, sir, Mr. Wallison?

Mr. WALLISON. There are other central banks that do that. I think the French central bank does that.

The CHAIRMAN. Did you say the French central bank?

Mr. WALLISON. Yes.

The CHAIRMAN. But I thought they lost monetary policy to the European Bank. So they don't have monetary any more, ECB does.

Mr. WALLISON. Yes, I suppose it's possible, if the ECB has taken over all the central bank responsibilities. But I think the national central banks do continue to have some responsibility for monetary policy within those countries. But I just wanted to mention that they are proposing to do this in the U.K., to return some responsibility to the Bank of England that was taken away.

But it is a troubling idea, because the central bank has important responsibilities, and the idea of giving it responsibilities that would otherwise be handled by a political organ of the government,

in some ways, compromises its independence. And in the United States this is very troubling, because to weaken the dollar through compromising—

The CHAIRMAN. Time has expired.

Mr. WALLISON. —the independence of the central bank is a problem.

The CHAIRMAN. The time has expired.

Mr. CLEAVER. Thank you, Mr. Chairman.

The CHAIRMAN. I think many of the national central banks will welcome your restoring to them powers that I understand they all lament having lost.

The gentleman from California is now recognized.

Mr. SHERMAN. Let me ask the independent bankers, under the recapture provisions, your members could be taxed if they have assets of over $10 billion. Are you confident that every future Administration will not hit you with any significant taxes for the cost of bailing out the big folks on Wall Street?

Mr. MENZIES. I think the answer is, what's the right number? Should it be $10 billion? Should it be $50 billion? Should it be $100 billion? I think that is an economic question and a political question, and I don't have the answer to either.

Mr. SHERMAN. Do you believe any of your members are singly and by themselves systemically important? Not that—yes, obviously, community bankers, as a group, are systemically important. But would you put any of your members in that category?

Mr. MENZIES. We do not believe we have systemically important members. And we do believe we are systemically important to every community we serve.

Mr. SHERMAN. You were saying that you do not believe that any one of your members meets the statutory definition of being—

Mr. MENZIES. Of being systemically important, no.

Mr. SHERMAN. So, none of your members is going to be able to benefit from an implicit Federal guarantee that says, "You are 'too-big-to-fail,' and unsecured creditors will get some sort of bail-out assistance in order to safeguard our economy from systemic risk." Your uninsured creditors don't get any of that, right?

Mr. MENZIES. No. If we fail, we fail. Our uninsured creditors are not paid. It's as simple as that.

Mr. SHERMAN. So do you think that the tax should be imposed on any entity that is too small to be considered "too-big-to-fail?"

Mr. MENZIES. Absolutely not.

Mr. SHERMAN. Okay. Mr. Baker, welcome back.

Mr. BAKER. Thank you.

Mr. SHERMAN. Hedge funds are often under $10 billion. But you folks—some of your members engage in pretty sophisticated—some would say risky—investment strategies. You were careful to point out that many of them don't.

Do you believe that a $9 billion hedge fund with tens of billions of dollars of contingent liabilities should be subject to this tax so that we can recoup the costs of bailing out a systemically important institution?

Mr. BAKER. I think the whole manner of who is assessed, and to what extent, for the failure of an unrelated enterprise—for example, if I am understanding the mark properly, it could be an insur-

ance company that has activities totally unrelated to the hedge fund sector performance. The question becomes, how far does one go in extending the assessment on—financial in nature—outside the sector in which you are performing? So I—

Mr. SHERMAN. Do you think that if we bail out an insurance company, only the insurance companies should pay the tax, and if we bail out a commercial bank, only the commercial banks should pay the tax?

Mr. BAKER. It's unclear as to the economic resolution at the scale of the—the difficulty and the assets of the particular sector. It certainly is something worth a discussion. I would say, as far as my members will go, we are not looking for bailouts. We haven't received a bailout. Now, we—

Mr. SHERMAN. Well—

Mr. BAKER. —fortunately, because of the length of the future, and how uncertain it is, we may be subject to resolution. But the distinction between the two is pretty significant.

Mr. SHERMAN. Let me interrupt and go to Mr. Swagel.

Can you run a modern economy if the major players do not believe that the major players are likely to be bailed out, should it come to that? Can we run this country without bailouts being available when Treasury thinks they ought to be?

Mr. SWAGEL. Right. If the major players think that there is a possibility of a bailout, that will affect their behavior. If, for some reason, as you—

Mr. SHERMAN. So—oh, yes. Obviously, if you go out and tell everybody, as we apparently—unbeknownst to me—did, prior to Lehman Brothers, that everybody like Lehman Brothers is going to get bailed out, and then you don't do it, then you're building the house of cards and then you're not protecting those cards from the wind.

But my question is, can you—

The CHAIRMAN. The gentleman's time has expired.

Mr. SWAGEL. I would just briefly note that Lehman's senior debt was trading at 10 cents on the dollar before it failed, and the auction cleared at 9 cents on the dollar. So people had a pretty good sense of what was going to happen to Lehman.

The CHAIRMAN. The hearing is now adjourned. I thank the witnesses for their persistence in staying through a couple of votes.

And let me say anyone who wants to—we have asked specifically of Ms. D'Arista—but anybody who has any further information to send in, we will be glad to get it.

[Whereupon, at 3:40 p.m., the committee was adjourned.]

A P P E N D I X

October 29, 2009

FOR MORE INFORMATION, call:202-225-4465 • www.house.gov/garrett

EMBARGOED UNTIL DELIVERY
Thursday, October 29, 2009

Contact: Erica Elliott
Phone: 202-744-2693

Garrett Opening Statement for Financial Services Committee Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's Financial Services Committee hearing titled "Systemic Regulation, Prudential Matters, Resolution Authority & Securitization":**

"In the last several months, it was my impression that there was a developing consensus that the Federal Reserve should be given less power, not more. But in reading over this discussion draft in the very limited time we've had to review the most important legislation this committee will consider in most of our lifetimes, I am struck by how much power it is given.

"Although not singled out as a systemic uber-regulator in name, don't be fooled. The Fed is given primary supervision over systemic firms and can even override lesser regulators that won't comply with its wishes.

"In the name of mitigating systemic risk, the Fed is also given unlimited authority to systematically dismantle a private company. This is a lot more sweeping than imposing tougher capital standards.

"I, for one, given the extraordinary government interventions into private firms we've already seen, with the trampling of the rule of law in order to benefit political favorites in the auto bankruptcies for instance, am very uncomfortable with this sweeping, unchecked power – especially for an entity that failed to effectively regulate many of the large bank holding companies already under its purview."

###

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

SYSTEMIC REGULATION, PRUDENTIAL MEASURES, RESOLUTION AUTHORITY AND SECURITIZATION

before the

FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

October 29, 2009

2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding proposed changes under consideration that would improve our financial regulatory system and prevent a recurrence of the costly events of the past year. We need to create a system of macro-prudential supervision and a credible resolution mechanism for systemically important financial firms to address the fundamental causes of the current crisis.

First and foremost, we must find ways to impose greater market discipline on systemically important institutions. Unfortunately, the actions taken during the past year have proven that some financial organizations are too big to fail under our current regulatory regime. This notion creates a vicious circle that needs to be broken.

The financial crisis has taught us that many financial organizations have grown to such size and complexity that, should one of them fail, it could pose systemic risk to the broader financial system. The managers, directors and supervisors of these firms ultimately placed too much reliance on risk management systems that proved flawed in their operations and assumptions. Meanwhile, the markets have funded these organizations at rates that implied they were simply too big to fail. In addition, the difficulty in supervising these firms was compounded by the lack of an effective mechanism to resolve them without damaging the broader financial system.

In a properly functioning market economy there will be winners and losers, and some firms will fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the market's incentive to monitor the actions of similarly situated firms. The most important challenge now is to find ways to impose greater market discipline on systemically important financial organizations.

We have also learned from this financial crisis that market discipline must be more than a philosophy to ward off appropriate regulation during good times. It must be enforced during difficult times. Given this, we need to develop a resolution regime that provides for the orderly wind-down of large, systemically important financial firms, without imposing cost to the taxpayers. In contrast to the current situation, this new regime should not focus on propping up the current firm and its management. Instead, the resolution regime should concentrate on maintaining the liquidity and key activities of the organization so that the entity can be resolved in an orderly fashion without disrupting the functioning of the financial system. Losses should be borne by the stockholders and bondholders of the holding company, and senior management should be replaced. Without a new comprehensive resolution regime, we will be forced to repeat the costly, ad hoc responses of the last year.

My testimony addresses the urgent need to create a credible resolution regime that can effectively address failed financial firms regardless of their size or complexity and assure that shareholders and creditors absorb losses without cost to the taxpayer. This mechanism is at the heart of a sustainable solution -- a comprehensive resolution facility

that will impose losses on shareholders and unsecured debt investors, while maintaining financial market stability and minimizing systemic consequences for the national and international economy. The credibility of this resolution mechanism would be further enhanced by requiring each financial holding company with subsidiaries engaged in non-banking financial activities to have, under rules established by the FDIC, a resolution plan that would be annually updated and published for the benefit of market participants and other customers. Under this requirement, large financial organizations would have to demonstrate that they could be effectively broken up into their functional components and liquidated in an orderly way.

In addition, my testimony discusses the FDIC's perspective on improving the supervision of systemically important institutions and the early identification and remediation of issues that pose risks to the financial system. The new structure should address such issues as the industry's excessive leverage, inadequate capital and over-reliance on short-term funding. In addition, the regulatory structure should ensure real corporate separateness and the separation of the insured bank's management, employees and systems of its affiliates. Risky activities, such as proprietary and hedge fund trading, should be kept outside of insured banks and subject to enhanced capital requirements.

The combined enhanced supervision and unequivocal prospect of an orderly resolution will go a long way to assuring that the problems of the last several years are not repeated and that any problems that do arise can be handled without cost to the taxpayer.

The Need for Improved Resolution Authority

The current crisis has clearly demonstrated the need for a single resolution mechanism for failing financial firms that will restore market discipline by imposing losses on shareholders and creditors and replacing senior management. A timely, orderly resolution process that could be applied to both banks and non-bank financial institutions, and their holding companies, would prevent instability and contagion and promote fairness. It would enable the financial markets to continue to function smoothly, while providing for an orderly transfer or unwinding of the firm's operations. The resolution process would ensure that there is the necessary liquidity to complete transactions that are in process at the time of failure, thus addressing the potential for systemic risk without creating the expectation of a bailout.

Under the new resolution regime, Congress should raise the bar higher than existing law and eliminate the possibility of open assistance for individual failing entities. The new resolution powers should result in the shareholders and unsecured creditors taking losses. Consideration also should be given to imposing some haircut on secured creditors to promote market discipline, limit costs to the receivership, and distribute market losses more broadly. The priority protection given to secured creditors under both the bankruptcy code as well as the FDIC's resolution mechanism creates incentives to rely excessively on short term, secured financing. Too many creditors have looked to the

value of their collateral -- as opposed to the credit worthiness of their counterparties -- in making credit decisions.

Limitations of the current resolution authority

The FDIC's resolution powers are very effective for most failed bank situations. However, systemic financial organizations present additional issues that may complicate the FDIC's process of conducting an efficient and economical resolution. As noted above, many financial activities today take place in financial firms that are outside the insured depository institution and beyond the FDIC's existing authority. These financial firms must be resolved through the bankruptcy process, as the FDIC's resolution powers only apply to insured depository institutions. Resolving large complex financial firms through the bankruptcy process can be destabilizing to regional, national and international economies since there is no protection for the public interest, and the process can be complex and protracted and may vary by jurisdiction.

By contrast, the powers that are available to the FDIC under its statutory resolution authorities can resolve financial entities much more rapidly than under bankruptcy. The FDIC bears the unique responsibility for resolving failed depository institutions and is therefore able to plan for an orderly resolution process. Through this process, the FDIC works with the primary supervisor to gather information on a troubled bank before it fails and plans for the transfer or orderly wind-down of the bank's assets and businesses. Importantly, the FDIC has the authority to create bridge institutions to

maintain the bank's franchise value and critical operations pending their sale. In doing so, the FDIC is able to maintain public confidence and perform its public policy mandate of ensuring financial stability.

Resolution authority for systemically important financial firms

Financial firms often operate on a day-to-day basis with little regard to the legal structure of their affiliates. That is, employees of the holding company may provide vital services to a subsidiary bank because the same function exists in both the bank and the holding company. One affiliate may provide IT services to other parts of the organization. Loan servicing and asset management may also be provided by one affiliate to the insured bank and other subsidiaries. Foreign deposits may fund domestic loans. Some complex derivatives positions are comprised of transactions booked by investment banking affiliates and other transactions booked in the insured bank. This intertwining of functions can present significant issues when trying to wind down the firm. For this reason, there should be requirements that mandate greater functional autonomy of holding company affiliates.

In addition, to facilitate the resolution process, the holding companies should have an acceptable resolution plan that could facilitate and guide the resolution in the event of a failure. Through a carefully considered rulemaking, each financial holding company should be required to make conforming changes to their organization to ensure that the

resolution plans could be effectively implemented. The plans should be updated annually and made publicly available.

Congress should also prohibit open company assistance that benefits the shareholders and creditors of individual institutions. This ban should apply to any assistance provided by the government including lending programs provided by the Federal Reserve Board under Section 13(3) of the Federal Reserve Act. The government should not be in the position of picking winners and losers among poorly managed firms that can no longer function without government assistance. Those institutions should be placed into receivership, and their shareholders and creditors, not the government, should be required to absorb losses from the institution's failure.

This means that Congress should do away with the provision in current law that allows for an exception to the standard claims priority where the failure of one or more institutions presents "systemic risk." In other words, once a systemic risk determination is made, the law permits the government to provide assistance irrespective of the least cost requirement, including "open bank" assistance which inures to the benefit of shareholders. The systemic risk exception is an extraordinary procedure, requiring the approval of super-majorities of the FDIC Board, the Federal Reserve Board, and the Secretary of the Treasury in consultation with the President.

We believe that the only time a systemic risk exception should made available is when there is a finding that the entire system is at risk and that even healthy institutions

cannot obtain access to liquidity. Whatever support is provided should be broadly available and justified in that it will result in least cost to the government as a whole. If the government suffers a loss as a result of an institution's performance under this exception, the institution should be placed into receivership and resolved in accordance with the standard claims priority.

The initiation of this type of systemic assistance should require the same concurrence of the super-majority of the FDIC Board, the Federal Reserve Board and the Treasury Department (in consultation with the President) as under current law. This should be true, whether it is the FDIC or any other governmental entity providing the assistance, including that provided by the Federal Reserve Board through its Section 13(3) authority. In addition, we believe that additional requirements are appropriate for this type of systemic assistance, such as advance consultation with the Congressional leadership and a subsequent audit by the GAO. The risk of moral hazard from such programs is just as acute, whether the assistance is coming from the FDIC or another governmental entity and thus the triggering mechanism should set a very high bar.

Funding Systemic Resolutions

To be credible, a resolution process for systemically significant institutions must have the funds necessary to accomplish the resolution. It is important that funding for this resolution process be provided by the set of potentially systemically significant financial firms, rather than by the taxpayer. To that end, Congress should establish a

Financial Company Resolution Fund (FCRF) that is pre-funded by levies on larger financial firms -- those with assets of at least $10 billion. The systemic resolution entity should have the authorities needed to manage this resolution fund, as the FDIC does for the Deposit Insurance Fund (DIF). The entity should also be authorized to borrow from the Treasury and those borrowings should be repaid by the financial firms that contribute to the FCRF. We believe that a pre-funded FCRF has significant advantages over an ex post funded system. It allows all large firms to pay risk-based assessments into the FCRF, not just the survivors after any resolution, and it avoids the pro-cyclical nature of requiring repayment after a systemic crisis.

Resolution Authority for Depository Institution Holding Companies

To have a process that not only maintains liquidity in the financial system but also terminates stockholders' rights, it is important that the FDIC have the authority to resolve both systemically important and non-systemically important depository institution holding companies, affiliates and majority-owned subsidiaries in the case of failed or failing insured depository institutions. When a failing bank is part of a large, complex holding company, many of the services essential for the bank's operation may reside in other portions of the holding company, beyond the FDIC's authority. The loss of essential services can make it difficult to preserve the value of a failed institution's assets, operate the bank or resolve it efficiently. The business operations of large, systemic financial organizations are intertwined with business lines that may span several legal entities. When one entity is in the FDIC's control while the other is not, it significantly

complicates resolution efforts. Unifying the holding company and the failed institution under the same resolution authority can preserve value, reduce costs and provide stability through an effective resolution. Congress should enhance the authority of the FDIC to resolve the entire organization in order to achieve a more orderly and comprehensive resolution consistent with the least cost to the DIF, after consultation with the holding company's primary regulator.

When the holding company structure is less complex, the FDIC may be able to effect a least cost resolution without taking over the holding company. In cases where the holding company is not critical to the operations of the bank or thrift, the FDIC should be able to opt out -- that is, allow the holding company to be resolved through the bankruptcy process. The decision on whether to employ enhanced resolution powers or allow the bank holding company to declare bankruptcy would depend on which strategy would result in the least cost to the DIF. Enhanced authorities that allow the FDIC to efficiently resolve failed depository institutions that are part of a complex holding company structure when it achieves the least costly resolution will provide immediate efficiencies in bank resolutions.

The Need for Improved Supervision and Regulation

The unprecedented size and complexity of many of today's financial institutions raise serious issues regarding whether they can be properly managed and effectively supervised through existing mechanisms and techniques. Our current system clearly

failed in many instances to manage risk properly and to provide stability. Many of the systemically significant entities that have needed federal assistance were already subject to extensive federal supervision. For various reasons, these powers were not used effectively and, as a consequence, supervision was not sufficiently proactive.

Insufficient attention was paid to the adequacy of complex institutions' risk management capabilities. Too much reliance was placed on mathematical models to drive risk management decisions. Notwithstanding the lessons from Enron, off-balance sheet-vehicles were permitted beyond the reach of prudential regulation, including holding company capital requirements. The failure to ensure that financial products were appropriate and sustainable for consumers caused significant problems not only for those consumers but for the safety and soundness of financial institutions. Lax lending standards employed by lightly regulated non-bank mortgage originators initiated a downward competitive spiral which led to pervasive issuance of unsustainable mortgages. Ratings agencies freely assigned AAA credit ratings to the senior tranches of mortgage securitizations without doing fundamental analysis of underlying loan quality. Trillions of dollars in complex derivative instruments were written to hedge risks associated with mortgage backed securities and other exposures. This market was, by and large, excluded from federal regulation by statute.

A strong case can be made for creating incentives that reduce the size and complexity of financial institutions. Financial firms that pose systemic risks should be subject to regulatory and economic incentives that require these institutions to hold larger

capital and liquidity buffers to mirror the heightened risk they pose to the financial system. In addition, restrictions on leverage and the imposition of risk-based premiums on institutions and their activities would act as disincentives to growth and complexity that raise systemic concerns. In contrast to the standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both their size and complexity. To address pro-cyclicality, the capital standards should provide for higher capital buffers that increase during expansions and are available to be drawn down during contractions. In addition, these firms should be subject to higher Prompt Corrective Action standards under U.S. laws and holding company capital requirements that are no less stringent than those applicable to insured banks. Regulators also should take into account off-balance-sheet assets and conduits as if these risks were on-balance-sheet.

The Need for a Financial Services Oversight Council

The significant size and growth of unsupervised financial activities outside the traditional banking system -- in what is termed the shadow financial system -- has made it all the more difficult for regulators or market participants to understand the real dynamics of either bank credit markets or public capital markets. The existence of one regulatory framework for insured institutions and a much less stringent prudential regulatory scheme for non-bank entities created the conditions for arbitrage that permitted the development of risky and harmful products and services outside regulated entities.

A distinction should be drawn between the direct supervision of systemically-significant financial firms and the macro-prudential oversight and regulation of developing risks that may pose systemic risks to the U.S. financial system. The former appropriately calls for the identification of a prudential supervisor for any firm that raises potential systemic risks. Entities that are already subject to a prudential supervisor, such as insured depository institutions and financial holding companies, should retain those supervisory relationships.

The macro-prudential oversight of system-wide risks requires the integration of insights from a number of different regulatory perspectives -- banks, securities firms, holding companies, and perhaps others. Only through these differing perspectives can there be a holistic view of developing risks to our system. As a result, for this latter role, the FDIC supports the creation of a Council to oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. In addition, for systemic entities not already subject to a federal prudential supervisor, this Council should be empowered to require that they submit to such oversight, presumably as a financial holding company under the Federal Reserve -- without subjecting them to the activities restrictions applicable to these companies.

Supervisors across the financial system failed to identify the systemic nature of the risks before they were realized as widespread industry losses. The performance of the regulatory system in the current crisis underscores the weakness of monitoring systemic risk through the lens of individual financial institutions and argues for the need to assess

emerging risks using a system-wide perspective. The current proposal addresses the need for broader-based identification of systemic risks across the economy and improved interagency cooperation through the establishment of a new Financial Services Oversight Council. The Oversight Council described in the proposal currently lacks sufficient authority to effectively address systemic risks.

In designing the role of the Council, it will be important to preserve the longstanding principle that bank regulation and supervision are best conducted by independent agencies. Careful attention should be given to the establishment of appropriate safeguards to preserve the independence of financial regulation from political influence. To ensure the independence and authority of the Council, consideration should be given to a configuration that would establish the Chairman of the Council as a Presidential appointee, subject to Senate confirmation. This would provide additional independence for the Chairman and enable the Chairman to focus full time on attending to the affairs of the Council and supervising Council staff. Other members on the Council could include, among others, the federal financial institution, securities and commodities regulators. In addition, we would suggest that the Council include an odd number of members in order to avoid deadlocks.

The Council should complement existing regulatory authorities by bringing a macro-prudential perspective to regulation and being able to set or harmonize prudential standards to address systemic risk. Drawing on the expertise of the federal regulators, the Oversight Council should have broad authority and responsibility for identifying

institutions, products, practices, services and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, and completing analyses and making recommendations. In order to do its job, the Council needs the authority to obtain any information requested from systemically important entities.

The crisis has clearly revealed that regulatory gaps, or significant differences in regulation across financial services firms, can encourage regulatory arbitrage. Accordingly, a primary responsibility of the Council should be to harmonize prudential regulatory standards for financial institutions, products and practices to assure that market participants cannot arbitrage regulatory standards in ways that pose systemic risk. The Council should evaluate differing capital standards that apply to commercial banks, investment banks, and investment funds to determine the extent to which different standards circumvent regulatory efforts to contain excess leverage in the system. The Council could also undertake the harmonization of capital and margin requirements applicable to all over the counter (OTC) derivatives activities, and assure that differences in the treatment of OTC derivatives and exchange traded derivatives do not create dis-incentives for derivatives to be centrally traded on exchanges or through CCPs. This would facilitate interagency efforts to encourage greater use of standardized, centrally traded derivatives.

The Council's rulemaking authority should serve as a floor that must be met and could be exceeded, as appropriate, by the primary prudential regulator. Primary

regulators would be charged with enforcing the requirements set by the Council. However, if the primary regulators fail to act, the Council should have the authority to do so. The standards set by the Council should be designed to provide incentives to reduce or eliminate potential systemic risks created by the size or complexity of individual entities, concentrations of risk or market practices, and other interconnections between entities and markets. Any standards set by the Council should be construed as a minimum floor for regulation that can be exceeded, as appropriate, by the primary prudential regulator.

The Council should have the authority to consult with systemic and financial regulators from other countries in developing reporting requirements and in identifying potential systemic risk in the global financial market. The Council also should report to Congress annually about its efforts, identify emerging systemic risk issues and recommend any legislative authority needed to mitigate systemic risk.

Some have suggested that a council approach would be less effective than having this authority vested in a single agency because of the perception that a deliberative council such as this would need additional time to address emergency situations that might arise from time to time. Certainly, some additional thought and effort will be needed to address any dissenting views in council deliberations. However, a Council with regulatory agency participation will provide for an appropriate system of checks and balances to ensure that decisions reflect the various interests of public and private stakeholders. In this regard, it should be noted that the board structure at the FDIC, with

the participation of the Comptroller of the Currency and the Director of the Office of Thrift Supervision, is not very different from the way the Council would operate. In the case of the FDIC, quick decisions have been made with respect to systemic issues and emergency bank resolutions on many occasions. Based on our experience with a board structure, we believe that decisions could be made quickly by a deliberative council.

Conclusion

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial companies, especially those that are systemically important to the financial system. The FDIC stands ready to work with Congress to ensure that the appropriate steps are taken to strengthen our supervision and regulation of all financial companies -- especially those that pose a systemic risk to the financial system.

I would be pleased to answer any questions from the Committee.

MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

RICHARD H. BAKER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing on

Systemic Regulation, Prudential Matters, Resolution Authority and Securitization

---

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

OCTOBER 29, 2009

TESTIMONY OF MANAGED FUNDS ASSOCIATION

Systemic Regulation, Prudential Matters, Resolution Authority and Securitization
October 29, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Financial Services' hearing, "Systemic Regulation, Prudential Matters, Resolution Authority and Securitization" held on October 29, 2009. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies around the world.

MFA appreciates the opportunity to express its views on financial regulatory reform, including the important subjects of investor protection, systemic risk and regulation for managers of private pools of capital, including hedge fund managers. In our view, any revised regulatory framework should address identified risks, while ensuring that private pools of capital are still able to perform their important market functions. It is critical, however, that consideration of a regulatory framework not be based on misconceptions or inaccurate assumptions.

Hedge funds are among the most sophisticated institutional investors and play an important role in our financial system. They provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or improve their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. Hedge funds engage in a variety of investment strategies across many different asset classes. The growth and diversification of hedge funds have strengthened U.S. capital markets and provided their investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, hedge funds help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

To perform these important market functions, hedge funds require sound counterparties with which to trade and stable market structures in which to operate. The recent turmoil in our markets has significantly limited the ability of hedge funds to conduct their businesses and trade in the stable environment we all seek. As such, hedge funds have an aligned interest with other stakeholders, including retail investors and policy makers, in reestablishing a sound financial system. We support efforts to protect investors, manage systemic risk responsibly, and ensure stable counterparties and properly functioning, orderly markets.

Hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were, and remain, substantially less leveraged than

banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance despite the fact that our industry, and our investors, have suffered mightily as a result of the instability in our financial system and the broader economic downturn. The losses suffered by hedge funds and their investors did not threaten our capital markets or the financial system.

Although hedge funds are important to capital markets and the financial system, the relative size and scope of the hedge fund industry in the context of the wider financial system helps explain why hedge funds did not and do not pose systemic risk. With an estimated $1.5 trillion under management, the hedge fund industry is significantly smaller than the U.S. mutual fund industry, with an estimated $9.4 trillion in assets under management, or the U.S. banking industry, with an estimated $13.8 trillion in assets. According to a report released by the Financial Research Corp., the combined assets under management of the three largest mutual fund families are at $1.9 trillion, which exceeds the total assets of the entire hedge fund industry. Moreover, because many hedge funds use little or no leverage, their losses did not pose the same systemic risk concerns that losses at more highly leveraged institutions, such as brokers and investment banks, did. A study by PerTrac Financial Solutions released in December 2008 found that 26.9% of hedge fund managers reported using no leverage. Similarly, a March 2009 report by Lord Adair Turner, Chairman of the U.K. Financial Services Authority (the "FSA"), found that the leverage of hedge funds was, on average, two- or three-to-one, significantly below the average leverage of banks.

Though hedge funds did not cause the problems in our markets, we believe that the public and private sectors (including hedge funds) share the responsibility of restoring stability to our markets, strengthening financial institutions, and ultimately, restoring investor confidence. Hedge funds remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to our capital markets. We are committed to working with the Administration and Congress with respect to efforts that will restore investor confidence, stabilize our financial markets, and strengthen our nation's economy.

I. A "SMART" APPROACH TO FINANCIAL REGULATORY REFORM

MFA supports a smart approach to regulation, which includes focused, effective, and efficient regulation and industry best practices that (i) promote efficient capital markets, market integrity, and investor protection and; (ii) better monitor and reduce systemic risk. Smart regulation will likely entail increasing regulatory requirements in some areas, modernizing and updating antiquated financial regulations in other areas, and working to reduce redundancies, overlaps, and gaps between agencies wherever possible.

A key step in creating a smart regulatory framework is identifying the intended objectives of regulation – strengthening investor protection and market integrity and reducing systemic risk. Doing so will help ensure that proposals are considered and applied in a focused manner to achieve those objectives, which is likely to improve the

functioning of our financial system. Not doing so runs the risk of creating more harm than good, as we witnessed last year with the SEC's ban on short selling.

A smart regulatory framework should include comprehensive and robust industry best practices designed to achieve the shared goals of monitoring and reducing systemic risk and promoting efficient capital markets, market integrity, and investor protection. Since 2000, MFA, working with its members, has been the leader in developing, enhancing and promoting standards of excellence through its document, *Sound Practices for Hedge Fund Managers ("Sound Practices")*.[1] As part of its commitment to ensuring that *Sound Practices* remains at the forefront of setting standards of excellence for the industry, MFA has updated and revised *Sound Practices* to incorporate the recommendations from the best practices report issued by the President's Working Group on Financial Markets' Asset Managers' Committee. MFA and other industry groups have also created global, unified principles of best practices for hedge fund managers.

Because of the complexity of our financial system, an ongoing dialogue among market participants and policy makers is a critical part of the process of developing smart, effective regulation. MFA and its members are committed to being active, constructive participants in the dialogue regarding the various regulatory reform topics.

Regulation is not a panacea for the structural market breakdowns that still exist in our financial system. One such structural breakdown is the lack of certainty regarding major public financial institutions (*e.g.*, banks, broker dealers, insurance companies) and their financial condition. Investors' lack of confidence in the financial health of these institutions has been, and may continue to be, an impediment to investors' willingness to put capital at risk in the market or to engage in transactions with these firms, which, in turn, are impediments to market stability. The comprehensive stress tests earlier this year on the 19 largest bank holding companies were designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. While those stress tests appear to have helped develop greater certainty, we believe that it is also important for policy makers and regulators to ensure that accounting and disclosure rules are designed to promote the appropriate valuation of assets and liabilities and consistent disclosure of those valuations.

Though regulation cannot solve all of the problems in our financial system, careful, well thought out financial regulatory reform can play an important role in restoring financial market stability and investor confidence. The goal in developing regulatory reform proposals should not be to throw every possible proposal into the regulatory system. Such an outcome will only overwhelm regulators with information and added responsibilities that do little to enhance their ability to effectively fulfill their agency's missions. The goal should be developing an "intelligent" system of financial regulation, as former Fed Chairman Paul Volcker has characterized it.

---

[1] MFA's *Sound Practices* is available at: http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf

We believe that regulatory reform objectives generally fall into three key categories. Those categories are: investor protection, market integrity and prudential regulation, including registration of advisers to private pools of capital; systemic risk regulation; and regulation of market-wide issues, such as short selling. I would like to focus my testimony today on systemic risk regulation, including a resolution authority framework.

II. SYSTEMIC RISK REGULATION

I would like to highlight what we believe are the key aspects of systemic risk regulation as well as offer some thoughts on some of the key aspects of the systemic risk framework set out in the Administration's *"Bank Holding Company Modernization Act of 2009"* and the discussion draft of the *"Financial Stability Improvement Act of 2009"* (together, the "Systemic Risk Proposals") as well as the Administration's and discussion draft of the *"Resolution Authority for Large, Interconnected Financial Companies Act of 2009"* (together, the "Resolution Authority Proposals").

The first step in developing a systemic risk regulatory regime is to determine those entities that should be within the scope of such a regulatory regime. There are a number of factors that policy makers are considering as they seek to establish the process by which a systemic risk regulator should identify, at any point in time, which entities should be considered to be of systemic relevance. Those factors include the amount of assets under management of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants. MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, as Chairman Bernanke said in response to a question at the October 1st hearing before the Committee,[2] the industry should be considered within the systemic risk regulatory framework, especially in terms of information gathering. We also agree with the statement made by Chairman Bernanke in response to a question at that hearing that no individual hedge fund is likely to become systemically relevant. As policy makers and regulators seek to determine whether any individual hedge fund is of systemic relevance, it is important that consideration be given to the relatively small size of hedge funds compared to other financial institutions, the relatively low levels of leverage used by hedge funds, and the narrower focus of hedge funds. As institutional investors, hedge funds do not provide payment and settlement services to the public nor are hedge funds licensed to open bank accounts or brokerage accounts for the public. For these reasons, and others, any losses that hedge funds may have experienced may have disappointed their investors and managers, but did not cause systemic risk during this global crisis.

It is also important to define the intended objectives of systemic risk and resolution legislation. It is our understanding that the intended objectives are to develop enhanced prudential regulation that allows systemically relevant firms to continue to conduct business, but do so in a manner that reduces the likelihood of systemic risk and of a firm becoming "too big to fail", but to provide a resolution framework that is capable

---

[2] Hearing on *"Federal Reserve Perspectives on Financial Regulatory Reform Proposals"* before the House Committee on Financial Services.

of dealing with any situation when a failing firm could jeopardize the entire financial system.

We support those objectives and believe that they are best achieved through a framework that addresses participant, product and structural issues that can cause systemic risk. It is important in developing and implementing the systemic risk framework to do so in a manner that avoids the unfair competitive advantages gained by market participants with a government guarantee and also avoids the moral hazards that can result from a company having a government guarantee. It is also important that the framework be developed and implemented in a manner that allows investors, lenders and counterparties to understand relevant rules and have confidence that those rules will be applied consistently in the future. When investors do not have that confidence, they are less likely to put their capital at risk in our markets. The ad hoc nature and lack of clarity with respect to certain government programs over the past year has had adverse effects with respect to the willingness of investors and lenders to put capital at risk, with negative consequences for our markets and our economy.

To achieve the objectives of reducing the potential systemic risks of systemically relevant entities and developing appropriate resolution authorities, MFA believes that the systemic risk and resolution authority framework should have the following components:

- A central systemic risk regulator with oversight of the key elements of the entire financial system, across all relevant structures, classes of institutions and products, and an assessment of the financial system on a holistic basis;
- Confidential reporting by every financial institution, generally to its "functional" regulator, which would then make appropriate reports up to the systemic risk regulator, providing information that the regulator determines is necessary or advisable to enable it to adequately assess, on both a current and a forward-looking basis, potential risks to the financial system;
- Direct, prudential regulation of entities determined to be systemically relevant by the systemic risk regulator;
- A clear, singular mandate for the systemic risk regulator to protect the financial system, including the ability to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system, though such authority should be implemented in a way that avoids the unfair competitive advantages gained by market participants with a government guarantee and also avoids the moral hazards that can result from a company having a government guarantee;
- Clear rules regarding prudential regulation and resolution authorities so that investors, lenders and counterparties have certainty regarding the regulatory framework relevant to their activities; and
- Ensuring that the systemic risk regulator has adequate authority to enable it to be forward-looking to prevent potential systemic risk problems, as

well as the authority to address systemic problems once they have arisen; and implements that authority by focusing on all relevant parts of the financial system, including structure, classes of institutions and products.

MFA Views on the Systemic Risk Proposals

MFA believes that the above approach is generally consistent with the approach taken in the Systemic Risk Proposals. In particular, we are supportive of the Proposals' approach of creating a central systemic risk regulator and a mechanism designed to foster greater communication and coordination among financial regulators. We also support risk reporting, which we believe should generally be made to the financial institution's functional regulator, who will in turn provide reports to the systemic risk regulator, though it is critical that such reporting be done on a confidential basis. We also generally support the Systemic Risk Proposals' approach to systemic risk regulation, which calls for strong, prudential regulation of systemically relevant firms, though we encourage policy makers to consider what type of heightened regulation is appropriate for different types of systemically relevant firms.

Because there will likely be significant differences in the business models of systemically relevant firms, with different risks associated with those businesses, we believe appropriately tailored regulation of systemically relevant firms, rather than one-size-fits-all regulation of those firms, is the appropriate approach to systemic risk regulation. In this regard, we support the approach of the Systemic Risk Proposals in providing the systemic risk regulator with authority to differentiate among systemically relevant firms based on their risk, complexity, financial activities, and other factors the regulator deems appropriate.

We are concerned, however, with the approach taken in the Systemic Risk Proposals of subjecting non-bank, systemically relevant firms to the Bank Holding Company Act (the "BHCA"). The BHCA was designed principally to separate banking and commercial activities for depository institutions. While the BHCA may be an appropriate systemic risk regulatory framework for banks, if it were applied to non-bank, systemically relevant firms, the BHCA's restrictions regarding engaging in commercial activities would impose unfair and inappropriate burdens on those non-bank firms. In particular, we are concerned with several specific aspects of the Systemic Risk Proposals, including those that would:

- Subject non-bank, systemically relevant firms to section 4 of the BHCA, which was designed to impose significant restrictions on the ability of bank holding companies to engage in non-banking activities;

- Fail to protect the confidentiality of potentially proprietary information reported to the systemic risk regulator; and

- Impose the holding company model on all systemically relevant firms, which does not seem appropriate for investment advisers and their funds, which are not structured as parent/subsidiaries.

These BHCA restrictions could effectively preclude non-bank, systemically relevant firms from conducting their primary business (such as investing in a range of commercial entities), which would lead to significant, adverse consequences for our capital markets and our economy.

In addition, we believe the focus on capital requirements is misapplied with respect to investment firms. Capital requirements are primarily intended to provide a cushion, as a form of prudential regulation, to ensure that institutions that have obligations to the public (such as bank depositors, insurance policyholders, or the government) are able to meet those obligations despite losses they may suffer on their lending or other activities. On the other hand, investment firms manage other people's money, not their own capital. They may leverage the equity capital they receive from investors by borrowing from counterparties (usually on a collateralized basis) or making investments with inherent leverage (*i.e.*, futures or options) and putting up margin as collateral. Their counterparties are thus able to protect themselves without capital requirements for the investment firm because they can look to the collateral or margin that has been posted. Moreover, investment firms have no access to taxpayer funding, and any losses the funds they manage experience are borne by the investors in those funds. If the public policy objective is to limit the potential systemic risk that the investing activities of such firms may have, the more effective way to achieve that is through leverage limitations and appropriate collateral and margining regimes.

Instead of subjecting non-bank, systemically relevant firms to the BHCA, we encourage policy makers to develop a new framework for systemic risk regulation of these firms. With respect to the prudential regulation of non-bank, systemically relevant firms, we believe that this new framework should provide a systemic risk regulator with the authority to:

- Require non-bank, systemically relevant firms to report to the systemic risk regulator, on a confidential basis, information that the regulator determines is necessary or advisable to enable it to adequately assess, on both a current and a forward-looking basis, potential risks to the financial system, equivalent to the proposed reporting to the SEC envisioned under the "*Private Fund Investment Advisers Registration Act 2009*";

- Conduct supervision and inspections with respect to non-bank, systemically relevant firms;

- Establish limits on the amount of leverage that a non-bank, systemically relevant firm may use, giving appropriate consideration to factors such as the nature of the firm's strategy and assets and whether the firm posts collateral to protect the counterparty extending leverage;

- Establish margining or collateral requirements for the investment activities of non-bank, systemically relevant firms, giving appropriate consideration to factors such as the nature of a firm's strategy and assets; and

- In extreme cases, require non-bank, systemically relevant firms to reduce their market and counterparty exposure.

MFA Views on the Resolution Authority Proposals

As stated above, MFA supports a resolution authority framework that provides a regulator with the ability to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system. In that regard, MFA is generally supportive of the Resolution Authority Proposals. In particular, we are supportive of the approach of giving the regulator a strong set of authorities to take a variety of actions as it deems appropriate once the regulator has determined that such intervention is necessary to avoid significant, adverse systemic consequences.

It is critical that the regulator implements its resolution authority in a way that avoids the unfair competitive advantages gained by market participants that have a government guarantee and also in a way that avoids the moral hazards that can result from a company having a government guarantee. We are concerned, however, that the Resolution Authority Proposals do not sufficiently protect against this risk because it does not establish a clear policy mandate to the resolution authority with respect to the regulator's implementation of its extensive authority. We believe policy makers should establish a clear mandate to the regulator that the regulator should use its authority only to ensure an orderly resolution of the systemically relevant entity for the purpose of reducing systemic risk. We believe that, without such a mandate, certain systemically relevant entities may be perceived as being "too big to fail", which would create the unfair competitive advantages discussed above.

We also believe that it is important for policy makers to ensure that the resolution authority framework is consistent with the systemic risk framework. We are concerned, however, that the Resolution Authority Proposals and the Systemic Risk Proposals as currently drafted have some ambiguities with respect to how they interrelate. The Resolution Authority Proposals are unclear regarding whether all critically undercapitalized, systemically relevant entities are within their scope, or whether only a subset of such companies are within their scope. It is also unclear, for example, whether critically undercapitalized, systemically relevant entities will be subject to mandatory bankruptcy proceedings, as contemplated by the Systemic Risk Proposals, or an alternative resolution regime, as contemplated by the Resolution Authority Proposals. We encourage policy makers to clarify these ambiguities so that all relevant parties, including market participants and regulators, have a clear understanding of how these related frameworks are intended to work together.

CONCLUSION

Hedge funds, as sophisticated institutional investors, have important market ıctions, in that they provide liquidity and price discovery to capital markets, capital to npanies to allow them to grow or turn around their businesses, and sophisticated risk nagement to investors such as pension funds, to allow those pensions to meet their ıre obligations to plan beneficiaries. MFA and its members appreciate that smart ulation helps to ensure stable and orderly markets, which are necessary for hedge ıds to conduct their businesses. We also appreciate that active, constructive dialogue ween policy makers and market participants is an important part of the process to 'elop smart regulation. We are committed to being constructive participants in the ulatory reform discussions and working with policy makers to reestablish a sound ıncial system and restore stable and orderly markets.

MFA appreciates the opportunity to testify before the Committee. I would be ›py to answer any questions that you may have.

Embargoed until
October 29, 2009, at 9:30 a.m.

Statement of

John E. Bowman
Acting Director, Office of Thrift Supervision

regarding

Systemic Regulation, Prudential Matters, Resolution Authority and Securitization

before the

Committee on Financial Services
United States House of Representatives

October 29, 2009

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W.
Washington, DC 20552
202-906-6288

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on

Systemic Regulation, Prudential Matters, Resolution Authority and Securitization

Before the Committee on Financial Services
United States House of Representatives
October 29, 2009

Statement of John E. Bowman
Acting Director, Office of Thrift Supervision

I. Introduction

Good morning, Chairman Frank, Ranking Member Bachus and members of the Committee. Thank you for the opportunity to testify today on "Systemic Regulation, Prudential Matters, Resolution Authority and Securitization." We appreciate the Committee's efforts to improve the supervision of the nation's financial institutions and to prevent a recurrence of problems affecting the housing market, the financial sector and the larger economy.

In this testimony, I will present the views of the Office of Thrift Supervision on the draft bill, the Financial Stability Improvement Act of 2009.

II. OTS Views on Financial Regulatory Reform Legislation

Financial Services Oversight Council

The OTS strongly supports the establishment of a Financial Services Oversight Council (Council) made up of the Secretary of the Treasury and all of the Federal financial regulators. Among other responsibilities, the Council would identify entities that should be designated as systemically important. The Council would also issue formal recommendations for the financial regulators to adopt material prudential standards for such firms and to set risk management standards for systemically important systems and activities regarding payment, clearing and settlement.

The draft bill provides a regime to resolve systemically important firms when the stability of the financial system is threatened. The resolution authority would supplement and be partially modeled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act.

OTS's view on these aspects of the draft bill is guided by our key principle that any financial reform package should create the authority to supervise and resolve all systemically important financial firms. The U.S. economy operates on the principle of healthy competition. Enterprises that are strong, industrious, well–managed and efficient succeed and prosper. Those that fall short of the mark struggle or fail; other, stronger enterprises take their places. Enterprises that become "too big to fail" subvert the system

when the government is forced to prop up failing, systemically important companies — in essence, supporting poor performance and creating a "moral hazard."

The establishment of a strong and effective Council would create a mechanism for each of the financial regulators to provide their valuable insight and experience to the systemic risk regulator.

Supervision and Regulation of Large, Interconnected Financial Firms

As noted in the previous section, the OTS strongly supports the supervision and regulation of large, interconnected financial firms. There is a pressing need for a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose unacceptable risk to financial stability. The systemic risk regulator should have the authority and the responsibility for monitoring all data about markets and companies, including, but not limited to, companies involved in banking, securities and insurance.

The continued ability of banks, thrifts and other entities in the United States to compete in today's global financial services marketplace is critical. A systemic risk regulator should be charged with coordinating the supervision of conglomerates that have international operations. Safety and soundness standards, including capital adequacy, risk management and other factors, should be as comparable as possible for entities that have multinational businesses.

Supervision and Regulation of Federal Depository Institutions

The OTS strongly supports fixing what is broken in the nation's financial regulatory framework by addressing the problems that caused the current financial crisis and could cause the next one. As noted in previous testimony, the OTS believes that merging agencies does not fit into that category. Because the thrift charter and thrift institutions would continue to exist, the industry would be better regulated and consumers would be better served by retaining the OTS, a primary regulator that understands the operations of consumer and community lenders. For this reason, the OTS does not support the merger of the OTS and the Office of the Comptroller of the Currency (OCC), or the establishment of a single federal bank regulator that would merge the OTS, OCC and the state bank supervisory functions of the Federal Reserve Board and the Federal Deposit Insurance Corporation.

In addition, the OTS is particularly troubled by the proposed merger approach envisioned by the revised version of the draft scheduled for mark-up. The discussion draft represents a significant departure from the Administration's white paper on Financial Regulatory Reform and the original legislative language, both of which would have abolished both the OTS and the OCC, and established a new agency called the National Bank Supervisor. The discussion draft would instead preserve the OCC and create within the OCC a new Division of Thrift Supervision.

If Congress concludes that merging agencies would accomplish an important public policy goal, then we believe Congress should reorganize federal bank supervision for the 21st Century by establishing a strong new agency with a name that is recognizable to consumers and accurately reflects its mission. The Office of the Comptroller of the Currency has not had currency-related functions since the Banking Act of 1935 retired national bank currency in favor of Federal Reserve notes.

Moreover, if employees of both the OTS and the OCC had an equal opportunity to compete for positions, then the resulting agency would be more cohesive and would benefit from the most qualified and capable workforce and leadership. If this bill were to pass as currently drafted, OTS employees would be singled out and put at a significant disadvantage vis-à-vis their counterparts at other agencies. The situation would be particularly onerous for OTS employees who are not examiners and who would not work directly in the Division of Thrift Supervision. Instead of having a fair opportunity to obtain a position in the reconstituted agency based on merit and on-the-job performance, they would be folded into current divisions of the OCC.

We are concerned that OTS employees could regard this approach as unfair and punitive, and that such an approach would send the wrong signal to the OTS workforce, as well as to all federal employees. We also believe that this approach would run the danger of establishing an agency without the unity and harmony necessary for any successful enterprise.

An important way the Committee could mitigate the impact would be to include for OTS employees all of the employee protections included in the bill to establish the Consumer Financial Protection Agency (CFPA). Most important among these protections would be a five-year protection from a reduction in force. Such protections are not included in the draft bill that was available to us for review and we believe strongly that OTS employees should be accorded the same treatment as prospective CFPA employees.

As currently drafted, the draft bill would send the wrong message to all federal employees about how they would be treated in an agency consolidation. The timing of such a signal could hardly be worse, when a large percentage of federal employees are nearing retirement age and federal agencies are redoubling their efforts to attract the workforce of the future to respond to the call to federal service.

The OTS has an outstanding, highly skilled and experienced workforce. If regulatory consolidation takes place, a merger of equals into a new agency would assure better employee morale, a better work environment and a higher-quality outcome.

Congress should model its approach to agency consolidation on the recent merger of the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board into the new Federal Housing Finance Agency.

We strongly urge the Committee to reaffirm that Congress values the service of federal employees and to ensure that the draft bill promotes a fair, even-handed approach that would result in a harmonious agency with employees hopeful about the future of the agency and their role in it.

Regulation of Savings and Loan Holding Companies

Under the Committee discussion draft, most thrift holding companies would become bank holding companies under the Bank Holding Company Act of 1956. The proposed changes would also apply to the unitary savings-and-loan holding companies that were grandfathered in the Gramm-Leach-Bliley Act of 1999. Such an entity would be required to form and register a special-purpose holding company to be governed by regulations drafted by the Federal Reserve Board.

The OTS does not support forcing thrift holding companies to be regulated by the Federal Reserve Board. This conversion would constitute an unnecessary and costly burden, especially to small thrifts that did not contribute in any way to the financial crisis.

This proposal seems to assume that thrift and bank holding companies are the same. The OTS knows this is not the case. Consumer and community lenders, particularly mutual institutions, and their holding companies are vastly different from large, complex banks and their diversified holding companies. The overwhelming majority of thrift holding companies need to be regulated by their prudential regulator not

for their systemic significance, but for the impact of their operations on the underlying insured depository institutions.

The OTS position is guided by the key principle that changes to the financial regulatory system should address real problems. This provision does not address a real problem. As is the case with the regulation of thrift institutions, OTS believes that entities became savings-and-loan holding companies based on their business models, typically of providing everyday financial services to America's consumers and communities. The OTS is not the proper regulator for systemically significant conglomerates, but the agency is indeed the proper regulator for the holding companies of community-oriented thrifts that engage in relationship banking in cities and towns across the nation.

The OTS supervises both thrifts and their holding companies on a consolidated basis. Under the draft bill, thrifts and their holding companies would be supervised by different agencies. We believe that the OTS, the prudential supervisor of thrifts, should continue to regulate their holding companies, except in the case of a thrift that is systemically significant.

Savings-and-loan holding company supervision is an integral part of OTS oversight of the thrift industry. OTS conducts holding company examinations concurrently with the examination of each thrift subsidiary, supplemented by off-site monitoring. We believe the consolidated regulation of the thrift and its holding company

has enabled us to effectively assess the risks of the entire entity, while retaining a strong focus on protecting the Deposit Insurance Fund.

The OTS has a wealth of expertise and a keen understanding of small, medium-sized thrifts, including mutual thrifts, and their holding companies. Consolidated supervision is particularly important for these entities, because separate regulation of the thrift and holding company would be especially costly, burdensome and inefficient for them. We are concerned that if the Federal Reserve became the regulator of these holding companies, it would focus most of its attention on the largest holding companies to the detriment of small and mutual savings-and-loan holding companies.

However, as mentioned earlier, the OTS believes a systemically important savings-and-loan holding company should be regulated by the systemic regulator. This is consistent with our key principle that any financial reform package should create the ability to supervise and resolve all systemically important financial firms.

Enhanced Resolution Authority

The OTS strongly supports providing a resolution regime for all systemically important firms. Given the events of recent years, it is essential that the federal government have the authority and the resources to act as a conservator or receiver, and to provide an orderly resolution of systemically important institutions, whether banks, thrifts, bank holding companies or other financial companies. The authority to resolve a distressed systemically important firm in an orderly manner would ensure that no bank or

financial firm is "too big to fail." A lesson learned from recent events is that the failure or unwinding of systemically important companies has a far reaching impact on the economy, not just on financial services.

III. Conclusion

In conclusion, the OTS strongly supports the Committee's goals of creating a system of financial regulation that ensures protections for consumers, while building a strong supervisory framework to prevent another financial crisis. Although we disagree with some of the details, we agree that the time for reform is now.

Thank you again, Mr. Chairman, Ranking Member Bachus, and Members of the Committee, for the opportunity to testify on behalf of the OTS.

We look forward to continuing to work with the members of this Committee and others to fashion a system of financial services regulation that better serves all Americans and helps to ensure stability for this nation's economy.

Statement of Jane D'Arista[1]
Representing Americans for Financial Reform
Before the Committee on Financial Services
Hearing on
"Systemic Regulation, Prudential Matters, Resolution Authority and Securitization"
October 29, 2009

Chairman Frank, Ranking Member Bachus and Members of the Committee, it is a privilege to appear before you to testify on the Titles of the draft legislation under discussion today. These provisions address the need to improve crisis management and offer reforms to address the long-festering problems that caused the financial sector to unravel in 2007 and 2008. It is now widely acknowledged that changes in the regulation and structure of the financial system and the behavior of its largest institutions resulted in a level of fragility that caused a freeze on lending within the financial sector and to the real economy. The proposed legislation recognizes these changes, offers remedies to deal with the problems they have caused and to prevent a recurrence of the events of 2007-2008.

While the importance of derivatives' contribution to systemic fragility has been discussed in earlier hearings, the various titles of the draft legislation under discussion today recognize that another major cause of the crisis was the interconnections among the largest financial institutions. These interconnections were the result of their borrowing and lending to one another to fund proprietary trading – the buying and selling of assets and derivatives for their own rather than customers' accounts. As the borrowing within the financial sector rose to higher multiples of their capital, the system became undercapitalized; it became more likely that any interruption in the ability of leveraged institutions to fund the huge positions their borrowings had created could erode their capital cushions to the point of insolvency.

[1] Jane D'Arista is a Research Associate at the Political Economy Research Institute (PERI) and Co-Coordinator of its Committee of Economists and Analysts for Financial Reform.

In addition, the short-term funding strategies on which the largest institutions increasingly relied also contributed to the system's vulnerability and to an explosion of global liquidity as assets were monetized through their use as collateral for borrowing to buy more assets. The liquidity that resulted from rising leverage exacerbated the inherent procyclicality of the system, expanding credit over the course of the boom years and leading to a rapid contraction as the downturn developed.

Meanwhile, the profound change in financial structure brought about by the rise in securitization magnified the risks caused by leverage and short-term borrowing. Securitization transformed a bank-based system into a market-based system and the expansion in holdings of tradable asset-backed securities by every segment of the financial industry changed the rules of the game in ways that increased the vulnerability of non-financial sectors to disturbances originating in finance. The wider application of fair-value accounting affects banks and pension funds in ways that have introduced market risk to households, businesses and state and local governments – a risk from which they were partially shielded under a bank-based system.

Discussions of how the problems that contributed to the crisis should be addressed tend to focus on points that lie somewhere between two distinct approaches. One relies on the discretion of authorities to identify systemic risk and on higher capital requirements to prevent future problems. Another, the so-called "macroprudential approach", views credit expansion as the crux of the problem. It advocates two main reforms: first, a return to the quantitative restrictions that were removed by the pressure for deregulation and second, the introduction of countercyclical regulatory and monetary tools to control the growth of the financial sector and the way that growth affects the real economy.

The remainder of my testimony will elaborate briefly on these points and offer support for my view that the revival of quantitative tools offers the better approach to preventing a repetition of the problems that caused the financial crisis; that without the use of quantitative tools to strengthen the framework of prudential regulation, the risk that another systemic crisis will occur is real.

The Growth in Leverage

The rise in financial sector debt from 63.8 percent to 113.8 percent of GDP over the decade from 1997 to 2007 is a telling indicator of how leverage bloated the system.[2] Addressing the fundamental ways in which the system failed will require an understanding of how leverage contributes to liquidity in a boom, feeds bubbles and causes implosions when bubbles burst. During the credit boom that fed the housing bubble, rising levels of borrowing inflated the size of individual institutions and the financial sector as a whole, fueled the increase in financial industry profits and made possible the excessive levels of compensation doled out to managers and employees of the largest firms.

The scale of leverage was exacerbated by deregulation – in particular, the Financial Services Modernization Act (Gramm-Leach-Bliley) of 1999 that permitted banks to borrow in order to fund traditional and nontraditional financial investments and the Securities and Exchange Commission's relaxation of the leverage limit for investment banks from $12 to $30 per $1 of capital in 2004. The collapse of Bear Stearns, Lehman Brothers and AIG and the subsequent infusions of capital, loans and guarantees to creditors of the largest institutions by the Treasury, the Fed and the FDIC revealed the extent to which excessive leverage throughout the financial system had made many institutions vulnerable to any event that might threaten their ability to roll over the funding that supported their inflated balance sheets.

Proprietary Trading

Mounting leverage within the financial sector made possible the extraordinary growth in proprietary trading over the last decade as commercial banks joined investment banks and hedge funds in using borrowed funds to make investments for their own accounts rather than the accounts of customers. Profits earned by engaging in proprietary trading are larger than earnings on services to customers but also much riskier. In effect, the

[2] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts,* various issues.

proprietary trading of commercial and investment banks enabled them to produce high profit levels like those the growing number of hedge funds were reporting over the same period.

Higher leverage ratios made it possible for institutions to borrow much more without adding more capital backing, to take much larger (and thus more risky) positions and to make substantial profits on investments with relatively low margins. Moreover, many institutions were attracted by an additional incentive: their trading accounts were booked off balance sheet and not monitored by regulators or scrutinized by credit rating agencies. As a result, proprietary trading exacerbated risk while leaving the system seriously undercapitalized.

An equally critical problem is that proprietary trading creates conflicts of interest as it puts institutional traders in competition with their customers. Anticipating changes in market prices based on information about clients' buy-sell orders, institutions can evade discovery or restrictions if they use off-balance-sheet trading positions to engage in "front running" by placing orders for their own accounts before executing trades for their customers. Such behavior is obviously inconsistent with their fiduciary responsibility as intermediaries. Moreover, since financial resources are ultimately derived from the earnings and savings of nonfinancial sectors, the profits financial institutions earn by trading for their own accounts produce no benefits for either the economy as a whole or for those whose money is really at risk in the game.

As proprietary trading accelerated the growth of leverage, it also caused problems for central banks in both developed and developing countries. Carry trades drove up the volume of international capital flows and exerted a substantial influence on interest rate differentials and exchange rates as institutions borrowed short-term at low interest rates to invest in higher-yielding long-term assets. At the end of the 1990s and again after 2005, the so-called yen-dollar carry trade made up a substantial share of proprietary trading. Converting yen borrowed at low interest rates into dollars to buy assets that paid higher rates depressed the value of the Japanese currency, caused the dollar to appreciate

and produced gains for traders from differences in interest rates and currency appreciation. The scale of carry trade activity is unreported and unknown. But the fact that the unwinding of positions in the wake of the collapse of a large hedge fund (Long Term Capital Management) in 1998 caused the yen to appreciate 7 percent in a single day in October and 17 percent by the end of the year bears out warnings that the international markets have become an arena for speculation,[3]

Leverage Changes Funding Strategies

Rising levels of leverage and the growth of proprietary trading expanded the market for repurchase agreements (repos) which are essentially short-term borrowings backed by pledges of securities. In the decade from 1991 to 2001, repos used as a source of funding for commercial and investment banks, finance companies and hedge and private equity funds rose from $230 billion to $788 billion. By year-end 2001, liabilities for repos were larger than checkable deposits and equaled 20 percent of banks' total deposits. At the end of 2007, security repos had jumped three-fold to $2.4 trillion before falling back to $1.8 trillion as the credit crunch unfolded in the fourth quarter of 2008. The peak year for financial sector borrowing through security repos was 2006 when their increase was only one-third less than the increase in checkable and time deposits.[4]

The dramatic rise in the use of security repurchase agreements had the effect of intensifying the interconnectedness of financial institutions. Half or more of the financial sector's liabilities for repos in the years after 2001 were held as assets by other financial institutions. Other sources of funding for US financial institutions were foreign banks and the commercial paper market. A substantial share of the commercial paper used by banks, investment banks, finance companies and other financial institutions to fund traditional investments and off-balance-sheet positions was bought and held by other financial institutions, especially money market mutual funds (MMMFs). The extent to which intra-sector borrowing and lending contributed to systemic risk was dramatically

[3] International Monetary Fund, *Global Financial Stability Report,* various issues Bank for International Settlements, *Annual Report,* various issues.
[4] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts,* various issues.

demonstrated by the threat Lehman Brothers' collapse posed for other financial institutions and the degree of government intervention it prompted.

Because such a large share of financial sector funding was borrowed in the short-term repo and commercial paper markets, the loss of confidence triggered by the Lehman bankruptcy almost immediately caused a halt in funding for the major financial institutions. Many institutions were unable to roll over the loans they had used to buy assets and were forced to sell those assets at whatever prices were offered. Others faced calls for additional collateral as prices of the assets backing outstanding loans declined. The unwillingness of financial institutions to lend to one another caused what some see as an implosion in the financial sector. Others saw the freeze as a run on the financial sector by the financial sector itself. There was no protection against the capital charges that threatened the solvency of a number of institutions. Indeed, the requirement for fair value accounting for tradable assets made the capital of financial institutions a conduit to insolvency rather than a cushion from it.

Securitization

Because of its profound impact on the structure of financial markets, securitization – packaging pooled loans for resale in securities markets – is among the most important financial innovations that emerged in the final decades of the 20th century. As the process gained momentum, a larger share of the credit banks supplied to households was transformed into securities issued by investment banks and sold to institutional investors. At the same time, there was a symmetrical shift in households' savings from banks to pension and mutual funds. As a result, the major portion of borrowing and saving by households moved to the capital markets and the scale of that shift transformed US financial structure from a bank-based to a market-based system.

Securitization erased many of the protections households had enjoyed under the bank-based regulatory structure put in place by New Deal reforms in the 1930s. As the debt and savings of this sector became increasingly exposed to interest rate and market risk,

the IMF noted that households had become the shock absorbers of last resort for the financial system.[5] Subsequently, they were called on to absorb the consequences of the risks that had brought the system to collapse in 2008 when, as taxpayers, they undertook the role of rescuing financial institutions from flawed markets for opaque securitized assets.

The choice of securitization as a solution to a volatile interest rate environment was first made in the early 1970s as rising interest rates in the unregulated international banking market caused severe disintermediation for a domestic system in which interest rate caps had been imposed in 1933. For almost 40 years, interest rate caps had made it possible for depository institutions to make 30 year fixed-rate mortgage loans and had contributed to financial stability. But as institutions lost deposits to the external market, the government sponsored agencies (GSEs - Fannie Mae, Freddie Mac and Ginnie Mae) were authorized to create a secondary market for outstanding mortgage loans to address the problems faced by savings institutions and banks in holding mortgages in portfolio without access to funding.

The problem for these institutions intensified when, at the end of the 1970s, interest rate ceilings became meaningless as the Fed's efforts to break inflation led to rate increases that were effectively driving mortgage lenders to the brink of insolvency. The Monetary Control Act of 1980 ended rate ceilings and, given that thrifts could only make housing-related loans, their only rational response was to offer adjustable rate mortgages (ARMs) that shifted the interest rate risk to the homebuyer and proved to have only limited popularity. Meanwhile, the thrift industry continued to sink under a legacy of long-term, low-interest-rate mortgage loans. The scale of the problem was apparent in the expansion of the GSEs' role in buying and securitizing mortgages. By the end of 1983, mortgage-backed securities (MBS) issued by these agencies totaled $253 billion or 20 percent of outstanding residential mortgages.[6]

---

[5] International Monetary Fund, *Global Financial Stability Report,* April 2005.
[6] Jane D'Arista, *Rebuilding the Framework for Financial Regulation,* Briefing Paper No 231, Economic Policy Institute, 2009.

The Secondary Mortgage Market Enhancement Act of 1984 gave securitization a further boost by exempting private issues of MBS from registration and disclosure in favor of reliance on assessments by a few nationally recognized rating agencies. After passage of the Act, the MBS market expanded rapidly as less-regulated, non-depository lenders such as mortgage brokers and finance companies increased their role in originating and selling mortgages. By the end of the 1980s, every segment of the financial industry had begun to buy, hold and trade MBS. The privileged position of the MBS market – both private and public – contributed to the build-up of the housing bubble. And as MBS filtered into every corner of US financial markets and beyond, the impact of the rising price of housing gave a substantial boost – and posed a major threat – to the net worth of American households. When the bubble burst, households' net worth fell because of the drop in the prices of their homes and then fell further as the value of MBS held in pension and mutual funds declined.

Meanwhile, the absence of capital restrictions on banks' securitization exposures under the original Basel Capital Adequacy Agreement of 1988 and the unregulated status of many mortgage originators resulted in an undercapitalization of what had become the largest US credit market. As the market developed, most MBS carried high ratings and continued to do so even as the volume of sub-prime mortgages increased. Credit rating agencies, originators, issuers and investors appeared to believe that securitization could actually diminish the risk of sub-prime mortgages when pooled. However, as the crisis unfolded, the absence of disclosure about the pools of mortgages backing these securities contributed to the severe disruption in confidence that exacerbated the credit crunch and made efforts to negotiate loan work-outs far more difficult than in the past. Moreover, managing the crisis has required unprecedented levels of government intervention, including the conservatorship of Fannie and Freddie.

Going forward, however, it is difficult to believe that pressure for securitizing mortgages as well as car loans and other forms of consumer credit will not continue. The removal of interest rate ceilings for depository institutions and their ongoing exposure to a volatile interest rate environment means that holding long-term mortgages and even medium-term

car loans in portfolio remains a threat to solvency that no increase in capital requirements could alleviate. Reform proposals will, therefore, need to address the concerns that have been raised by this innovative financial technique.

New Rules of the Game?

Treasury Secretary Timothy Geithner has said that addressing the fundamental ways in which the system failed will require comprehensive reform – not modest repairs at the margin, but new rules of the game. Many of the provisions of the draft legislation meet those criteria and others propose needed repairs. But there are a number of issues that are not addressed.

One of the more comprehensive reforms proposed, the creation of a Financial Services Oversight Council under Title I, is a much needed addition to the regulatory framework. Its role in evaluating firms and activities that are systemically important will enhance oversight and increase the availability of information to regulatory agencies and Congress. But I am among those who argue that authority to actually designate and deal with so-called Tier I institutions should be given to the Council rather than, as under Title II, to the Fed. Much has been said about the failure of the Fed to recognize and deal with the growing fragility of the system in the years before the crisis and the fact that Title XIII requires the central bank to obtain written permission from the Treasury before using its emergency lending powers suggests that expanding Fed powers should be approached with extreme caution.

Another important contribution to reform is the move toward more comprehensive regulation of the financial system embedded in Title VIII. Increasing the Fed's role in supervising risk management standards for systemically important payment, clearing and settlement activities conducted by nonbank financial institutions and giving the Fed authority to supervise financial market utilities that have no other supervisory agency is more than a marginal repair. Nevertheless, Section 806 takes a step backward from rigorous oversight by extending lender-of-last-resort privileges to these institutions while

exempting them from reserve requirements and thus freeing them from the obligation to participate as a channel for the Fed's monetary influence.

The provisions of Title III offer proposals for clarifying the regulatory framework and Title XII deals with gaps in the authority of regulatory agencies to liquidate or otherwise resolve holding companies that have been designated as Tier 1 institutions. They reflect the need for clarifications to meet current conditions but they do not address the causes of the financial crisis or ways to prevent future crises. Most of the relevant preventive measures in these Titles are included in the provisions of Title VI which tighten regulations for transactions involving affiliates and subsidiaries of bank holding companies.

Arguably, the most important provision of the bill in terms of crisis-prevention is Section 609 of Title VI. This section treats credit exposures on over-the-counter derivatives, repurchase agreements and reverse repurchase agreements as extensions of credit for purposes of tightening loan-to-capital limits for national banks. The provision may have the desired effect of reducing balance sheet concentrations. However, it should be strengthened by extending the margin requirements introduced in the 1930s to cover purchases of all financial instruments, not just equities. By targeting all financial and nonfinancial investors, margin requirements would be more effective in reducing concentrations that lead to asset bubbles.

Moreover, while Section 609 makes a real contribution to changing the rules of the game, it also points up the absence of many other provisions needed for comprehensive reform. For example, the loan-to-capital limits on credits to individual non-financial borrowers under the National Bank Act should also be extended to financial institutions in order to rein in the web of interconnections that has increased systemic risk. Other quantitative measures are also needed to prevent the reemergence of institutions that threaten the stability of the system. These include maximum loan-to-value ratios on the asset side of lenders' balance sheets and – given that leverage played so large a role in exacerbating

systemic risk – explicit leverage ratios for the liability side of the balance sheets of all large financial institutions.

A notable omission in the bill is the absence of provisions dealing with proprietary trading. Re-imposing leverage limits at lower levels would help moderate the activity. But given the absence of benefits to the economy and the extensive potential for conflicts of interest with customers, it could be (and has been) argued that banning the practice altogether is justified. Meanwhile, proprietary trading continues and the profits (and potential bonuses) it provides have permitted repayment of TARP funds by some large institutions. This has been interpreted as signs of renewed systemic stability. In reality it has perpetuated systemic risk and made it more difficult to remove FDIC guarantees for the liabilities of these institutions.

In dealing with problems posed by securitization, Title IX makes an important contribution in extending the registration, disclosure and reporting requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 to securitizers of asset-backed securities. More important, it requires any securitizer to retain an economic interest in the credit risk associated with the assets underlying the securitization and adds requirements for information on loan levels, the compensation of brokers and originators and how much credit risk the originator has retained. These provisions will bring greater transparency to the process but more is needed. For example, requiring that securitized products be traded on exchanges would add real time information on prices and the volume of trading. Another improvement would be to encourage the use of covered bonds as a complement or replacement for securitization.

The use of covered bonds gives lenders access to long-term funding from investors and protects them against the interest rate and market risk of having to roll over short-term funding while holding long-term assets. It requires that assets be ring-fenced to protect bondholders against the credit risk posed by the lender while ensuring that the lender retains full exposure in the event that one or more of the loans becomes non-performing or defaults. Thus it gives both lenders and funders strong incentives to diligently screen

the credit risks they assume. Over time, the use of covered bonds would alter the structure of credit markets by reviving the role of portfolio lending, effecting a profound change that would increase market stability and mitigate the effects of fair value accounting on capital held by institutions across the financial system.

In summary, I would urge the Committee to choose rules over discretion – to add the quantitative rules that can moderate the growth of financial institutions, control excessive credit expansion and prevent the recurrence of the economic tragedy we have experienced as a result of the failure of our financial system.

Thank you for your time and attention.

Secretary Timothy F. Geithner
FINAL Written Testimony
House Financial Services Committee
October 29th, 2009

Chairman Frank, Ranking Member Bachus, members of the House Financial Services Committee, it is a pleasure to appear before you today as we continue working towards comprehensive reform of our financial system.

The Chairman and the Committee have made important progress over the past several weeks.

Against strong opposition, you have acted swiftly to lay the foundation for far-reaching reform that would better protect consumers from unfair and fraudulent lending practices, regulate the derivatives market, improve investor protection, reform credit rating agencies, and extend basic oversight to hedge funds and other unregulated financial entities.

Today, the Committee carries that momentum forward, tackling an extremely difficult and important issue: how to prevent excessive risk-taking by large financial firms and make sure that when those firms fail during a future crisis, the government can contain damage to the economy without imposing costs on taxpayers.

Over the past few decades, we have seen the significant growth of large, highly leveraged financial firms. These firms benefited from the perception that the government could not afford to let them fail, creating a classic moral hazard problem.

During the recent financial crisis, in order to preserve the stability of the financial system, protect the savings of Americans and prevent greater economic fallout, the government was forced to step in and stand behind almost all of these firms. That cannot happen again.

No financial system can operate efficiently if financial institutions and investors assume that the government will protect them from the consequences of failure. We cannot put taxpayers in the position of paying for the losses of large private financial institutions. We must build a system in which individual firms, no matter how large or important, can fail without risking catastrophic damage to the economy.

In June, the Administration outlined a comprehensive set of proposals to achieve this goal. Since then, after extensive work, the Chairman has drafted new legislation.

We believe that the test for any effective set of reforms is whether it has five key elements. And we believe that the Chairman's bill meets that test.

Orderly Resolution of Failing Financial Institutions

First, the federal government must have the ability to resolve failing major financial institutions in an orderly manner, with losses absorbed not by taxpayers but by equity holders, unsecured creditors and, if necessary, other large financial institutions.

In all but the rarest of cases, bankruptcy will remain the dominant tool for handling the failure of non-bank financial firms. But as the collapse of Lehman Brothers showed, the Bankruptcy Code is not an effective tool for resolving the failure of a global financial services firm in times of severe economic stress.

The Bankruptcy Code focuses almost exclusively on maximizing the interests of a firm's creditors, with little or no concern for spill-over effects on the financial system or the economy. It often moves too slowly. And it contains too few mechanisms for the stabilization of critical operations of a failed firm.

Recognizing this, Congress established a separate resolution regime for banks and thrifts, allowing the Federal Deposit Insurance Corporation (FDIC) to accomplish orderly failures of depository institutions. We need to adapt this effective and proven mechanism to address the significant risks associated with the failure of large financial institutions.

Under the proposed special resolution authority, a failing firm would be placed into an FDIC-managed receivership. The purpose of the receivership would be to unwind, dismantle, sell, or liquidate the firm in an orderly way that protects the financial system at lowest cost to taxpayers. Shareholders and other providers of regulatory capital of the failing firm would be forced to absorb losses, and managers responsible for the failure would be replaced.

Such an approach allows the government to reduce the risk that failure would result in panic by creditors and shareholders of other firms and helps maximize recovery of the value of the firm's assets.

Use of the proposed resolution authority would only be permissible if a financial firm is in default or in danger of imminent default; if the failure of the firm would have serious adverse effects on financial stability; and if use of the proposed regime would avoid or mitigate those adverse effects. We need strong checks and balances and any action would require agreement by the FDIC, the Federal Reserve, and the Treasury, in consultation with the President.

No Open-Bank Assistance to Failing Financial Institutions

The second element of effective reform is making sure that any individual firm that puts itself in a position where it cannot survive without special assistance from the government must face the consequences of failure.

The proposed resolution authority would not authorize the government to provide open-bank assistance to any failing firm. In other words, it would not permit the government to put money into a failing firm unless that firm is in government receivership and on the path to being unwound, sold or liquidated.

The authority would facilitate the orderly demise of a failing firm, not ensure its survival, and would strengthen market discipline and reduce moral hazard risks.

Protecting Taxpayers from Losses

The third element of effective reform is making sure that taxpayers are not on the hook for any losses that might result from the failure and subsequent resolution of a large financial firm.

The government should have the authority to recoup any such losses by assessing a fee on large financial firms. These assessments should be stretched out over time, as necessary, to avoid adding to the pressure induced by the crisis.

Such an ex-post funding mechanism has several advantages over an ex-ante fund. Most notably, it would generate less moral hazard because a standing fund would create expectations that the government would step in to protect shareholders and creditors from losses. In essence, a standing fund would be viewed as a form of insurance for those stakeholders.

Limiting the Federal Reserve's and the FDIC's Emergency Authorities

The fourth element of effective reform is limiting the emergency authorities of the FDIC and the Federal Reserve so that they are subject to appropriate checks and balances and can be used only to protect the financial system as a whole.

These authorities should only allow for temporary support, with an appropriate fee, that is designed to enable healthy institutions to continue operating and to prevent the disruption of credit flows during a severe economic downturn.

Specifically, the Federal Reserve's ability to extend credit to failing non-bank firms under section 13(3) of the Federal Reserve Act should be eliminated. Going forward, the Federal Reserve should be able to use 13(3) only to provide liquidity to solvent firms during periods of severe stress in the financial markets or US economy.

Use of the Federal Reserve's 13(3) authority should require prior written consent of the Treasury. With these reforms, the Federal Reserve would preserve its valuable central bank authority to act as the lender of last resort for a financial system in crisis, but would no longer be able to come to the rescue of failing firms such as Bear Stearns or AIG.

The FDIC should only be able to provide liquidity or guarantees to solvent non-bank financial firms with strong checks and balances. Any such use must be authorized by the Treasury and two-thirds of the boards of the Fed and the FDIC. In addition, any use must be recouped with assessments on the largest non-bank firms.

Stronger Constraints on Size and Leverage

The fifth element of effective reform is giving the federal government stronger supervisory and regulatory authority over major financial firms, and making sure that key financial markets and market infrastructure have buffers strong enough to absorb losses associated with periods of financial stress.

Regulators must be empowered with explicit authority to force major financial firms to reduce their size or restrict the scope of their activities when necessary to limit risk to the system. This is an important tool to deal with the risks posed by the largest, most interconnected financial firms.

Regulators must be able to impose tougher requirements – most crucially, stronger capital rules and more stringent liquidity standards – which would reduce the probability that major financial firms experience financial distress, either through capital depletion or a run by creditors. This would provide strong incentive for these firms to shrink, simplify, and reduce their leverage.

In addition, major firms must be subject to a prompt corrective action (PCA) regime and be required to prepare and regularly update what some have called "living wills," which are plans for their rapid resolution in the event of distress. These plans would leave us better prepared to deal with a firm's failure, and provide another incentive for firms to simplify their organizational structures and improve their risk management.

To build-up shock absorbers system-wide, all firms must face higher prudential requirements. We are negotiating a new international accord to establish a level playing field for capital requirements. This accord will raise capital requirements, improve the quality of capital, establish strong liquidity requirements that reduce reliance on unstable short-term funding, raise capital charges on more risky activities and help make regulation less pro-cyclical, so that they will more likely dampen rather that amplify future instability.

We must also improve supervision and regulation of derivatives markets and critical payment, clearing, and settlement systems; increase transparency throughout the financial system; and align incentives to improve securitization markets. This should be done at home and abroad.

Finally, we must close loopholes and reduce possibilities for gaming the system.

Monitoring threats to financial stability will fall to the proposed Financial Services Oversight Council. The Council would have the duty and authority to identify any financial firms whose size, leverage, complexity, and interconnectedness pose a systemic threat and require those firms to submit to a system of heightened supervision and regulation.

The Federal Reserve would oversee individual major financial firms so that there is clear, inescapable, single-point accountability. The Fed already supervises all major U.S. commercial banking organizations on a firm-wide basis and all major investment banks as well.

Conclusion

The current rules in place for our financial system are inadequate and outdated.

We have all experienced what happens when, during a crisis, the government is left with limited tools and limited choices. That is the searing lesson of last fall.

In today's markets, capital moves at speeds unimaginable when our current regulatory framework was created. And today's economy requires that Congress bring that framework into

the 21st century, granting the government carefully constrained power to contain damage to the economy while managing the failure of large, complex financial institutions.

The bill before the Committee does that.

It represents a comprehensive, coordinated answer to the moral hazard problem posed by our largest, most interconnected financial institutions. It produces strong, accountable supervision of all our major financial firms and imposes costs not on the taxpayer but with the risk-takers, where they belong. It deters excessive risk taking and forces firms to better protect themselves against failure. It creates a strong, resilient, well-regulated financial system that can better absorb failure when it happens. And it establishes a resolution regime allowing the government, when the financial system is at risk, to unwind and break up a failing financial firm without imposing costs on taxpayers.

What this bill does not do is provide a government guarantee for troubled financial firms. It does not create a fixed list of systemically important financial firms. It does not create a permanent TARP-like authority. It does not give the government broad discretion to step in and rescue insolvent firms. And it does not give comfort to investors, creditors, counterparties, or management that the government will be there to absorb losses from risky business strategies.

With this bill we are looking forward, not backwards. We are looking to provide future Administrations with better options than existed last year. This is still an extremely sensitive moment for the financial system. Investors across the country and around the world are closely watching each step we take. And it is important for them to understand that the bill we are debating today is about giving the government better tools to deal with future crises, while we work to repair the damage caused by this crisis.

Mr. Chairman, the American people are counting on us to get this right and to get this done. You have made enormous progress already and we look forward to working with you so that we can put in place comprehensive reforms that will restore confidence in our financial system at home and abroad.

Thank you.

Statement of MetLife, Inc.

Before the

U.S. House of Representatives Committee on Financial Services

On

Systemic Regulation, Prudential Matters, Resolution Authority and Securitization

October 29, 2009

Statement made by Steven A. Kandarian
Executive Vice President and Chief Investment Officer
MetLife, Inc.

Introduction

Chairman Frank, Ranking Member Bachus, members of the Committee, my name is Steve Kandarian and I am the Chief Investment Officer for MetLife, Inc. ("MetLife"). I want to thank you for inviting me to testify today at this hearing on Systemic Regulation, Prudential Matters, Resolution Authority and Securitization. I am here today in my capacity as an executive of MetLife. My testimony reflects the views of MetLife.

MetLife is a leading provider of insurance, employee benefits and financial services with operations throughout the United States and the Latin America, Europe and Asia Pacific regions. Through its subsidiaries and affiliates, MetLife reaches more than 70 million customers around the world and MetLife is the largest life insurer in the United States (based on life insurance in-force). MetLife companies offer life insurance, annuities, auto and home insurance, retail banking and other financial services to individuals, as well as group insurance and retirement and savings products and services to corporations and other institutions. MetLife has a large, diversified investment portfolio that supports our promises, including investments in financial institutions and mortgage and asset-backed securities. In our 140 plus year history we have grown into a global company that is strong and trusted by our customers and our shareholders and we pride ourselves on having accomplished this not by taking unnecessary risks but through thoughtful strategies prudently implemented. We believe this view was reinforced by the results earlier this year of the capital assessment exercise, or "stress tests," performed by the Federal Reserve on MetLife. In addition, we were the only company among the 19 participants in the stress tests that did not also participate in the TARP Capital Purchase Program.

You have asked that MetLife provide its perspective on the various topics covered by the Obama Administration's regulatory reform proposals, including systemic risk, prudential matters, and resolution authority, as well the Committee's discussion drafts on these topics, which were released earlier this week (the "discussion drafts"). MetLife is the largest life insurer in the United States, based on life insurance in-force. We are also the only life insurer that is also a financial holding company. Because of our financial holding company status, the Federal Reserve serves as the "umbrella" supervisor of our holding company, in addition to the various "functional regulators" that serve as the primary regulators of our insurance, banking and securities businesses, such as our state insurance regulators, the OCC, and the SEC. While I will comment on certain aspects of the draft legislation, I believe that I can best contribute to the dialogue on systemic risk, holding company supervision, and resolution authority by providing some observations about the potential impact – generally and on insurance companies specifically – of the proposals being discussed. In addition, we have included at the end of this statement some suggested guidelines that we believe are important to keep in mind in connection with improving the securitization process.

We support the efforts of Congress and the Administration to address the root causes of the recent financial crisis and better monitor systemic risk within the financial system. It is reassuring to see that you are proceeding thoughtfully and deliberatively.

While we want to ensure that the activities that led to the problems in the financial market are subject to proper regulation and oversight, we believe that Congress should consider whether its proposals are appropriately tailored to address the problems and be confident that its solutions do not result in unintended consequences, which will only lead to new problems. We are pleased to be able to serve as a resource to the Committee in this effort.

Systemic Regulation, Prudential Matters, and Resolution Authority

The Administration and Congressional discussion drafts propose, among other things, to establish a new regulatory structure to oversee systemic risk within the financial system, enhance the prudential regulation of bank holding companies ("BHCs") and FHCs, and authorize federal regulators to assist and/or wind down certain financial companies whose failure could pose a threat to financial stability or economic conditions in the United States. In reviewing the discussion drafts, we have some questions about how each of the pieces will fit together, particularly how new regulators and regulatory structures would coordinate with existing regulators and regulatory structures, both on the domestic and the international front. For example, Congress proposes to establish a Federal Insurance Office ("FIO") but does not consistently require other regulators to consult and coordinate with that office or state insurance departments when they are taking actions that could impact a specific insurer or the insurance industry. We would propose that whenever an action taken by a federal official will affect a specific insurer or the insurance industry, that official should consult with the FIO. Also, new disclosure requirements should be reconciled with existing securities laws or exchange rules and requirements. We think it is critical that these questions be addressed as part of the regulatory reform process.

Systemic Risk

We recognize the need to identify, monitor, and control systemic risk within the financial system to help avoid future financial market crises. But, we are concerned that creating a system under which companies are subjected to different requirements will result in an unlevel playing field, which will raise its own issues and problems. This issue becomes particularly problematic if only a single company (or very small number of companies) in an industry is designated as a Tier 1 FHC. As proposed, we believe the concept of designating Tier 1 FHCs and subjecting such companies to enhanced prudential standards, including risk-based capital requirements, credit concentration limits, leverage limits, liquidity requirements and risk management requirements will create vulnerabilities in the financial system and result in an unlevel playing field.

Systemic threats can stem from varied sources, in addition to large institutions. For example, systemic risk can arise from problems affecting a collection of small institutions, rapidly increasing exposures to a particular asset class, unexpected volatility in key markets, pervasive deficiencies in risk management methodologies, or difficulties in the financial system's payments, clearing, and settlement infrastructure. Attempting to monitor, assess, and address systemic risk by focusing a higher level of regulation on a

discrete group of companies under a "tiered" system could result in little or no oversight of these types of sources, leaving the financial system exposed to potentially significant problems.

We propose that Congress consider regulating systemic risk by regulating – or enhancing existing regulation of – the activities that contribute to systemic risk and requiring that such regulation be applied and enforced without regard to the type or size of institution that is conducting the activity. Linking regulatory requirements, such as capital or risk management practices, to the activity rather than to the size of the institution engaging in the activity will help closing existing – and prevent future – regulatory gaps that could be exploited by companies looking to operate under a more lenient regulatory regime. The proposed systemic risk overseer could monitor the financial system as a whole, help identify new or growing sources of systemic risk, provide guidance on appropriate regulation of such activities, and ensure that regulators uniformly enforce consistent requirements on the companies engaged in these activities.

In addition, an activity-based system would help avoid the following negative consequences stemming from the unlevel playing field that would be created under a tiered system:

- Economies of scale and efficient allocation of capital could be adversely impacted to the detriment of consumers and shareholders of Tier 1 FHCs, as these companies will have to operate under higher regulatory standards than their non-Tier 1 competitors.

- Allowing non-Tier 1 FHCs to operate at less than a "well capitalized" and "well managed" status on a consolidated basis while engaging in the same activities as their Tier 1 competitors introduces additional systemic risk into the financial system and encourages companies to seek ways to qualify for the more lenient form of regulation.

- A tiered system that imposes heightened regulation and prudential standards on certain companies, as well as questions about the treatment of interests in such companies during a resolution proceeding, could adversely impact how such companies are perceived by analysts, investors and counterparties. Congress should carefully consider whether it wants to introduce uncertainty in the markets and make it more difficult for Tier 1 FHCs to raise capital or generate liquidity, which was one of the key problems that accelerated the financial crisis.

Benefits of Functional Regulation

The discussion drafts also propose to make significant changes to the concept of functional regulation. We need clarity and consistency on the treatment of insurers, and do not believe that they should be treated differently than banking and securities subsidiaries by taking away their status as "functionally regulated subsidiaries." In our view, the system of functional regulation worked well in the insurance industry, both

before and during the financial crisis, with few problems arising out of the regulated insurance companies, and can continue to be effective going forward.

Currently, the FED as the financial holding company regulator works in partnership with the other functional regulators, including state insurance regulators. While the FED currently serves as the "umbrella" supervisor of all BHCs, including FHCs like MetLife, the Bank Holding Company Act ("BHCA") appropriately limits its supervisory powers with respect to functionally regulated subsidiaries, including insurance companies. Supervision of these subsidiaries is left primarily to the subject matter experts, in our case, the state insurance departments. In order to fulfill its role as the "umbrella" supervisor the FED is able to obtain information and examine the non-functionally regulated subsidiaries of a BHC or FHC. With respect to the functionally regulated subsidiaries, the FED is able to obtain and rely on audited financial statements, reports submitted to functional regulators, and reports of examination prepared by the subsidiary's functional regulator and may conduct certain examinations. In our experience, the FED and the functional regulators have worked cooperatively, sharing information and insights that allow each regulator to perform its function. We believe that this model has worked well and we have benefited from the observations of our FED examiners.

Under the proposal, the new systemic regulator would have authority to prescribe more stringent prudential standards, conduct exams, require reports and enforce regulations; these powers would extend to all subsidiaries with no deference given to functional regulators, creating potential for inconsistent regulation. In addition, more stringent activity restrictions could be placed on functionally regulated subsidiaries than required by the functional regulators. In granting these authorities and extending them to functionally regulated subsidiaries, the proposed legislation arguably makes the new systemic regulator in some areas the de facto regulator for the entire Tier 1 company, including its insurance company subsidiaries, even though the new systemic regulators requirements may be in conflict with or duplicative of the work of the functional regulator. In contrast to other functionally regulated businesses, the discussion draft provides no enforcement role for state insurance regulators and instead leaves direct enforcement action to the FED.

To avoid these issues, we encourage Congress to maintain the structure that is currently in place for functionally regulated subsidiaries. We do believe that a new systemic risk regulator should have the ability to collect information and documents for the purpose of monitoring systemic risk. However, with respect to the insurance industry, any systemic regulator should be required to use the proposed FIO as a resource to help it collect and compile information from the insurance industry that it may need to fulfill its function. In addition, given the likelihood that the new systemic risk regulator will have limited insurance experience, we believe that when taking action that affects insurance company subsidiaries of an entity that is subject to the jurisdiction of the systemic risk regulator, the systemic risk regulator should give deference to the views of the proposed FIO, which, in turn would consult with the appropriate state insurance regulators.

Prompt Corrective Action and Enhanced Resolution Authority

The discussion drafts propose a new prompt corrective action ("PCA") regime for Tier 1 FHCs that tracks in many respects standards applicable to depository institutions and introduces a new resolution authority that would give the federal government new powers to assist and/or resolve BHCs or FHCs whose failure could have adverse effects on financial stability or economic conditions in the United States. We are pleased that the drafters have excluded certain types of institutions from the enhanced resolution authority provisions, including insurance companies, in recognition of the fact that there is already an effective process for addressing the resolution of distressed insurance companies under existing state law.

We are concerned, however, that in adopting the same type of tiered structure as has been proposed for addressing systemic risk, the PCA and enhanced resolution authority create potential conflicts. For example, under the proposed PCA regime, the measures which could be imposed if a Tier 1 FHC is less than well capitalized, include compelling divestiture or liquidation of an insurance company subsidiary, restricting capital distributions and mandating changes to the composition and compensation of management, could conflict with the insurance regulatory regime. Moreover, under the proposed enhanced resolution authority for BHCs and Tier 1 FHCs (and their non-excluded subsidiaries), what if the new federal resolution authority decided to wind down a financial holding company that also has a large insurance subsidiary? Given their different missions, the federal resolution authority might seek one treatment of the insurance subsidiary that is in direct conflict with the desires of state insurance regulators. In addition, it appears that neither a company that may be subject to the new resolution authority nor investors in such a company or counterparties in transactions with the company would know whether the bankruptcy code or the new resolution regime would apply. As a result, creditors, counterparties and other stakeholders will likely find it difficult to assess their credit risks to Tier 1 FHCs or BHCs subject to the enhanced resolution authority. This uncertainty would result in these companies paying a higher risk premium that would place them at a competitive disadvantage both domestically and globally and lead to higher costs that will ultimately be borne by consumers and shareholders.

In addition, only certain financial companies will bear the costs associated with utilization of the enhanced resolution authority through assessments that will be levied on these institutions. Given that the enhanced resolution authority is intended to benefit the nation as a whole, we do not believe that imposing its costs on a limited number of companies is appropriate.

Dangers of an Unlevel Playing Field

If the new systemic regulator is given the authority suggested in the discussion drafts, as described above, Tier 1 FHCs will have to operate on a different playing field

than their non-Tier 1 competitors. In addition to those cited above, other examples of this outcome include:

- If categorization and tiering of Tier 1 FHCs are left to the new systemic regulator, it could create an unlevel playing field, if widely divergent businesses and corporate forms are not considered. For example, would a mutual insurer be treated the same as a publicly traded insurer? Will the proposed regulatory regime account for the very different investment portfolios held by insurers as compared to banks?

- Stricter activity restrictions could be imposed on functionally regulated subsidiaries of Tier 1 FHCs than on those of their non-Tier 1 competitors.

- Companies engaged exclusively in activities "not financial in nature" would not be Tier 1 FHCs. Thus, firms engaged exclusively in activities deemed not financial in nature under the BHCA, e.g., real estate investment and management, would have a competitive advantage over Tier 1 FHCs engaged in those activities. So while these firms will engage in activities that could contribute significantly to the overall amount of risk in the financial system, they will do so without having to comply with any regulation applicable to a Tier 1 FHC or other regulated institution or oversight by the new systemic risk regulator.

So what is the problem with creating different regulatory standards for different categories of financial services providers that directly compete with each other? Subjecting financial services providers who are engaged in the same lines of business or providing the same products to different standards will inevitably result in attempts to avoid the stricter form of regulation. As a result of the recent credit crisis there has been much discussion about the role of regulatory arbitrage. We have also heard that certain activities, which may have been curtailed in heavily regulated parts of the industry, may have continued in more lightly regulated institutions, exacerbating the existing problem. Although we can try to design barriers to prevent activity from moving to the least regulated type of entity, history shows that it is not possible to anticipate the ways that can be devised to get around these barriers.

We are not suggesting that the financial services industry is perfectly regulated now or that Congress should sit by and do nothing to address the problems that we have seen in the recent past. Instead we are strongly encouraging Congress to continue to think carefully about the consequences – including the unintended consequences – of the changes that are being proposed on the companies that may be subject to Tier 1 FHC status, the companies that will not be subject to Tier 1 FHC status, and the investors and the customers of all of these companies. Rather than creating new regulatory bodies and new classes of financial companies that are subject to differing regulation, we suggest that Congress regulate activities that contribute to systemic risk, rather than creating a system of regulation that uses size of the financial institution as a key criterion. We believe that such a system would be more effective, easier to administer, and would result in fewer unintended consequences than the tiered structure proposed in the discussion

drafts. In addition, Congress might also consider whether it can direct the better leveraging of existing regulatory capabilities where appropriate authority has already been delegated to the regulators. Recent examples of utilizing existing authority can be found in (i) interagency guidance on funding and liquidity risk management directed to banks and BHCs to reinforce Principles for Sound Liquidity Risk Management & Supervision issued by the Basel Committee in September 2008, and (ii) September 2009 U.S. Treasury Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms (in consultation with bank regulators and supported by the Basel Committee).

Improving Securitization Markets

Historically, the securitization market has played an instrumental role in making financing available to American consumers and companies.[1] This financing, whether in the form of credit card financing, auto loans, mortgage loans, etc., has been a driver of U.S. economic growth during the last 30 years and has contributed to our higher standard of living.

As of the end of the first quarter of 2009, existing transactions in the securitization market had provided over $11 trillion dollars in financing to the U.S. economy. However, this number is rapidly declining. Unfortunately, current conditions in the securitization market are preventing it from contributing to U.S. economic recovery in a meaningful way during a very critical time.

Recent government programs like TALF and PPIP have supported new issuance and improved market liquidity in certain securitization sectors, but this is only temporary relief. Fundamental changes to certain practices are needed to ensure the securitization market's long-term sustainability as a major source of credit for the economy.

The following set of guidelines, if implemented, will contribute to restoring investor confidence in this market. It is recognized that some of these guidelines are being addressed in the various legislative and regulatory proposals put forward by Congress, the Obama Administration and the Securities and Exchange Commission relating to asset-backed securitization and regulation of credit rating agencies. It may not be necessary to include each and every point in a legislative proposal to improve the securitization markets, but believe that using them as a general guide crafting regulatory and market reforms can help renew investor confidence and allow securitization once again to become a source of financing that contributes to economic growth.

[1] The views expressed in this section do not apply to the securitization of life settlements. MetLife opposes the securitization of life settlements because it would invariably lead to more stranger-originated life insurance (life insurance purchased on a person by someone without a legitimate insurable interest) and would result in securities with unknown risks.

Alignment of Incentives

The economic incentives of the various participants in the securitization market are often misaligned. Some have a very short term focus and others depend on long term results. This misalignment is a root cause of many of the securitization market's problems today, and the market's inability to recover more rapidly. Here are some examples of this issue:

- Loan originators benefit from origination fees and often from servicing fees, but have limited economic interest in the actual long-term performance of securitized loans.

- Most rating agencies derive the bulk of their business and compensation upfront from the rating of new transactions, with no impact from the actual long-term performance of those transactions. This gives them little incentive to devote sufficient resources to the ongoing monitoring of structured products.

- Investment banks – when an aggregator of collateral for securitization - are incentivized to structure and market transactions as quickly as possible, with no repercussions from the long-term performance of these transactions.

- On the other hand, institutional investors and their clients (e.g., pensioners, policyholders and retail investors) derive benefit and incur risk from the long-term performance of these transactions.

There are various ways to better align incentives, including: (a) meaningful equity retention by originators and investment banks when acting as an aggregator of collateral, (b) strong representations and warranties from originators and banks, with the clear option to put back unqualified loans to originators and investment banks and (c) deferred or contingent compensation or compensation "clawbacks" or "escrows" for originators and investment banks tied to the long-term performance of securitization transactions. Implementation of any of these solutions, of course, must take into consideration the differences among the various types of securitizations (i.e., CMBS, RMBS and ABS), as well as the differences within the individual types (e.g., agency vs. non-agency RMBS).

Mitigation of Conflicts of Interest

Current practices in the securitization markets often present substantial conflicts of interest for many market participants. These conflicts may not be acted upon, but their mere presence detracts from the system's credibility and reduces investor trust and public confidence. These are some of the conflicts present in the current system:

- Although rating agencies must provide an impartial view of the credit quality of transactions, they risk losing a sale (and future business) if they have a more negative view than other agencies competing for that transaction.

- Certain critical servicing functions are often performed by institutions (or their affiliates) that also hold junior bonds in a transaction (or other related collateral outside the transaction), which may lead servicers to act in ways that are detrimental to senior bondholders.

Some actions that could help mitigate these conflicts of interest include: (a) consideration of alternative compensation models for rating agencies that extend for a longer time horizon and encourage ongoing monitoring, (b) implementation of transparency standards as to methodologies, analysis, data, and process to ensure independence in ratings decisions, (c) requirement for subordinated debt held by servicers or their affiliates to receive distributions only after all other debt has been fully paid off, and (d) requirement for control of securitization trusts to be exercised by the majority of bondholders rather than the junior bondholder class.

Improved Transparency

Structured finance investors are often unable to obtain key information that would allow them to make better investment decisions in some sectors. This leads to illiquidity, market distortions, or both. Here are some examples:

- Historical performance information on securitized assets is often incomplete or unavailable.

- Frequently, asset performance information in certain sectors is presented on a "pro-forma" basis, which can often be overly aggressive and misleading.

- Current performance information on securitized assets is often limited and not reported in a timely fashion.

- Rating agency surveillance reports often lack the frequency and depth required for investors to make better investment decisions.

The following are examples of actions that could improve transparency in the securitization markets: (a) establish minimum disclosure standards for assets to qualify for securitization, including granular loan level information when relevant, (b) require borrowers and servicers to provide key information on their securitized loans on a periodic basis, including supporting analysis for loan modifications or extensions granted by servicers, (c) require that rating agencies provide a set of performance statistics on a periodic basis during the life of a transaction and (d) establish an audit requirement to certify data accuracy and to review provider (e.g., trustee, servicer and depositor) compliance with required service standards.

Transaction Simplification

The complexity of many structured finance securities has added to the sector's recent problems. To some extent, the lack of liquidity we have seen of late can be

attributed to the performance volatility of these transactions. This volatility could be partially mitigated with simpler structures. Some examples of this problem are:

- The size of many subordinate tranches, including junior AAA rated bonds, are often very small relative to the total amount of bonds in a securitization. As a result, losses on the underlying collateral can make these bonds behave in a binary way; either pay in full or lose the entire principal.

- Also, due to the small size of most bonds in a transaction and their resulting sensitivity to collateral losses, the ratings of these bonds can vary widely over time.

- In sectors such as commercial real estate, securitized loans are often part of a broader, complex financing package to the same borrowers and properties. This results in conflicting interests among multiple lenders and a lack of clarity about risk. It also results in a more difficult workout process for distressed loans.

Here are some alternatives to simplify structures: (a) establish a minimum relative size for subordinated bonds in a securitization transaction, (b) limit the number of bonds in securitization transactions to one per rating letter grade instead of the three now commonly used and (c) when a loan is part of larger financing package, extensive disclosure should be required regarding the structure of the overall financing package and the holders of other debt pieces.

Conclusion

In conclusion, we want to recognize the efforts of this Committee in taking on the complex task of updating our financial services regulatory structure and improving the securitization process. Addressing the issues that caused the financial crisis and proactively trying to prevent future crises are goals that are important to all of us. We hope that you will continue to reach out to us – and to all stakeholders – so that together we can develop solutions that are good for businesses, consumers and our overall economic system.

Testimony of

R. Michael S. Menzies, Sr.
President and CEO, Easton Bank and Trust Company
Easton, Maryland

On behalf of the
Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Financial Services

Hearing on

"Systemic Regulation, Prudential Matters, Resolution Authority and Securitization"

October 29, 2009
Washington, D.C.

Introduction

Chairman Frank, Ranking Member Bachus, Members of the Committee, my name is Michael Menzies, and I am the President and CEO of Easton Bank and Trust Company, Easton, Maryland, and the Chairman of the Independent Community Bankers of America. [1] Easton Bank is a state-chartered community bank with $150 million in assets. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on proposals to address systemic financial risks to our economy.

Too-big-to-fail institutions and the systemic risk they pose were at the heart of our financial and economic meltdown. Just over one year ago, due to the failure of our nation's largest institution's to adequately manage their highly risky activities, key elements of the nation's financial system nearly collapsed. Other parts – especially our system of locally owned and controlled community banks – were not in similar danger. But community banks, the cornerstone of our local economies, have suffered; both from the steps government had to take to deal with the crisis – especially steps taken to subsidize too-big-to-fail institutions – and from our severe recession.

This was, as you know, a crisis that community banks did not cause. A crisis driven by a few unmanageable financial entities that nearly destroyed our equity markets, our real estate markets, our consumer loan markets, the global finance markets and cost Americans more than $12 trillion in net worth. A crisis that forced the federal government to inject almost $10 trillion in capital and loans and guarantees to large complex financial institutions whose balance sheets were over leveraged and lacked adequate liquidity to offset the risks they had taken. A crisis that has brought the world markets to a point where they even question if the U.S. dollar should be retained as the reserve currency of the world. A crisis driven by the ill conceived logic that some institutions should be allowed to exist even if they are too big to manage, regulate and fail.

This committee is now engaged in the monumental and historic task of crafting legislation that will reduce the chances that risky and irresponsible behavior by large or unregulated institutions will again lead us into economic crisis.

---

[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $1 trillion in assets, $800 billion in deposits, and more than $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

ICBA commends you and President Obama's Administration for tackling this important undertaking. The President's plan takes strong steps toward addressing systemic risks posed by too-big-to-fail financial firms. This testimony provides detailed recommendations to make them even stronger. In addition, an addendum to my statement includes ICBA's specific reactions to the discussion draft which the Committee and Treasury released on October 27. Community bankers believe that the best way to protect consumers is to end the too-big-to-fail concentration risks.

Addressing Systemic Risk

ICBA supports the proposal to identify specific institutions that may pose systemic risk and to subject them to stronger supervision, capital, and liquidity requirements. Our economy needs more than an "early warning" about possible problems; it needs a real cop on the beat.

But, the plan could be enhanced to better protect taxpayers and safeguard the financial system. ICBA believes that systemically risky holding companies should pay fees for their supervisory costs and fund – in advance – a new systemic risk fund. ICBA also strongly supports the "Bank Accountability and Risk Assessment Act of 2009" introduced by Rep. Luis Gutierrez (H.R. 2897) which would require the FDIC to impose an additional fee on any insured bank affiliated with a systemic risk institution. This would better account for the risks these institutions pose and strengthen the Deposit Insurance Fund.

These strong measures are not meant to punish those institutions for being large, but to guard against the risks they pose and to protect the taxpayers and the public. They would hold these large institutions accountable and discourage them from taking on extraordinary risky behavior or benefiting from being "too big to fail." However, if these enhancements are not enough, the President's proposal sensibly calls for a plan to resolve failing institutions. Our testimony details how Congress can further enhance the President's plan.

But to truly prevent the kind of financial meltdown we faced last fall, and to truly protect consumers, the plan must go further. It should direct systemic risk authorities to develop procedures to downsize the too-big-to-fail institutions in an orderly way.

ICBA is pleased that the plan maintains the state banking system and believes that any final bill should also maintain the thrift charter. Both charters enable community bankers to follow business plans that are best adapted to their local markets and pose no systemic risk.

Summary of ICBA Key Recommendations

The following key points summarize ICBA's position on dealing with systemic risk institutions:

- Create a systemic risk regulator (either the Federal Reserve or in conjunction with a council of regulators) to monitor and supervise all institutions that pose a threat to our financial stability.
- The systemic risk regulator should be headed by a presidential appointee, subject to Senate confirmation, in order to assure the body's independence from political pressures.
- If the Federal Reserve is given priority in serving this role, provide the Financial Services Oversight Council with clear policy setting and oversight authority over the Federal Reserve, including the power to establish capital, liquidity and other requirements for systemic risk firms, the power to over-rule Fed decisions by a majority vote of the Council, and the power to force the Fed to take actions.
- Identify institutions that potentially pose systemic danger and make them subject to substantially higher capital and liquidity requirements, plus more rigorous supervision and stress testing.
- Give the systemic risk regulator the authority to declare an institution insolvent when capital falls below well-capitalized and the institution cannot raise new private capital.
- Grant receivership, conservatorship and bridge bank authority to the FDIC to operate an insolvent institution and develop a restructuring, downsizing or dissolution plan.
- Eliminate too-big-to-fail so the future failure of a systemic risk institution would not threaten the stability of our economic system.
- Reduce the 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, and strengthen the cap by eliminating loopholes permitting organic growth.
- Downsize financial institutions that continue to pose a systemic danger below systemic danger limits within five years, by selling assets or bank units to other qualified entities, including community banks.
- Consider reinstating the Glass-Steagall Act, prohibiting the common ownership of commercial and investment banks, to reduce risk and downsize systemically important institutions.
- Impose a systemic risk premium on all "Tier I" financial holding companies, broadly defined to include all large complex financial firms that have the potential of posing a systemic risk.
- Require all FDIC-insured affiliates of large complex financial firms to pay a systemic risk premium to the FDIC in addition to their regular FDIC premiums to compensate the FDIC for the increased risk they pose.
- Broaden the assessment base used by the FDIC to determine a bank's premium by including total assets minus tangible equity for the assessment base, rather than domestic deposits. A broader assessment base would result in a fairer assessment system reflecting a banks' risk.
- Retain the system of federal and state bank chartering and do not create a single, monolithic federal regulator.

Enhance Systemic Risk Regulation

The Administration's proposal expands the authority of the Federal Reserve to supervise all institutions that could pose a threat to financial stability, including non-banks, and creates a Financial Services Oversight Council to identify emerging systemic risks in firms and market activities and improve interagency cooperation. These proposals are a substantial improvement over the current system, but can be enhanced to truly protect consumers, local communities and our economy.

Make Federal Reserve the Primary Systemic Risk Regulator

Our nation needs a strong and robust regime of systemic risk regulation and oversight. It is clear that reckless lending and leveraging practices by too-big-to-fail institutions were the root of the current economic crisis. The only way to maintain a vibrant banking system where small and large institutions can fairly compete – and to protect taxpayers – is to aggressively regulate, assess and eventually downsize institutions that pose a risk to financial stability.

ICBA supports creating a systemic risk regulator, and we have no problem with designating the Federal Reserve as the primary systemic risk regulator or creating a systemic risk council to serve in that capacity. The Federal Reserve is the agency currently best equipped to take on this new role. However, we share the concerns expressed by some in Congress that without proper direction and oversight, the Fed may be slow or reluctant to act to address systemic risks. Some Members of Congress have justifiably criticized the Fed for its slow response to the congressional mandate to promulgate new rules to govern the unregulated segments of the mortgage industry or for its promotion of the Basel II capital agreement. Indeed, one of the weaknesses of the Administration's proposal is that the Federal Reserve is given too much new power with no accountability for enforcement.

Enhance Duties of Council

The proposed Financial Services Oversight Council must have strong powers to be effective. The Council should have the power to set clear policy and have oversight authority over the Federal Reserve, including the power to establish capital, liquidity and other requirements for systemic risk firms, the power to over-rule Fed decisions by a majority vote of the Council, and the power to force the Fed to take actions. In addition, the Fed should be required to report to Congress on a regular and frequent basis, so that Congress can also exercise oversight to ensure that the Fed is properly and appropriately implementing its new authority.

The Council should be responsible for identifying gaps in regulation and recommending institutions that should come under consolidated supervision by the Federal Reserve. It is critical to extend supervision and oversight to those non-bank entities that contributed

to the current financial crisis largely because they did not fall under any agency's regulatory umbrella.

Identify Systemic Risk Institutions

Generally speaking, systemic risk institutions are sufficiently large that diversification no longer mitigates risk. Instead, their risk profiles increasingly come to resemble that of the financial market itself, leaving them vulnerable to any major shock to the financial markets.

When companies like Morgan Stanley and Goldman Sachs and Lehman Brothers are leveraged 25 to 34 to one, when they have less than 4 cents at risk for every dollar in assets, their success or failure determines the future of the markets. According to Bridgewater Financial Group (HBR August 2009)[2] in September of 2008 the Bank of America was leveraged 73 to 1 and if it were to capitalize all of its off balance sheet entities it would have been leveraged 134 to 1. That means less than 1 penny of capital at risk for every dollar of assets.

Congress and the Council must establish clear principles to identify systemic risk institutions. It is not difficult to identify the handful of mega-bank financial institutions that are systemically risky,, but at the margins, defining systemically important institutions by asset size alone is insufficient. Institutions that are not systemically risky may become so through growth, complexity, and counterparty risk. Flexibility ensures that the systemic risk regulator can respond to changes in the market, but they should always operate under clearly articulated principles.

Some contend that systemic risk institutions should not be publicly identified because that would give them an unfair advantage in the marketplace. We disagree. Institutions that potentially pose systemic risk must be identified. Supervision by specific regulators and the enforcement of any rules designed for systemic risk institutions might make this obvious anyway. Status as a systemic risk institution should not be a signal to markets that an institution will not be allowed to fail, but rather that its failure would raise systemic concerns.

The fundamental purpose would be to make clear that these institutions will be subject to substantially higher capital and liquidity requirements, plus more rigorous supervision in order to protect the financial system and the economy. They also should support a systemic risk fund to prevent taxpayers from being first on the hook to pay for a troubled systemic risk institution. This will help mitigate any "advantage" they might receive from being too big and too risky. In addition, more liquidity and better supervision will decrease the chance that an institution will fail in the first place. And, in the event of failure, the systemic risk fund and higher capital will protect taxpayers.

---

[2] Harvard Business Review, August 2009

Systemic Risk Guidelines

ICBA suggests as a guideline that a systemic risk financial institution is one that has more than $100 billion in assets, and has a risk profile that is susceptible to one or more risk factors. While not all institutions with more than $100 billion in assets are by definition systemically significant, all institutions in excess of $100 billion in assets should be examined closely to determine their systemic importance with special attention paid to the following factors:

- Provision of systemically essential services within the economy.
- Use of leverage – both traditional and embedded in derivatives.
- Status as a major client and/or counterparty risk and guarantees.
- Overall balance sheet exposure and liability.
- Overall level of participation/integration with capital markets, especially high risk activities such as proprietary trading activities.
- Trade in derivative instruments which can potentially multiply risk exposures as well as mitigate, especially writing of derivatives contracts.
- Dependence on short-term non-depository funding from capital markets such as commercial paper.
- Off-balance sheet activities.
- Rate of asset growth.
- Deposit concentration.
- Organizational complexity and capability of management.

Give FDIC Sole Resolution Authority

We must take measures to end too-big-to-fail by ensuring there is a mechanism in place to declare an institution in default and appoint a conservator or receiver that can unwind or sell off the institution's operations in an orderly manner. In order to maintain market discipline, as part of the process, shareholders and management responsible for the institution's demise should not be protected. The systemic risk regulator, in consultation with appropriate bank regulatory agencies, must have the authority to declare an institution insolvent when capital falls below well-capitalized and the institution cannot raise new private capital. Agencies insulated from politics – not the Treasury as proposed by the Administration – should make these calls.

We strongly support the Administration's proposal to grant receivership, conservatorship and bridge bank authority to the FDIC to operate an insolvent institution, including its holding company and affiliates, and develop a restructuring, downsizing or dissolution plan. The FDIC should have sole authority to determine how a systemically important institution should be resolved. The FDIC has extensive experience resolving banks and has the infrastructure in place to exercise conservatorship and receivership powers over financial companies.

The FDIC should have clear guidelines for resolving failing systemic risk institutions leading to restructuring and downsizing through sales of assets. At a minimum, systemic risk financial holding company shareholders should not be protected. Government must re-establish credibility that shareholders of financial institutions will bear the full loss in any insolvent financial institution. This core principle of capitalism has been repeatedly violated or in the often cited words of Allan H. Meltzer[3], "Capitalism without failure is like religion without sin – it doesn't work."

Clear seniority must be established among types of uninsured financial institution creditors. Uninsured creditors should not be supported like bank depositors – they receive market rates of return and should bear the risks of the marketplace. In the event of a failure, they should have their claims written down or become the new equity holders as they would in bankruptcy.

Congress should also modify the Administration's plan to give the FDIC resolution authority over all bank holding companies regardless of size in order to promote consistent and efficient resolution of all bank holding companies, not just systemic risk FHCs.[4] The current bifurcated resolution authority between the FDIC and the bankruptcy courts has added significant costs to many receiverships and resolutions.

Require Insolvency Contingency Plan

As the Lehman Brothers failure demonstrated, subverting market expectations, especially too-big-to-fail expectations, can be extremely destabilizing. Therefore a clear, rules-based process must be followed. Systemic risk FHCs should have an insolvency contingency plan which the resolution authority can use in the event of failure. Firms determined to be systemically important should be required to have a pre-approved plan worked out with the systemic risk regulators in advance and in place to deploy in the event of receivership or conservatorship. This plan should include close monitoring of their counterparty exposures for possible spillover effects. Regulators should ensure systemic risk institutions are organized so they can continue to perform systemically important functions during a resolution process.

End Too-Big-To-Fail

Ending too-big-to-fail is one of the most critical issues facing our nation. The only way to truly protect consumers, our financial system, and the economy is by finding a solution to rein in too-big-to-fail institutions. One of the weaknesses in the Administration's proposal is that it assumes special treatment for systemic risk FHCs, which could result in the perpetuation of the too-big-to-fail doctrine. One of the goals of

---

[3] University Professor of Political Economy at Carnegie Mellon University, and Visiting Scholar at the American Enterprise Institute, author of *A History of the Federal Reserve, Volume 1: 1913-1951*

[4] S.1540, the Resolution Reform Act of 2009, provides for this authority.

any regulatory restructuring plan should be to eliminate too-big-to-fail so the future failure of a systemic risk institution would not threaten the stability of our economic system.

Indeed, implicit in the FDIC's role in resolving insolvent institutions is the end of the too-big-to-fail doctrine, which has driven the creation of systemic risk institutions and given too-big-to-fail institutions an unfair competitive advantage.

In a speech earlier this year, Federal Reserve Chairman Ben S. Bernanke outlined the risks of the too-big-to-fail system:

> [T]he belief of market participants that a particular firm is considered too big to fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem.[5]

FDIC Chairman Sheila Bair, in remarks before the ICBA annual convention in March, 2009, said, "What we really need to do is end too-big-to-fail. We need to reduce systemic risk by limiting the size, complexity and concentration of our financial institutions." [6] The Group of 30 report on financial reform stated, "To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries."[7]

What has become painfully apparent during this financial crisis is that the failure of some firms would, indeed, have systemic consequences with national and even global implications. That is why Congress last fall reluctantly authorized $700 billion, with not so much as a hearing, to keep some of these institutions afloat.

It is clear that without a mandated downsizing and restructuring of these too-big-to-fail institutions, if they faced insolvency in the future, the government would have no choice but to bail them out again. That is unacceptable.

The only way to truly and effectively eliminate too-big-to-fail is to eliminate institutions that are so large and so complex that their failure would pose a grave threat to our financial system and national economy. That means, quite bluntly, that Congress must

---

[5] Financial Reform to Address Systemic Risk, at the Council of Foreign Relations, March 10, 2009
[6] March 20, 2009
[7] "Financial Reform; A Framework for Financial Stability, January 15, 2009, p. 8.

require institutions that currently fall into that category must be restructured and downsized to the point where they no longer pose a systemic risk, and their failure would no longer threaten our national economic well-being.

My testimony will discuss several ways this can be accomplished.

Consider Reinstating Glass-Steagall

One way to downsize too-big-to-fail banks and reduce their complexity is to separate banks according to the type of business they conduct. Up until 1999, the Glass-Steagall Act of 1933 prohibited the common ownership of commercial banks and other financial institutions such as investment banks and insurance companies. The Gramm-Leach-Bliley Act of 1999 repealed Glass-Steagall, paving the way for the formation of trillion-dollar financial conglomerates.

Some world-renowned economists are now calling for the reinstatement of the Glass-Steagall Act as a way to reduce both risk in the banking industry and the size of institutions.

Earlier this year, former Federal Reserve Chairman and current advisor to the President Paul Volcker suggested the idea of separating retail banking from investment banking in a Group of 30 report he authored. More recently, Bank of England Governor Mervyn King suggested that splitting the core aspects of banking from its riskier elements could help avoid future financial crises and their attendant public cost.

ICBA, which opposed the repeal of Glass-Steagall when it was first introduced, believes Congress should consider reinstating the Glass-Steagall Act. There are significant conflicts of interest when a single institution both grants credit through lending and uses credit through investing. Investment activities are by their nature risky activities that could lead to enormous losses. And even though there are theoretical firewalls that separate commercial from investment banking activities, in times of stress, it is virtually impossible to keep them distinct.

Reinstating Glass-Steagall would serve the dual purpose of reducing risk and forcing institutions to downsize. ICBA thinks it should be seriously considered.

Strengthen Deposit Concentration Cap

Another way to reduce the size of too-big-to-fail institutions is to immediately reduce and strengthen the 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The current cap is insufficient to control the growth of systemic risk institutions the failure of which will cost taxpayers dearly and destabilize our economy.

Unfortunately, government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Even after the financial meltdown, TBTF banks are getting even bigger and financial resources are becoming even more concentrated in fewer firms. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger with even higher deposit concentrations.

Congress should consider reducing the nationwide deposit concentration cap by one percent per year for the next five years. Congress also should strengthen the cap by eliminating loopholes that permit organic growth. Institutions that exceed the cap should be required to downsize within five years through selling assets and bank units to other qualified entities, including community banks. Banks that fail to comply with this requirement in a timely manner should be subject to severe monetary and non-monetary penalties until such time that they come into compliance.

Downsizing Systemic Risk Institutions is Essential

Congress should make clear that downsizing of systemic risk institutions is not only desirable, it is essential if we are to avoid future financial calamities. It is clearly not in the public interest to have so much power and concentrated wealth in the hands of so few, giving them the ability to destabilize our entire economy.

The Administration's plan includes valuable incentives to encourage downsizing. ICBA strongly supports the Administration's proposal to subject systemic risk FHCs to stricter and more conservative prudential standards than those that apply to other bank holding companies – including higher standards on capital, liquidity and risk management. Capital requirements should be graduated for institutions $100 billion in assets and larger to protect against losses, and act as a disincentive to growth that increases systemic risk. The imposition of systemic risk fees, which will be discussed later, also should serve as a disincentive to unbridled growth.

Financial institutions that continue to pose a systemic risk should be required to downsize to below systemic risk limits within five years, or face harsh monetary and management penalties. Any dissolution plan should include breaking up the institution and selling off pieces to other institutions, including community banks.

Research suggests that economies of scale and scope in banking are exhausted at much smaller sizes, but size does yield monopoly (market) power, 'synergies of conflict of interest' and an implicit subsidy provided by the taxpayer guaranteeing the bank against default and insolvency. [8] These abuses must end for a vibrant, competitive financial services marketplace to emerge from this crisis.

The Justice Department should have the authority to downsize systemic risk institutions through reinvigorated and reformed antitrust policy. Regulators should closely examine

[8] Buiter, Too Big To Fail Is Too Big.

– and deny – new merger applications that would result in the creation of new too-big-to-fail institutions.

Impose Systemic Risk Premiums

Large complex financial institutions created the most severe economic crisis in the United States since the Great Depression through poor underwriting practices, predatory credit practices and a system of financial interdependence that no one, even in these companies, understood. Since last October, Congress has invested $700 billion in the Troubled Asset Relief Program and over $700 billion in stimulus to rescue the economy, and the Federal Reserve has also dedicated hundreds of billions of dollars to aide the failing economy. Out of these funds, the Federal government has dedicated more than $150 billion in taxpayer and FDIC funds to shore up the nine largest banks and $70 billion in assistance and guarantees to AIG. Although some of these institutions have repaid the assistance, the current financial crisis illustrates the enormous risk that large complex financial institutions pose to taxpayers and the FDIC. As a result, ICBA urges Congress to impose two types of systemic risk fees against large complex financial institutions to compensate the taxpayers and the FDIC fund for this risk exposure.

Holding Company Premiums. First, Congress should impose a systemic risk premium on all systemic risk financial holding companies, broadly defined to include all large complex financial firms that have the potential of posing a systemic risk. Part of this first premium would pay for improved regulation of systemic risk. Additionally, part should be made available to the FDIC to fund the administrative costs of systemic resolutions and other costs associated with an orderly unwinding of the affairs of a failed institution.

Bank Premiums. Second, Congress should require all FDIC-insured affiliates of large complex financial firms to pay a systemic risk premium to the FDIC in addition to their regular FDIC premiums to compensate the FDIC for the increased risk they pose. Because their depositors and creditors receive superior coverage to the coverage afforded depositors and creditors of community banks, the largest financial institutions should pay an additional premium. The FDIC's Deposit Insurance Fund is ultimately responsible for insuring the deposits in those institutions. Enhancing resources available to the FDIC through a systemic-risk premium would reduce the risk that taxpayers would be called on to resolve a systemic risk depository institution.

The Bank Accountability and Risk Assessment Act of 2009, H.R. 2897, introduced by Financial Institutions Subcommittee Chairman Luis Gutierrez, would impose just such an annual systemic risk premium on all banks and thrifts that are part of systemically significant holding companies.

H.R. 2897 addresses other deposit insurance issues, which should be part of regulatory restructuring legislation. In addition to a systemic risk premium, the legislation would

create a system for setting rates for all FDIC insured institutions that is more sensitive to risk than the current system. First, the legislation requires the FDIC to examine risks throughout a bank's holding company, when the FDIC establishes rates for a bank. Recent history has demonstrated that the risk to the FDIC and taxpayers cannot be determined solely by looking at a depository institution in isolation. Second, the bill requires the FDIC to consider the amount of assets and liabilities, not just the categories and concentrations of assets and liabilities.

Modernize Assessment Base

Finally, H.R. 2897 would create an assessment base that is more closely linked to the risks in insured institutions and would create greater parity between large and small banks. The current assessment formula which is based on domestic deposits was created in 1933 when most banks relied on domestic deposits as a source of funding. That is no longer true. Large banks today use brokered deposits, foreign deposits, and other sources, for funding, to the point where domestic deposits only account for a little more than 50 percent of their deposit base. Community banks, which generally don't have access to the same capital markets, still rely primarily on domestic deposits. Over the years, this has placed an inequitable burden on community banks to fund the Deposit Insurance Fund, while our nation's largest banks pay proportionally less. The assessment base needs to be brought up to date to reflect the realities of today's financial marketplace.

The bill would broaden the assessment base used by the FDIC to determine a bank's premium by including total assets minus tangible equity for the assessment base, rather than domestic deposits. A broader assessment base would result in a fairer assessment system with the larger banks paying a share of the assessments that is proportional to their size rather than their share of total deposits.

Under the current system that assesses only domestic deposits, banks with less than $10 billion in assets pay approximately 30% of total FDIC premiums although they hold approximately 20% of total bank assets. Furthermore, 85-95 percent of the funding for these community banks comes from domestic deposits, while for banks with $10 billion or more in assets the figure is approximately 52 percent. Thus, while community banks pay assessments on nearly their entire balance sheets, large banks pay on only half. Under H.R. 2897, banks with less than $10 billion in assets would pay about 20% of FDIC premiums, which is in line with their share of bank assets.

Moreover, the proposed base is more closely linked to risk. The amount of assets that a bank holds is a more accurate gauge of an institution's risk to the DIF than the amount of a bank's deposits. Bad assets, not deposits, cause bank failures, and all forms of liabilities, not just deposits, fund a bank's assets. Most of the $18 billion in actual losses that the DIF incurred in 2008 came from the resolution of IndyMac Bank F.S.B., a bank with $32 billion in assets including many subprime loans and mortgage-backed securities but only $19 billion in deposits.

The proposed assessment base of assets minus tangible equity was used by the FDIC for the special assessment adopted this May. The bill would establish assets (minus tangible equity) as the assessment base for all regular and special FDIC assessments. The change would reduce the assessments of 98% of the banks with less than $10 billion in assets, keeping millions of dollars in community banks, which continue to lend to small businesses and consumers throughout America.

Improve Financial Markets

A risk-retention requirement for mortgage-backed securities could be a useful tool in regulating risk associated with the securitization process, if coupled with an exemption from the retention requirement for mortgages subject to comprehensive standard underwriting requirements, such as loans sold to the housing government sponsored enterprises or guaranteed by the Federal Housing Administration.

ICBA endorses stronger regulation of over-the-counter derivatives because of the central role credit default swaps played in the current financial meltdown.

ICBA also supports further hedge fund regulation including requiring hedge funds to (1) register with the Securities and Exchange Commission (2) disclose appropriate information on an ongoing basis to allow supervisors to assess the systemic risk they pose individually or collectively.

Enhance Supervision of Systemically Important Payment, Clearing and Settlement Systems

ICBA supports the Administration's proposal to provide the Federal Reserve with new authority to identify and regulate systemically important payment, clearing and settlement systems. This expanded authority would allow the Federal Reserve, in conjunction with a system's primary federal regulator, to collect applicable information and to subject covered systems to regular, consistent, and rigorous on-site safety and soundness examinations to enforce compliance with applicable risk management standards.

The recent financial crisis highlighted the ineffectiveness of a patchwork regulatory structure for systems critical to the clearance and settlement of financial transactions and confidence in our financial markets. The Federal Reserve has a wealth of relevant expertise and resources that should be extended to all systems deemed systemically important. These systems should also have access to Reserve bank accounts, financial services, and the discount window for emergencies.

Additional Structural Issues

Maintain Dual Banking System and Do Not Create a Monolithic Federal Regulator

ICBA is pleased that the President's plan retains the system of federal and state bank chartering and does not recommend creating a single, monolithic federal regulator. We also very much appreciate Chairman Frank's recent pledge to preserve the thrift charter and a diverse regulatory system with checks and balances.

The current system provides valuable checks and balances in policy making and implementation. We should no more eliminate these checks and balances in the current bank regulatory system than eliminate the multiple branches of government that are the foundation of our country. Overwhelming concentration of power in any governmental or economic sector is counterproductive and unwise. Further, ICBA supports independent bank regulatory agencies because they are more insulated from political pressures, and can deal more objectively with those they are charged to regulate. If a single regulator were to go off in the wrong direction, there would be no offsetting regulatory voices, as we have today.

The single bank regulator concept solves a problem that we simply do not have; it was the unregulated parts of the financial industry, such as Wall Street investment houses and mortgage brokers, which caused the problems in our economy. Congress and the Administration must focus on addressing these challenges. New regulatory restructuring rules should target systemic-risk institutions to reduce the dangerous concentration of financial and economic assets. The regulated community banks are the victims and have held up remarkably well in this severe recession. Abolishing a regulatory system that worked makes no sense at all.

As the single Federal bank chartering agency, it would continuously tilt the playing field in favor of national banks at the expense of the state banking system. Having both state and federal regulators creates a flexible system of checks and balances that promotes innovation, preserves consumer choice and fosters overall systemic resiliency. In fact, our dual banking system has served our nation in times of prosperity and crisis remarkably well for nearly 150 years.

A single Federal regulator would focus its attention on the nation's largest institutions – its key clients. Community banks would be an afterthought. Congress should maintain a bank regulatory system that recognizes the importance of community banks and Main Street America, and gives all community banks enforcement parity, proportional regulation and equal access with the Wall Street firms.

The current system of bank supervision – though admittedly complicated on paper, has weathered the current crisis reasonably well. It provides substantial uniformity of capital and supervisory standards, but also different perspectives and essential checks and balances.

Some have complained that these advantages also give institutions the opportunity to engage in "regulatory arbitrage," playing one regulator against another. Let me be completely clear on this, no institution should be able to escape a regulatory action,

such as a cease and desist or similar order, by changing charters. In fact, the Federal Financial Institutions Examination Council recently issued a statement that provides "that charter conversions or changes in primary federal regulator should only be conducted for legitimate business and strategic reasons." It goes on to say that, "Conversion requests submitted while serious or material enforcement actions are pending with the current chartering authority or primary federal regulator should not be entertained." [9]

In addition, we would require the systemic risk regulator, or the council, to harmonize regulatory standards (i.e., capital, margin, derivatives, etc.) to ensure no regulatory arbitrage based on charter or entity type.

Subject Unitary Thrift Holding Companies to the BHCA; Close ILC Loophole

Unitary thrift holding companies should be regulated as bank holding companies, supervised and regulated by the Federal Reserve on a consolidated basis, and subject to prohibitions on commercial activities. Many commercial entities used the unitary thrift loophole to get into the banking business. Unfortunately, the Gramm-Leach-Bliley Act of 1999 grandfathered existing thrift holding companies that qualified as unitary thrifts. By escaping the Bank Holding Company Act, these unitary thrifts have been able to evade consolidated supervision by the Federal Reserve and the long-standing policy of separating banking from commerce. This loophole should be shut down and unitary thrifts should be given a definite period of time to divest their commercial activities once they become subject to the Bank Holding Company Act.

Of course, the same must be said about the industrial loan company loophole, which remains open. Under this loophole, commercial companies may acquire or establish banks in several states. Administrative action and economic conditions have discouraged this activity in recent months, but unless the Congress acts, commercial companies could soon begin seeking banking charters again. Just imagine if major commercial firms had been heavily involved in the banking business last fall. The Administration has proposed the safest course – close the loophole in connection with this legislation.

Assistant Treasury Secretary for Community Financial Institutions

The current economic downturn has revealed just how critical community banks are to our country's financial system and why we need to give them appropriate consideration when devising national policies and programs. Recent reports by the FDIC indicate that even when the biggest banks have stopped lending, community banks have seen an increase in their loans. Despite the fact that they are a vital part of our nation's banking

[9] **FFIEC Statement on Regulatory Conversions;** FIL-40-2009, July 7, 2009

system, there is no Assistant Secretary at the Department of Treasury to coordinate federal policy for smaller financial institutions.

For more than two decades, Treasury has taken the lead in crafting the Federal government's response to crises in the banking sector and formulating regulatory reforms to prevent reoccurrences of the crises. Because Treasury plays a central role in Federal banking and economic policy, it is important that community banks have a voice inside Treasury advising the Secretary on how policies will impact community banks. Two actions by the Bush Treasury Department in response to the current financial crisis highlight the need for a community bank advocate inside Treasury.

First, Treasury created a money market mutual fund insurance program overnight with almost no statutory authority. The fees charged to the mutual fund industry for the guarantee were minimal compared to the price that banks pay for deposit insurance. Treasury's action gave a community bank competitor a significant advantage. The original plan would have given unlimited coverage to money market funds, which would have devastated community bank liquidity with runs on deposits. Although Treasury eventually limited coverage to amounts already in the funds, thanks to intervention by the FDIC and the banking industry, these events illustrate how the Treasury can overlook the community banking sector.

Second, when Fannie Mae and Freddie Mac were put in conservatorship last year, Treasury drastically misjudged the impact of the conservatorship on community bank holders of GSE preferred shares. Prior to the conservatorship, regulators had encouraged community banks to purchase GSE preferred shares as a safe investment that supported housing. Treasury believed that the conservatorship would impact few community banks, when, in fact, the actions wiped out large amounts of capital for hundreds of community banks. While we appreciate the limited tax relief Congress provided community bank preferred shareholders, many community banks are still burdened by the loss of capital caused by the devaluation of their GSE preferred shares.

H.R. 2676, the Oversight for Community Financial Institutions Act of 2009, introduced by Rep. Dennis Cardoza, would create an Assistant Treasury Secretary for Community Financial Institutions. H.R. 2676 would ensure that community banks – including minority-owned institutions – are given appropriate and balanced consideration in the Treasury policy-making process. This is absolutely vital to the continued health and strength of our nation's community banks and the communities they serve. ICBA urges Congress to include H.R. 2676 in the regulatory reform legislation.

Conclusion

ICBA appreciates this opportunity to testify on legislative proposals to restructure and reform our nation's system of financial regulation. It is vital that Congress take action, but it is essential that you take the right actions so that when America emerges from this

current crisis, our citizens continue to enjoy a vibrant economy and the ability to build a strong financial future. This committee should adopt strong legislation to deal with systemic risk and properly focus the effort to protect consumers.

We must end too-big-to-fail and reduce systemic risk in order to protect consumers, local communities, our financial system and the economy from the destabilizing effects that occur when a giant institution runs into trouble. Community banks are the very fabric of our nation. We fund growth, drive new business development, help families buy homes, finance education. We are not responsible for the current state of our economy but are the victim of others' bad practices. Yet, we continue to help the people and businesses in our communities recover from this crisis and find a way back to prosperity. ICBA looks forward to supporting a plan that embodies our recommended improvements.

Addendum

ICBA Testimony on Systemic Risk

October 29, 2009

Introduction

This addendum presents a preliminary analysis of the discussion draft dated October 27, 2009 presented by the House Financial Services Committee and the Treasury Department.

ICBA believes that this draft meets a substantial number of ICBA's key policy goals as expressed in our testimony. We will be reviewing this draft in more detail in the coming days, but what follows is our reaction to key aspects of the draft and some recommendations for further improvement.

Enhancing Regulation and Supervision of Systemically Risky Institutions

ICBA strongly supports the provisions of the discussion draft that designate the Federal Reserve as the systemic risk regulator and that appear to give it sufficient authority to carry out its responsibilities. We also support the enhanced authority of the Financial Services Oversight Council over the Federal Reserve's decisions. While the Federal Reserve has the expertise and experience to deal effectively with these matters, they are so critical that other agencies must be involved as well.

The discussion draft appears to provide the Federal Reserve the full range of authority over the activities of systemically risky institutions, as we recommend in our testimony. We will review this further and make any further recommendations if we believe them to be necessary.

ICBA had recommended that the Council and the Federal Reserve identify systemically risky institutions. The discussion draft adopts this recommendation with a clear prohibition that the Fed not publically name these institutions. This is an appropriate clarification that attempts to avoid the possibility that these institutions will benefit from this designation. Of course, there is the possibility that market participants could infer that an institution has been identified as systemically risky as a result of regulatory filings, e.g., SEC disclosures.

Downsizing Systemically Risky Institutions

ICBA is especially pleased that the discussion draft provides the Federal Reserve the authority to require a systemically risky holding company to sell assets or terminate

activities if they pose a threat to the company's safety and soundness or the nation's financial stability (Section 1104(a)(5)). This authority gets to the heart of many of the problems that led to the nation's financial meltdown. Some institutions have become so large that they cannot be effectively managed or regulated and must simply be downsized. ICBA recommends that the legislation direct the Federal Reserve to study each identified financial holding company to determine if it should be subject to this new authority.

Resolving Failing Institutions

The draft legislation gives the FDIC authority to responsibly resolve systemically risky holding companies. The bill gives the Treasury Secretary the sole authority to appoint the FDIC as receiver for a failed holding company. However, this vests a politically appointed official with tremendous power over the nation's economy. ICBA recommends that the legislation specifically empower the FDIC, as an independent agency, to recommend to the Secretary that he or she exercise this authority. Congress should also consider giving similar authority and responsibility to an institution's primary regulator.

Funding Resolutions

In our main testimony, ICBA recommends that funding for the resolution process be provided by the largest institutions in advance. We believe that a pre-funded resolution process has a number of advantages:

- It avoids an initial call on taxpayer funds that would be likely if an institution were to fail unexpectedly (which is – of course – the way these events typically unfold).
- It places the cost on institutions that may later fail, rather than only on institutions that haven't failed, providing an important equitable balance.
- Pre-funding avoids pro-cyclical effects; tapping the industry for modest, predictable contributions when times are good.

The FDIC's Deposit Insurance Fund provides a good example of how this could work. While there is much concern about the DIF's current funding levels, the fact is that the fund has operated exactly as intended. Even a full year into the deepest recession since the Great Depression, it maintained a positive balance through at least the first half of this year. (Even now, the DIF retains a robust cash balance, though much has been set aside for anticipated losses.) The Congress had many months to deliberate on legislation to enhance the FDIC's Treasury borrowing authority. And, the FDIC believes that the industry itself can recapitalize the fund without taxpayer resources. This is a commendable record and reflects well on the industry, the FDIC, and the Congress for establishing the system.

A pre-funded systemic risk fund could compile a similar record. It would not be necessary for it to accumulate enough cash to deal with every possible contingency.

But, it could have enough to tide the economy through another crisis such as we faced last fall. At that time, most policy makers believed Congress had to move with astonishing speed to address the crisis. An existing fund would allow the government to act quickly – under clear statutory authority – and allow the Congress time to review the situation in a deliberate fashion if even more resources are needed.

The post-funding system in the discussion draft should be a backstop to a pre-funded fund, but relying on post-funding when the entire system is collapsing is problematic. Post funding appears to work well in the context of state insurance regulation, where it is designed to deal with individual failures. In those cases, policy holders in an insurance company that fails due to mismanagement or fraud (rather than a systemic problem) can be made whole by contributions by the remaining healthy companies. In the case of widespread failures dues to a systemic situation, this concept does not work as well.

The discussion draft attempts to deal with this by stretching out the post-funding over 60 months. The downside of this approach is that the taxpayer funds are at risk and the failed institutions are – obviously – in no position to pay their fair share.

Nevertheless, ICBA strongly supports the provision in the draft that provides that only institutions over $10 billion in assets be assessed under this plan. This is clearly appropriate, since any institution smaller than that would not have had any role in creating the next systemic risk event. Congress should index this amount to address likely asset growth over time, particularly if this provision is not used until after a systemic event that will – all must hope – take place some time in the future.

Closing the ILC Loophole

ICBA strongly supports the provisions in the discussion draft that block the creation of additional industrial loan companies that may be owned by commercial firms. While we supported the Administration's proposal to completely close of the loophole – requiring the divestiture of existing commercially-owned ILCs – we recognize that Congress does not generally adopt such measures. When Congress closed the nonbank bank loophole in 1987 and the unitary thrift loophole in 1999, it included similar grandfathering language. These effectively prevented the establishment of dangerous combinations, such as a "Bank of Wal-Mart." We expect the discussion draft will have a similar effect, while not disrupting existing businesses.

Maintaining the Federal Thrift Charter

Even though the OTS would be merged into the OCC, ICBA is particularly pleased that the discussion draft retains the federal thrift charter, establishes a Division of Thrift Supervision within the OCC, and maintains key elements of the charter. As we indicated in our testimony, the vast majority of federal thrifts have served their

communities in a responsible manner and there was no reason to force them to adopt an entirely new charter.

We also support the draft's preservation of the dividend waiver process for mutual holding companies. This provision would allow, for the most part, the continuation of the dividend waiver policy under the Federal Reserve, subject to certain conditions. Under this policy, mutual holding companies that are owned partially by the public can pay dividends to those public stockholders just like most other publicly held companies. This helps them maintain their holding company structure, which helps them raise capital and yet remain a mutual institution.

Tightening Securitization Process

Section 1502 of the discussion draft would require an originator to retain an economic interest in any loan that it transfers to a third party. The bill would require securitizers of asset-backed securities to retain an economic interest in the underlying assets, unless the originators have retained an economic interest. In general, at a minimum, the retained interest would be a credit risk of between 5 and 10%. The federal banking agencies, jointly with the Securities and Exchange Commission can adjust the risk retention requirements or exempt loans from the risk retention requirements.

ICBA agrees that if the secondary mortgage market had required that all market participants have some skin in the game, the current crisis would not be as severe. Lawmakers need to be careful, however, to address the problems that created the subprime crisis without unnecessarily burdening mortgage and other types of credit. While the accounting treatment of the risk retention requirement is not entirely clear, it is clear that an originator will have to hold capital against its retained interest for the life of the loan. Over time, the retention requirement will limit an institution's capacity to originate loans.

The Mortgage Reform and Anti-Predatory Lending Act (H.R. 1728) adopted by the House this year, contains a 5% risk retention requirement for non-qualified mortgages. Among the features of H.R. 1728 is authority for regulatory agencies to treat mortgages under various government-related programs, such as FHA and Fannie and Freddie as "qualified mortgages", which are not subject to the 5% risk retention requirement. If H.R. 1728 is not incorporated in the legislation, then beneficial provisions from H.R. 1728, such as the exemptive authority for FHA and GSE loans should be incorporated in this legislation. In addition, we urge the Committee to include similar exemptive authority for similar loan programs, such as Farmer Mac. We are concerned that a bank could lose the flexibility to sell whole loans outside a securitization transaction, when that is in the best interest of the bank, such as when a bank is exiting a line of business. This flexibility should be retained.

TESTIMONY OF
T. TIMOTHY RYAN, JR.
PRESIDENT AND CEO OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:

"SYSTEMIC REGULATION, PRUDENTIAL MATTERS, RESOLUTION AUTHORITY AND SECURITIZATION"

OCTOBER 29, 2009

I. Introduction

Chairman Frank, Ranking Member Bachus, members of the Committee:

My name is Tim Ryan and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for your invitation to testify at this important hearing. My testimony will focus on the proposals for systemic risk regulation, with special emphasis on the proposal for resolution authority over systemically important non-bank financial institutions. I will also discuss the FDIC's proposals for extending resolution authority to all bank holding companies, as well as the proposal to impose activities restrictions on systemically important financial institutions that do not control a bank.

---

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

Finally, I will touch on securitization reform. On Tuesday, this Committee and the Administration released a discussion draft of the Financial Stability Improvement Act of 2009, which updates the Administration's earlier proposals (the "Discussion Draft"). While my testimony today reflects changes contained in the recent release, we look forward to commenting further on the Act and may supplement this testimony to discuss the revised proposals.

It has been just over a year since panic swept the global financial system, resulting in free falling markets during September and October of last year. Government authorities around the world responded aggressively to this panic, placing Fannie Mae and Freddie Mac into conservatorship, allowing Lehman Brothers to fail, and rescuing AIG, the Royal Bank of Scotland, Lloyds TSB, Fortis, Dexia and other major financial groups. Congress played a key role in this response by passing sweeping legislation, including the Housing and Economic Recovery Act of 2008, the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009. Those efforts have largely succeeded in stabilizing the financial system. But that stability is fragile and the economy continues to have many other weaknesses, including high unemployment and residential foreclosure rates.

Congress and the Administration have correctly recognized that ending the free fall and stabilizing the system is only half the battle. In order to avoid future financial crises of this magnitude, or at least reduce their frequency and severity, we need to strengthen our regulatory infrastructure so that it can focus on macro-prudential issues as well as it can focus on micro-prudential issues. If we do this

job right, not only will we reduce the likelihood of future crises, but we can also eliminate the weaknesses that give rise to the need or temptation to bail out financial institutions that may otherwise be considered "too big or complex to fail." Regulatory reform, correctly implemented, will also restore market and investor confidence, and contribute to financial and economic stability.

We believe that the systemic risk proposals, including the Discussion Draft's proposal on resolution authority for systemically important financial institutions, are critical keys to achieving these goals. As a result, we strongly support many of the proposal's concepts, but we believe some important changes need to be made to the draft legislation, especially with regard to the proposed resolution authority. With the appropriate changes, these policies can achieve their goals without producing any unnecessary, and presumably unintended, adverse consequences.

SIFMA has been, and is strongly committed to continuing to be, a constructive voice in this critically important public policy dialogue to restore confidence in our domestic and global financial system. Our members understand the value that a well-designed and implemented regulatory system brings to minimizing systemic risk. We believe that a global effort is required to develop such a regulatory system with common principles that limit regulatory arbitrage between and among nations.

II. Systemic Risk Proposals

The trouble with financial panics is not only the direct harm they do to the financial system and investors, but also the negative externalities that a weakened

financial system imposes on the rest of the economy. A strong financial system facilitates the sort of prudent risk-taking by businesses and investors necessary for a vibrant modern economy. It produces positive benefits in the form of widely available credit at desirable rates, deep and liquid trading markets, accurate asset prices, safe ways to preserve money and other assets for future use, favorable conditions for prudent business investing and healthy consumer spending and other benefits to the economy as a whole. When the public has confidence in the financial system, the interplay between the financial system and the rest of the economy has a multiplier effect on the supply of money and credit available. Thus, every dollar printed by the central bank or introduced into the economy by government spending is multiplied into an amount of money and credit available in the economy many times the initial dollar. These features of a healthy financial system foster economic growth, capital formation, business investments in capital, individual investments and savings, consumer spending and full employment.

When a financial panic occurs, the public and lending institutions lose confidence in the financial system, and so the amount of credit available severely contracts. This contraction of credit results in negative consequences to the rest of the economy in the form of excessive pessimism and risk reductions, reduced business investing, reduced consumer spending and increased unemployment. It is therefore critical to have a regulatory infrastructure that avoids panics, and their negative consequences, while allowing the financial system to operate properly in providing a healthy amount of credit and other positive benefits to the market. We believe that a systemic risk regulator will go a long way to address the

weaknesses in our current system and reduce the likelihood and severity of future panics.

A. Interrelated Nature of the Proposals

The Discussion Draft's proposals for a systemic risk regulator, enhanced prudential supervision and regulation, resolution authority for systemically important financial institutions, securitization reform and enhanced risk management of systemically important payment, clearance and settlement systems are all part of an interrelated package of proposals aimed at reducing systemic risk and strengthening our financial system. These proposals are the missing elements in our current financial regulatory infrastructure that have the most potential to prevent, or at least reduce the likelihood or severity, of the sort of financial panic we experienced last September and October, which led to most of the harm done to the financial system. Each element is dependent on the existence and shape of the other elements in order for the whole to work properly.

Each of these elements plays a critical role in preventing, or at least reducing the likelihood or severity, of a future financial crisis. We support the proposal for a Financial Services Oversight Council, with the Treasury Secretary as the Chair, and in which the Federal Reserve has a substantial role. The proposal for a systemic risk regulator should provide the authority for a single federal agency or a council of federal agencies to gather information from every financial institution operating in our economy, regardless of charter and whether the financial institution is otherwise subject to federal regulation and supervision. This power should give that single agency or council access to a wealth of

information that no federal agency or group of agencies currently has. It should also give that agency or council a sense of duty, backed up by legislative mandate, to use that information to identify weaknesses in the overall financial system and address them before they become problems that could result in the sort of panic that took place last September and October. If this proposal is successful, it should eliminate or reduce the likelihood of market meltdowns.

The proposals for enhanced prudential supervision and regulation can also play a critical role in avoiding financial panics and market meltdowns. Financial regulatory agencies need to set limitations and requirements in ways, and in compliance with international standards, that will prevent macro-risks to the system as well as micro-risks to the particular institution. It is also important to get the balance of regulation right, and not to overcompensate with standards that will stifle the economy. If we have the right prudential standards, the probability of a financial panic can be greatly reduced.

If stricter prudential regulation in the form of enhanced capital, liquidity and leverage requirements and greater activities restrictions is not coordinated with foreign and international standards, U.S. financial regulatory reform could give rise to disparate regulatory treatment, which could result in regulatory arbitrage. The Administration has called for a "global race to the top" on regulatory standards.[2] This suggests that U.S. and foreign regulators, through the G-20 and other groups, should coordinate on establishing consistent and high

[2] President Barack Obama, Remarks by the President on Financial Rescue and Reform, Federal Hall, New York, New York, September 14, 2009, *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall/.

standards for regulations. It is important to strike the right balance between setting high standards and being consistent with regard to regulating capital, leverage, liquidity and business activities. Otherwise, if a diverse group of regulators handle these issues in a piecemeal fashion, the U.S. may miss the critical opportunity to eliminate regulatory gaps. Conversely, a piecemeal approach risks over-regulation, which may create incentives to move U.S. jobs and businesses off-shore. In recent remarks, Treasury officials have identified these risks, noting that "[i]n a world of mobile capital, no single jurisdiction can achieve its regulatory objectives in isolation."[3]

Resolution authority for systemically important financial institutions is a fail-safe measure in case the "front-end" framework of systemic risk and prudential supervision and regulation does not always prevent panics or failures. Financial firms should be allowed to fail, imposing costs on their shareholders, management and creditors, regardless of whether they are large or small. If shareholders, management, creditors and other stakeholders believe that an institution will be bailed out because it is "too big or complex to fail," these stakeholders will take or allow greater risks than they would if they believed that the institution would be allowed to fail and they could lose some or all of their investments. Such excessive risk-taking as a result of this "moral hazard" can create systemic risk, as well as increasing the risk and costs of a financial crisis and the negative externalities that it produces.

---

[3] Acting Assistant Secretary for International Affairs Mark Sobel, Remarks to IIB Regulatory Breakfast Dialogue in Istanbul, October 5, 2009, *available at* http://www.ustreas.gov/press/releases/tg309.htm.

Conversely, the establishment of a resolution authority mechanism by statute, if properly structured, should eliminate the perceived need to bail out certain financial institutions because it would eliminate the risk that allowing them to fail would have such a severe domino effect on their counterparties, investors and the rest of the financial system that it would be more costly to the system to allow them to fail than to bail them out. Simply put, a properly established resolution authority mechanism would obviate the need for open-ended taxpayer support and instead provide for the orderly wind down and dissolution of such institution while limiting systemic risk to the financial system.

Finally, the proposals to focus enhanced scrutiny on the risk management policies and procedures of systemically important payment, clearing and settlement systems will ensure that these systems continue to reduce risk to the overall financial system, rather than becoming systems for concentrating, hiding or spreading risk.

B. Strong Support for the Overall Goals of the Discussion Draft

SIFMA strongly supports the overall goals of the Discussion Draft's systemic risk proposals though we continue to review the recent systemic risk and resolution authority release and the specific proposals contained in that release. As described below, we believe that some of the details in these proposals need to be revised so as not to produce unintended consequences. Primarily, these include provisions in the proposed resolution authority that would reduce judicial review of the claims process and replace the rules defining creditors' rights in the Bankruptcy Code with the very different and creditor-unfriendly rules contained

in the bank insolvency statute. They also include provisions in the systemic risk regulation proposal that would prohibit a systemically important financial institution, now called an identified financial holding company, from engaging in certain activities based on which side of the wall between banking and commerce the activities fall, rather than whether the activity is excessively risky or the particular institution is unable to manage the risk appropriately.

III. Resolution Authority for Systemically Important Financial Institutions

SIFMA strongly supports the Discussion Draft's proposed resolution authority for systemically important financial companies to the extent it gives a federal agency the authority to exercise core resolution powers. Core resolution powers include the authority to take control over a failing non-bank financial company as receiver or qualified receiver, to act quickly to transfer all or any part of the failing company's business to a third party or temporary bridge financial company at fair value to stabilize or wind down the company in a cost-effective and orderly fashion that minimizes systemic risk and solves the "too big to fail" problem. But SIFMA opposes replacing the transparent claims process and neutral rules governing creditors' rights in the Bankruptcy Code, which are more appropriate for non-banks, with the opaque claims process and creditor-unfriendly rules contained in the bank insolvency statute. Otherwise, the proposal will have the unintended consequence of seriously disrupting and causing permanent harm to the U.S. credit markets. Preserving a transparent and neutral claims process

based on the principles of the Bankruptcy Code will not interfere with the federal agency's power to move quickly to exercise its core resolution powers.

A. Purpose of the Proposed New Resolution Authority

The central purpose of the proposed resolution authority is to give a federal agency the power to act quickly so that a systemically important financial institution can be unwound in an orderly fashion without causing a domino effect throughout the financial system or otherwise unduly disrupting the markets. Under normal market conditions, the Bankruptcy Code is effective in dealing with failed or failing companies. The market has a deep understanding of its process and substantive rules, and generally considers both to be fair and predictable. During a financial panic, market meltdown or certain other circumstances, however, leaving the authority to deal with a large and interconnected financial company in the hands of a bankruptcy court, creditors committee or trustee in bankruptcy can create a risk of serious adverse effects on financial stability or economic conditions in the United States.

These adverse effects result largely because resolution of these companies through the normal bankruptcy process occurs far too slowly given the speed with which value can disappear during a market meltdown. This is true because of the extraordinary speed with which both credit disappears for financial companies during a financial crisis and the value of certain assets (such as qualified financial contracts) dissipates upon the commencement of bankruptcy proceedings. The follow-on effects of this loss of value are distributed throughout the financial

system, thereby increasing systemic risk and the cost of government intervention to stabilize the financial system.

The core resolution powers needed to achieve this purpose are the following:

- the power to allow federal regulator(s) to take control of a failed or failing company as receiver or qualified receiver if a systemic risk determination is made; and
- the power of the receiver or qualified receiver to act quickly to identify and sell the part of the business worth preserving to a third party at fair value and, when a third party buyer cannot be found at fair value, to establish a temporary entity called a "bridge financial company" to hold the part of the business worth preserving until it can be sold to a third party at fair value or wound down in an orderly fashion.

The part of the business left behind is then liquidated. The ultimate goal of the resolution authority is to wind up the affairs of a failed financial company in an orderly manner at the least cost and with the least disruption to the financial system. It is not meant to serve as a means to rescue or otherwise preserve the failing company.

These core resolution powers are designed to overcome the weaknesses in the bankruptcy process by providing a way for the systemically critical parts of a non-bank financial company's assets and liabilities to be preserved in the most cost-effective way, regardless of whether creditors within the same class are treated equally. This cherry-picking of assets and liabilities in the interest of

systemic stability would normally be antithetical to established bankruptcy policies, which favor equality of treatment for similar situated creditors. It is justified, however, in the case of systemically important non-bank financial companies because of the supervening policy goals of preserving the value of these entities and minimizing public costs.

What was most needed when Lehman failed, and when AIG was rescued, was not an adequate claims process, but instead the authority of a federal regulator to take control over the failing institutions and transfer the systemically important part of its business to a temporary bridge company until it could be sold to a third party at fair value or wound up in an orderly manner. Without the authority to resolve complex financial institutions, policymakers were left with two choices: let the company fail regardless of adverse consequences to counterparties and the financial system as a whole, as in the case of Lehman, or inject taxpayer dollars to support the company, as in the case of AIG. Both decisions have had substantially negative consequences on the financial markets.

B. The Claims Process

The Discussion Draft's proposal, however, goes beyond the creation of these core resolution powers. It also replaces the Bankruptcy Code's transparent judicial claims process and neutral rules for left-behind assets and liabilities with the opaque administrative claims process and creditor-unfriendly rules defining creditors' rights contained in the bank insolvency statute. Unlike the core resolution process, there is no compelling reason for extraordinary speed in the claims process for left-behind assets and liabilities because dividing up the pie

among left-behind claimants does not affect the systemically important portion of the business transferred to a third party or bridge company, but only the portion left behind to be liquidated. There is no need for the claims process for left-behind assets and liabilities to operate more quickly than a normal bankruptcy liquidation or for it to by-pass the normal procedural and substantive safeguards of bankruptcy, which were designed to comport with legitimate commercial expectations of creditors and principles of inter-creditor equity.

On the other hand, there are substantial policy reasons for allowing the due operation of the normal and expected safeguards to provide assurance that the market will have confidence that the process of left-behind assets and liabilities will be neutral, predictable and fair. The market has a deep understanding of the Bankruptcy Code, and its procedures and rules, and generally considers them to be neutral, fair and predictable. The market does not have a similar understanding or positive view of the claims process and substantive rules under the bank insolvency statute, particularly as it would apply to non-bank financial companies.

C. The Bank Insolvency Model

The Discussion Draft's proposal is modeled on the bank insolvency statute contained in Sections 11 and 13 of the Federal Deposit Insurance Act. The bank insolvency statute contains the sort of resolution framework that is essential for the proposed resolution authority to achieve its goals. The bank insolvency statute grants the FDIC power to take control over a failed or failing insured depository institution as conservator or receiver. It also authorizes the FDIC to act quickly to identify and sell any part of the business worth preserving to a third

party at fair value and, when a third party buyer cannot be found at fair value, to establish a temporary "bridge bank" to hold the part of the business worth preserving until it can be sold to a third party at fair value or wound down in an orderly fashion. These are the sort of powers that a federal agency needs to have to deal with a future AIG or Lehman Brothers, instead of leaving them in the hands of a bankruptcy proceeding or bailing them out. It is therefore sensible to model the "resolution process" component of the proposed resolution authority on these provisions from the bank insolvency statute.

The bank insolvency model is not the right model for the claims process and related rules for dividing up the left-behind assets and liabilities of non-bank financial companies that would otherwise be subject to the Bankruptcy Code in the absence of a systemic determination. The uncertainty produced by such a dramatic change in the "rules of the game" based on an after-the-fact determination will substantially increase the risks and uncertainties associated with financing entities of this type.

The claims process in the bank insolvency statute was deliberately designed to favor the FDIC, as creditor, over all other creditors. Because the FDIC insures an insured bank's deposits, it is typically the largest creditor of a failed bank. Indeed, the bank insolvency statute gives the FDIC a set of "super powers" that have no counterpart in the Bankruptcy Code. These superpowers allow the FDIC to subordinate or otherwise limit the claims of other creditors in ways that are inconsistent with neutral rules governing creditors' rights.

The claims process based on this model is subject to virtually no judicial review, except for de novo judicial review after the administrative claims process has been completed. The provision that allows a company to seek judicial review of the appointment of a conservator or receiver may even be a mirage since the federal agency succeeds by operation of law to all of the company's rights and powers, without any express carve-out of the power to seek judicial review, automatically upon its appointment as conservator or receiver.

Because the FDIC does not provide insurance for the liabilities of a non-bank financial company, the super powers contained in the bank insolvency statute are inappropriate when applied to non-bank financial companies, regardless of whether a systemic risk determination has been made.

D. Unintended Consequences

If the proposed new resolution authority includes the claims process and related rules from the bank insolvency statute it will produce a number of unintended consequences that would undermine many of the proposed bill's goals, reduce the efficiency of the credit markets and impose deadweight costs on our economy.

To provide just one illustration of these unintended consequences consider the differences between the avoidable preference rules in the two statutes. Under the Bankruptcy Code, perfected security interests are respected in a bankruptcy proceeding and cannot be set aside, as long as they were taken to secure a new extension of credit. As a result, financial companies can virtually always obtain emergency liquidity in a financial crisis if they have unencumbered collateral. In

contrast, the bank insolvency statute allows the FDIC to set aside any security interest taken "in contemplation of insolvency" of the failed institution. But all security interests are taken to guard against insolvency risk. As applied to non-banks, this provision could cut off a financial company's access to emergency liquidity during a financial crisis because of the uncertainty whether the security interest will be respected in the event a resolution proceeding becomes necessary.

If the proposed legislation retains the avoidable preference rule from the bank insolvency statute, financial companies that might be subject to its rules could also face higher credit costs and less credit availability during normal market conditions to account for the heightened risk that, if the entity faces financial distress or market disruption, asset-based financing will be unavailable to the entity, potentially accelerating its financial failure.

The bank insolvency statute also includes rules related to the treatment of contingent claims, fraudulent transfers, setoffs, repudiation of contracts, calculation of damages upon the rejection, and other matters that depart drastically from the bankruptcy model, ostensibly to favor federal deposit insurance claims that would not exist in the non-bank context. This departure from neutral, fair and equitable rules that would otherwise apply under the Bankruptcy Code is neither efficient nor fair.

E. Alternative Approaches to Preserve the Normal Claims Process

We believe that the proposed resolution authority should be amended to restore the claims process and rules defining creditors' rights contained in the

Bankruptcy Code. There are a number of possible ways to preserve the normal claims process, two of which are summarized below.

One approach would be to continue to allow non-bank financial companies to be removed from the bankruptcy system, but to harmonize the process and related rules for dividing up the pie among left-behind assets and liabilities of such companies in the Discussion Draft with the process and rules that would otherwise be applicable under the Bankruptcy Code. This would involve adding provisions to increase judicial involvement in the administrative claims process for left-behind assets and liabilities and to restore each of the Bankruptcy Code's substantive rules governing creditors' rights.

Another approach would be to replace all of the provisions relating to the claims process for left-behind assets and liabilities with a simple set of provisions that would cause such assets and liabilities to be resolved through the commencement of conventional proceedings under the Bankruptcy Code, subject to the federal agency's continuing to exercise its core resolution powers with respect to the assets and liabilities it determines should be sold or transferred for systemic reasons. The law could also authorize the federal agency to choose whether the left-behind assets and liabilities would be resolved under Chapter 11 or Chapter 7, and to participate in the bankruptcy proceedings in the capacity of debtor (having succeeded by operation of law to the powers of the shareholders and board of directors of the debtor) or bankruptcy trustee, as appropriate.

The benefit of either approach is to increase legal certainty as to how creditors of a systemically important financial institution will be treated under the

resolution statute, which will add to stability and confidence in the financial markets both during a financial crisis and in otherwise calm market environments.

F. Minimum Recovery

SIFMA strongly agrees with the Discussion Draft's proposal, modeled on a similar provision in the bank insolvency statute, to guarantee all creditors left behind a minimum distribution equal to what they would have received in a liquidation under the Bankruptcy Code, in the absence of a systemic risk determination. The Discussion Draft's proposed financial assistance powers should ensure that left-behind creditors have an adequate remedy to assure this minimum recovery right, if the federal agency exercises its core resolution powers in a way that favors some creditors over others for the benefit of the financial system. If, for example, the simple model of administering the left-behind claims through proceedings under the Bankruptcy Code is adopted, the remedy might be to provide the bankruptcy estate with a claim for any shortfall in value which could be pursued under appropriate supervision by representatives of the left-behind creditors.

G. Solution to the "Too Big to Fail" Problem

SIFMA supports the revisions included in the Discussion Draft's proposed resolution authority that are designed to solve the "too big to fail" problem. In particular, SIFMA supports imposing time limits on qualified receiverships. But we believe that a limit of 2-5 years is too long, and should be reduced to six months or some similar shorter period. Otherwise, qualified receiverships could amount to temporary de facto nationalizations.

SIFMA also supports restrictions on providing financial assistance outside the context of a receivership or qualified receivership, but we support the flexibility provided under the emergency financial assistance provisions in the context of when an economic distress determination has been made. However, we believe that it is inappropriate to require a federal agency to ensure that all unsecured creditors bear losses since this would interfere with the federal agency's core resolution power to transfer some liabilities to a third party or bridge financial company if necessary to stabilize or wind down the company in a cost-effective and orderly fashion that minimizes systemic risk.

H. Systemic Resolution Board; Fed Membership on FDIC Board

The FDIC has only limited experience with the type of large, complex and global institution that could be subject to the proposed legislation. We therefore strongly support the provisions in the Discussion Draft's proposed resolution authority that require the FDIC to consult with the regulators of the covered financial companies. But we do not believe that these consultation requirements are sufficient to ensure that the right experience is brought to bear in resolving systemically important non-bank financial companies. Instead, we believe that a new Systemic Resolution Board should be created. The new board should be chaired by the Secretary of the Treasury, with representatives from the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency and the SEC. The FDIC would be subject to the direction of the Systemic Resolution Board in exercising its powers. In addition, the appropriate functional regulator for a particular covered company should be a member of the Systemic Resolution

Board for purposes of that company and thereby directly involved in exercising the resolution authority with respect to that company.

We also strongly agree with the provision in the Discussion Draft that would give the Federal Reserve a seat on the FDIC's board, replacing the Office of Thrift Supervision if the Office of Thrift Supervision is merged with the Office of Comptroller of the Currency.

I. Increasing Legal Certainty

It is also important to include provisions in the proposed resolution authority that will increase legal certainty because of the systemic nature of the covered companies. For instance, we strongly agree with the provision in the Discussion Draft's proposed resolution authority that would require a federal agency to promulgate regulations regarding the allowance or disallowance of claims by the FDIC. But we believe the right entity to exercise this authority is our proposed new Systemic Resolution Board of which the FDIC would be only one member. We also do not believe this mandate is sufficient unless it is coupled with an express duty to promulgate regulations in a way that increases ex-ante legal certainty for everyone potentially affected. Nor should the FDIC or the Systemic Resolution Board be allowed to rely on the FDIC's existing rules, which were developed for banks in connection with a very opaque claims process and rules governing creditors' rights that are not appropriate for non-bank financial companies. Instead, we believe that the mandate should be combined with substantially more judicial review of the claims process to make it as

transparent as the bankruptcy process and with a restoration of the rules governing creditors' rights under the Bankruptcy Code.

The proposed legislation should also contain rules that increase legal certainty as to how customers and secured creditors can determine their rights, interests and priorities in securities held through a systemically important securities intermediary. Increasing legal certainty about how customers and secured creditors can protect themselves against the insolvency risk of securities intermediaries has been a U.S. national and international policy goal since at least 1987. This need is even more obvious as soon as one is made aware of the mind-boggling volumes of securities transactions, including securities collateral transactions, that are currently processed by the major clearing systems. According to data posted on the Federal Reserve's website, the average volume of U.S. government and agency securities transactions processed by the Fedwire Securities Service was $1.6 trillion per day or $419 trillion per year in 2008. Similarly, the Depository Trust Company, the principal U.S. securities settlement system for U.S. corporate securities, reported processing $455 trillion in securities transactions in 2008. A substantial, and largely immeasurable, volume of additional transactions is processed on the books of banks, brokers and other securities intermediaries, or directly between securities intermediaries, without going through Fedwire or DTC.

Clear legal rules in this area reduce systemic risk, reduce the costs and risks of securities transactions and secured credit during normal times, and help prevent seize-ups in the credit markets during times of financial stress. Any

prospect of legal uncertainty as to rights and remedies will cause severe anxiety among creditors, exacerbating the very problem the legislation attempts to resolve. In the early 1990s, the Federal Reserve, the American Bar Association, the American Law Institute and the National Conference of Commissioners on Uniform State Laws launched a major project to modernize Articles 8 and 9 of the Uniform Commercial Code and the federal regulations governing U.S. government securities. While this law reform effort has been hailed as highly successful outside of insolvency law, it is important that its benefits be confirmed in insolvency law, such as the proposed resolution law. Similar provisions also should be added to the Bankruptcy Code.

IV. FDIC Proposals

A. Resolution Authority over all Bank Holding Companies

The FDIC Chairman has recently proposed extending resolution authority to all bank holding companies, not only when a systemic risk determination has been made.[4] We believe that, at a minimum, this proposal should reflect the same considerations discussed above, including a limitation of such new authority to essential resolution powers. The claims process should remain in the hands of a bankruptcy court, and the rules defining creditors' rights should be the rules contained in the Bankruptcy Code. The FDIC should not be given administrative power over the claims process, but instead should be limited to acting in the capacity of the debtor or trustee in bankruptcy in any bankruptcy proceedings. To

[4] Chairman Sheila Bair, *Combining More Effective Bank Regulation with Market Discipline*, Transcript of Remarks to the International Institute of Finance Annual Meeting in Istanbul (Posted by Chairman Bair on the Harvard Law School Form on Corporate Governance and Financial Regulation, Oct. 21, 2009).

provide otherwise would produce all the same problems in the market discussed above with respect to systemically important non-bank financial companies.

B. Cross-Guarantee Liability

The FDIC Chairman has also proposed that cross-guarantee liability, which currently applies among commonly controlled insured depository institutions, should be extended to their holding company parents and non-bank affiliates.[5] This proposal raised serious policy issues, including fundamental questions about whether the FDIC should be able to "pierce the corporate veil" of bank holding companies and non-bank affiliates in order to use their assets to subsidize the FDIC's resolution of an affiliated insured institution.

C. Haircuts on Secured Credit

Finally, the FDIC Chairman has proposed that all claims of secured creditors be automatically reduced by 20% in any resolution proceeding in order to increase the incentive of these creditors to monitor their debtors.[6] Aside from the serious constitutional questions that this proposal may raise under the Takings Clause, as a former director of the FDIC, I can say with confidence that such a proposal is unworkable. If the various resolution proposals include the ability to abrogate the property rights of secured creditors, it would significantly impair traditional trading practices critical to our economy and distress potential and existing investors.

---

[5] *Id.*

[6] *Id.*

For example, this proposal would seriously disrupt the clearance and settlement systems on which so many of the other risk-reducing proposals rely. For more than two decades, these systems have been encouraged by regulators and other public policymakers to reduce the gap between trade date and settlement in order to reduce counterparty credit risk. The standard settlement cycle for corporate securities transactions has been reduced to three days after the trade, or T+3. Transactions in U.S. government securities are settled in real time. A consequence of compressing the settlement cycle is an increased need for intraday credit or daylight overdrafts. The huge volumes of transactions processed by the world's clearance and settlement systems, which amount to more than a ***quadrillion*** dollars per year, would grind to a halt without such intraday credit. Because the amount of intraday credit needed is many times the capital and sometimes even the balance sheets of the financial institutions providing the credit, the credit must be fully or over secured by high quality collateral. If such credit providers were subject to a mandatory 20% haircut on their secured claims against U.S. insured institutions, bank holding companies, identified financial holding companies or their affiliates, they would immediately cut-off all daylight overdraft credit to such institutions. Clearance and settlement systems would grind to a halt, or the settlement cycles would have to be extended to T+7, T+10 or even T+30. Not only would this dramatically increase counterparty credit risk, it is inconsistent with the velocity of modern finance.

Similarly, in the repo market today, financial firms raise short-term cash against collateral, and lenders assume their credit exposures are fully secured by

that collateral. A rule that imposed an automatic 20% haircut on secured claims would simply eliminate the willingness of anyone to lend in that market – and thus eliminate a critical source of funding that financial institutions depend on to manage their risk and fund their lending activity.

V. Activities Restrictions

The Discussion Draft would would subject a new category of financial institutions, formerly defined as Tier 1 FHCs, and now defined as identified financial holding companies, to the activities restrictions that apply to financial holding companies ("FHCs") under the Bank Holding Company Act. A financial institution may be classified as an identified financial holding company under the Discussion Draft without controlling a bank or otherwise being an "FHC" under the Bank Holding Company Act. An identified financial holding company can set up an intermediate holding company and move its financial operations to that holding company, which will then be regulated like a bank holding company, and subject to the same activities and other restrictions as a bank holding company.

The activities restrictions in the Bank Holding Company Act were designed to implement the so-called wall between banking and commerce. As a result, some permissible activities such as commercial lending can be high risk, while some impermissible activities can be low risk. We believe it would be inappropriate as a matter of public policy to extend a set of activities restrictions designed to reflect a wall between banking and commerce to identified financial holding companies that do not control a bank. To the extent the systemic risk regulator has the power to impose activities restrictions on identified financial

holding companies that do not control banks, we believe those restrictions should be limited to activities deemed to involve excessive risks or risks that the particular identified financial holding company does not have the capacity to manage properly.

VI. Securitization Reform

We support initiatives to align the economic interests of asset originators and securitization sponsors with investors. We believe that the principal goal of these efforts should be to establish and reinforce commercial incentives for originators and sponsors to create and fund assets that conform to stated underwriting standards and securitization eligibility criteria, thereby making those parties economically responsible for the stated attributes and underwriting quality of securitized loans. The creation and maintenance of effective mechanisms of this type will facilitate responsible lending, as well as a more disciplined and efficient funding of consumer assets via securitization.

Many securitizations already embed this concept through various structuring mechanisms, including via the retention of subordinated or equity risk in the securitization, holding portfolio assets bearing credit exposure that is similar or identical to that of securitized assets, and representations and warranties that require originators or sponsors to repurchase assets that fail to meet stated securitization eligibility requirements, among others. However, we do not believe that mandated retention of specific portions of *credit* risk—one such form of economic interest—necessarily constitutes the sole or most effective means of

achieving this alignment in all cases. Simply increasing the level of retention will not ameliorate this lack of alignment of incentives.

A 10% retention requirement will be, for many asset classes and institutions, an economically unmanageable level that is not correlated with the risk presented in those assets -- for example, prime mortgage or credit card loan transactions. Such a blunt retention requirement will also reduce the ability of lenders to finance new transactions, as valuable capital will need to be maintained against the retained positions. Hedging restrictions will create a situation where an increasing proportion of the risk on a financial institution's balance sheet will remain unhedged, and thus present heightened safety-and-soundness concerns. The crisis of the last two years has shown how significant a component of consumer finance securitization comprises; excessive credit risk retention requirements may serve to exacerbate the current scarcity of credit for consumers and small businesses.

There are numerous valid and competing policy goals that stand in opposition to requiring the retention of credit risk in both whole loan and securitization transactions. Among others, these include reduction and management of risk on financial institutions' balance sheets; balance sheet management; the redeployment of capital to enable financial institutions to originate more credit than their limited capital resources would otherwise allow; and in the case of securitization, the proper isolation of transferred assets (i.e., meeting legal criteria necessary to effect a "true sale,"). Moreover, we believe

that a risk retention requirement of 10% conflicts so greatly with the achievement of these goals, that it could cause some to be unattainable.

Balancing these competing and worthwhile policy goals suggests that retention and incentive alignment mechanisms other than universal credit risk retention requirements should be considered. This viewpoint was echoed by the IMF a few weeks ago in its *Global Financial Stability Report*, which expressed strong concerns about the potential unintended negative consequences of implementing suggested credit risk retention requirements and instead indicated that regulatory authorities "should consider other mechanisms that incentivize due diligence and may be able to produce results comparable to a retention requirement, including, perhaps, representations and warranties."[7]

We therefore believe that to the extent legislation is adopted to require risk retention, regulators should have flexibility to develop and apply alternative retention mechanisms. This flexibility should include the ability for regulators to specify permissible forms and amounts of retention, how retention requirements may be calculated and measured, the duration of retention requirements, whether and to what extent hedging or risk management of retained positions is permissible, and other implementation details. Specifically, we strongly believe that the bill should grant regulators the ability to lower the risk retention requirement below 5%. As drafted, it is unclear if this ability exists, because two

[7] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), pg. 31. <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>.

provisions seem to conflict.[8] If the bill intends to provide regulators with an ability to lower the risk retention requirements below 5%, we suggest clarifying the language. If the bill does not intend to grant this ability, we strongly urge the Committee to reconsider this point. The credit markets consist of originators with varied underwriting guidelines that offer many different products. Providing regulators of these market participants the ability to substantially reduce the risk retention requirement will act as an incentive to employ better origination standards for those products. A reduction of 10% to 5% does not provide enough incentive to achieve this goal.

Finally, we believe that it is imperative to achieve global harmonization and consistency of policy approaches to securitization risk retention. Different approaches are currently being considered or have been adopted in different jurisdictions, including a retention requirement adopted by the European Parliament which is roughly half of the 10% requirement set forth in the proposed bill.[9] Given the global nature of securitization activity and the mobility of global capital among jurisdictions, countries with considerably higher risk retention

[8] For example, in subsection (d)(1) the bill provides that specific regulators shall have authority to "jointly provide exemptions or adjustments to the requirements of this section, including exemptions or adjustments relating to the 10 percent risk retention threshold...." In contrast, subsection (c)(2)(A) provides that if certain standards are met, specific regulators may reduce the required percentage of risk retention to "less than 10 percent of the credit risk, but in no case less than 5 percent of credit risk...."

[9] One such approach was adopted by the European Parliament in May 2009. Article 122a to the Capital Requirements Directive prohibits EU banks from investing in securitizations unless the originator retains on an ongoing basis at least 5% of the material net economic interest of the securities securitized. The article proposes four ways the 5% retention requirement may be applied. The article's requirement is scheduled to go into effect on December 31, 2010 for new issues, and December 31, 2014 for existing securitizations where new underlying exposures are added or subtracted after that date. For more information, see: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2009-0367&language=EN&ring=A6-2009-0139#BKMD-35.

requirements will be put at a significant competitive disadvantage in the global credit markets. In addition, market inefficiencies may be produced by introducing substantively different retention standards throughout the world's financial markets. We believe that is essential for policymakers to coordinate their approaches in this area.

VII. International Cooperation and Coordination

With respect to each of the Discussion Draft's systemic risk proposals, it will be critical to cooperate and coordinate with foreign and international counterparts on such proposals. We are actively monitoring developments in the U.K., the European Union and by the Basel Committee on Banking Supervision on these topics. Close cooperation among policymakers on an international basis will be essential if we are to effectively address systemic risk and other challenges affecting the financial system. We strongly support the expanded membership and role of the Financial Stability Board, and the increased cooperation and coordination among regulators in major markets in the U.S., Europe, Asia and elsewhere around the world. There are several international groups in which the U.S. participates that work to further regulatory cooperation and establish international standards, including the Financial Stability Board, the G-20, the Basel Committee on Banking Supervision, IOSCO and the Joint Forum. Congress should continue to support and encourage the efforts of these groups.

VIII. Conclusion

In conclusion, SIFMA strongly supports the overall goals of the Discussion Draft as proposed by the Administration and this Committee. We

believe, however, that certain provisions require further review, comment and amendment. In particular, we believe that the proposed resolution authority should be amended to restore a transparent claims process and the rules governing creditors rights contained in the Bankruptcy Code. SIFMA has been, and is strongly committed to continuing to be, a constructive voice in this critically important public policy dialogue to restore confidence in our domestic and global financial system.

Testimony of the
National Association of Insurance Commissioners
before the

House Committee on Financial Services

"Systemic Regulation, Prudential Matters,
Resolution Authority and Securitization"

Thursday, October 29, 2009
9:30 a.m.

Thomas R. Sullivan
Insurance Commissioner of the State of Connecticut

Introduction

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify at this afternoon's hearing. My name is Thomas Sullivan, and I am the Insurance Commissioner of the State of Connecticut. I am also a member of the National Association of Insurance Commissioners, serving as chair of its Life Insurance and Annuities Committee. Today I am representing the views of my fellow regulators on behalf of the NAIC.

The National Association of Insurance Commissioners continues to welcome federal efforts to reform financial regulation in response to the economic turmoil of the past year. However, we continue to stress that state regulation of insurance has protected insurance consumers and companies from the worst of the financial crisis, and therefore should be preserved in any reform efforts. The insurance sector is critically important, but the business of insurance has not created the kinds of unrestrained and unregulated systemic risks that reform efforts seek to manage or prevent. Prudential oversight of insurers by the states works – our solvency and capital standards have ensured that policyholder commitments are met and that companies remain stable. Our system of supervision is compatible with the structure and goals of financial reform efforts, and we urge that our expertise and experience be embraced, not undermined, by any changes to the U.S. financial regulatory structure.

Insurance is a Unique Product, and State Insurance Regulation Provides Necessarily Unique Protection

Americans purchase personal or commercial insurance for a very specific reason: to protect themselves, their dependents, and the items they value from unknown risk. The guarantee

received by consumers in return for this purchase distinguishes insurance from other financial products currently under review, such as a home loan or a security. The economic well-being of every insurance consumer is affected by the strength and effectiveness of insurance regulation, and consumers clearly have an enormous financial and personal stake in making sure that insurers keep the promises that they make. Insurance products require policyholders to pay premiums in exchange for a legal promise of protection against risk. Effective insurance regulation must reflect the laws, values and unique risks of each state and region of the nation. This reality calls for maintaining the national system of state-based insurance regulation that has grown and evolved to meet the needs of consumers for over 150 years.

As the insurance market has become increasingly national and global in scope, state regulation has evolved and adapted, utilizing technology and other uniformity tools to streamline oversight where appropriate, while preserving local, accountable oversight. For example, the NAIC developed several important solvency initiatives including: risk-based minimum capital requirements that are geared toward an insurer's exposure to certain risks; codified statutory accounting principles and a uniform statutory annual statement for disclosure of financial results; and analysis and examination handbooks and procedures for state insurance regulators to ensure proper solvency assessment of insurers. The NAIC Accreditation Program is in force in all 50 states and ensures that all jurisdictions use the same baseline solvency standards.

Let me assure you, though, that in the wake of the financial crisis, we are not satisfied and we are not standing still. Last year, we have launched the Solvency Modernization Initiative, to

review our entire solvency system to seek areas for improvement. The SMI includes study of other financial supervisory modernization initiatives and solvency proposals in place or under development in other jurisdictions, including Australia, Canada, Switzerland and the EU, and ultimately will result in compiled principles for any needed reforms. The principles will facilitate dialogue with other jurisdictions and institutions and bring about a constructive reconciliation of U.S. solvency principles with solvency regimes in other countries, where appropriate. The consolidated principles would also provide a foundation for the NAIC to establish clear goals, priorities and long-term modernization plans that will result in a solvency assessment framework consistent with regulatory best practices. The initiative places emphasis on five key focus areas: capital requirements, international accounting, insurance valuation, reinsurance, and group solvency. We are fully committed to ensuring that our prudential oversight of insurers is effective and efficient, and ready to meet the challenges ahead.

Our rigorous oversight has resulted in high regulatory compliance, enabling our sector to avoid the level of insolvencies and market meltdowns that we have seen in other sectors of the financial community. Indeed, our national solvency system has protected the ability of companies to pay claims while remaining competitive and profitable. But while state insurance regulators are concerned that insurers remain profitable and provide a reasonable return for investors, the true focus of our regulation is the protection of policyholders and claimants. It is the forward-looking nature of insurance that compels regulators to make sure that sufficient funds are available to respond to consumers' needs.

Systemic Risk, Resolution Authority, and the Insurance Sector

In the view of state insurance regulators, an entity poses systemic risk when its status and activities have the ability to ripple into the broader financial system and initiate problems for counterparties, requiring extraordinary mitigation efforts. The insurance industry in general does not pose a systemic risk to the nation's financial markets to the extent we have seen in the banking and securities sectors; rather, insurance companies are more often the recipients or conduit of risk. Mortgage and title insurers, for example, do not generate systemic risk; rather, they facilitate the underlying loan transaction. The quality of the underlying banking transaction, and related underwriting, determines whether proliferation of such transactions increases systemic risk. Insurance tends to be far less leveraged than other sectors, and many of the risks assumed by insurers (mortality, property damage, etc) tend to be uncorrelated to other risks in the financial sector.

Exposure to systemic risk in the insurance sector, as opposed to the generation of systemic risk, typically flows from assets linked to the capital markets. As such, state regulators have placed appropriate restrictions on the investments held by insurers, and we are continuing to review those standards in light of losses in the capital markets. We are also assessing our reliance on private financial rating agencies, to determine their impact on insurer liquidity and investments.

Regardless of changes to our supervision of insurers, no regulatory system is so constraining as to eliminate the possibility of company failure, and indeed the threat of failure serves as a critical component of risk management for insurers. If a life insurer or property insurer were

to fail, regardless of size, state-based guarantee funds would protect existing policyholders and pay claims, and state insurance statutes prioritize policyholders over other creditors. As history has demonstrated, competition and capacity from over 7000 U.S. insurers fill marketplace voids left by the failed insurer.

State insurance commissioners have broad receivership authority over insurance companies. In the case of insurance subsidiaries, this receivership authority walls insurance company holdings off from the broader holding company. The insurer's assets cannot be used to satisfy the debts of its owner, thus ensuring the continued protection of policyholders. This "walling off" is a critical protection that should not be lost or compromised by federal efforts.

Proposals for Systemic Risk and Resolution Authority Reform

In the months since the Obama Administration's proposal for financial regulatory reform was unveiled, members and staff of the National Association of Insurance Commissioners have consistently delivered the same, overarching message to Congress: That a coordinated, national system of state-based insurance supervision has met, and will continue to meet, the needs of the modern financial marketplace while effectively protecting individual and commercial policyholders. We believe that any regime change that results in redundant, overlapping responsibilities will result in policyholder confusion, market uncertainty, regulatory arbitrage, and a host of other unintended consequences that will harm individuals, families, and businesses that rely on insurance for protection against the risks of everyday life. A federal regulator is not a prerequisite for systemic risk supervision that includes review of

the insurance sector – such a structure can overlay the existing state regulatory system without displacing it.

To that end, the NAIC has worked to communicate the following principles for systemic risk regulation to this Committee, the broader Congress, and the Administration:

First, we believe that any new system must incorporate, but not displace, the state-based system of insurance regulation. State insurance regulators are on the front lines in resolving approximately three million consumer inquiries and complaints each year, and that daily attention to the needs of individuals and businesses must remain a cornerstone after any reform effort. Our national solvency system has proven resilient during the financial crisis, so if supervision of systemically significant holding companies requires group capital standards, such requirements should be in addition to existing solvency requirements of the functional regulators.

Second, federal legislation should ensure effective coordination, collaboration and communication among all relevant state and federal financial regulators in the United States. Preservation of "functional regulation" should be a fundamental goal. In particular, financial stability regulation, as it relates to insurance, can only be stronger with the added expertise of the 13,000 people who currently work in our nation's state and territorial insurance departments. We can bring expertise and information on the condition of the insurance industry to bear in any systemic risk review. As such, state insurance regulators must have a meaningful seat at the table of the proposed Financial Services Oversight Council. In order to

provide a complete view of the financial system, regulators at the state and federal level must also have appropriate authority to share information.

Third, group supervision of complex holding companies that includes functional regulators is necessary, but preemption of state insurance regulators, if ever necessary, should result only after our efforts have been exhausted. Group supervision through "supervisory colleges" preserves functional regulation and provides a complete view of the activities within a complex holding company. There is a great benefit to having multiple sets of eyes looking at an institution, such as what exists with the current state-based insurance regulatory system. Preemption – and putting a single federal regulator in charge – would take away the crucial failsafe of allowing real and potential oversights by one regulator to be spotted and corrected by another. State insurance regulation is not without its challenges, but it allows for a system of checks and balances that mitigates regulatory capture and typically detects problems before they become systemic in nature.

Additionally, we would also stress that systemic supervision should consider the unique expectations of consumers, and the different regulatory structures for different entities within a holding company. For example, an AIG insurance policyholder is paying for a promise backed up by a solvency regime tailored to that promise. On the other hand, the counterparty to an AIG credit default swap may be merely speculating with no guaranty of success and with no underlying promise of protection. Systemic risk supervision of holding companies needs to recognize this reality so that the health of a well regulated entity within a holding

company is not sacrificed to preserve an unregulated operation within that same holding company.

These principles are focused on review of systemic risk, but they are equally critical in developing any federal mechanism to resolve large, complex financial institutions. A resolution mechanism responsible for "unwinding" problems in complex financial institutions that threaten economic stability (presumably when bankruptcy proves to be the more costly alternative), must work in tandem with the existing state-based receivership and guaranty fund regime for insurance companies. As previously noted, state insurance commissioners have broad authority and a long history of working through insolvencies in the marketplace. This experience and structure should be leveraged, and systemic resolution authority must continue to allow state regulators to protect the assets of the sound insurance entities from predation by unsound, poorly-regulated subsidiaries or the broader holding company. State receivership authority prioritizes policyholders as creditors of failed insurers, and we stress that federal resolution authority should respect this system so that assets of insurers can not be pulled from policyholders to pay off failings at the holding company level. One need look no further than AIG – where the insurance subsidiaries remained solvent while the holding company spiraled into failure – for illustration of this critical issue. We have experience in coordinating multi-state receiverships, as well as insolvencies of insurers within holding companies. Again, this proven system and expertise must be preserved.

The Congress is appropriately reviewing the scope and strength of financial supervision, and we welcome that attention. The proposals on the table, from expanding the Federal Reserve's authority to making significant changes to the scope of the Bank Holding Company Act, are far reaching and will impact insurance consumers. Better consolidated supervision of complex firms is needed, but we urge caution in pursuing any proposals that could impact our ability to adequately regulate the insurance market and protect insurance consumers, and ask that our perspective be considered by this Committee in the critical days and weeks ahead.

Mr. Chairman, thank you again for the opportunity to testify at today's hearing and I look forward to your questions.

Testimony of

Phillip L. Swagel

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

"Systemic Regulation, Prudential Matters, Resolution Authority, and Securitization"

Thursday, October 29, 2009

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify on the important topics of Systemic Regulation, Prudential Matters, Resolution Authority, and Securitization. I am a visiting professor at the McDonough School of Business at Georgetown University, and a non-resident scholar at the American Enterprise Institute. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Since I last testified before this committee on Wednesday, September 17, 2008—the week that Lehman and AIG failed and just before the introduction of the TARP legislation—a series of extraordinary measures have stabilized the financial system. These include a range of bold and innovative monetary policy actions by the Federal Reserve; a Treasury Department guarantee program for money market mutual funds; the Treasury Department's Capital Purchase Program and other measures using the TARP authority granted under the Emergency Economic Stabilization Act of 2008; and the Temporary Loan Guarantee Program (TLGP) put in place by the Federal Deposit Insurance Corporation (FDIC).[1] The stress tests carried out this year provided market participants with assurances regarding the viability of key financial firms. These actions did not prevent a deep and painful recession, but they did head off a meltdown of the financial sector that would have involved an even worse outcome for the U.S. economy.

The topics in this hearing and in the draft Financial Stability Improvement Act of 2009 concern both measures to help avoid a future crisis and proposals to change the way in which the government responds to crises should they happen nonetheless. These issues are closely related, since credible steps that provide certainty to market participants and lead them to believe that they will have costs imposed on them in a crisis would be expected to change risk-taking behavior and thus help make a future crisis less likely (though there are costs to changing investor behavior as well if this means that some productive investments are not funded and

[1] I have previously written about policy steps taken during the crisis in "The Financial Crisis: An Inside View," *Brookings Papers on Economic Activity*, Spring 2009.

thus do not take place as a result). With this in mind, it is useful to first consider the provisions in the draft legislation for new authorities once a crisis starts.

Subtitle G - Enhanced Resolution Authority

Providing new authorities in a crisis is the purpose of Subtitle G, the Resolution Authority for Large, Interconnected Financial Companies Act of 2009, which would create enhanced resolution authority for the government to take over a firm not covered by the existing FDIC resolution regime for banks. Put simply, this is a proposal for a permanent and supercharged TARP. The government would be allowed to put public money into a private firm without further authorization from the Congress, making this a permanent TARP. And the government would be authorized to repudiate contracts, making this a supercharged TARP.

Faced with a failing firm, the government would have the tools to prevent or cushion any feared potential consequences. Public money could be put into a firm to stabilize it, and/or losses could be imposed on creditors to avoid what might be feared as a chaotic collapse of an insolvent firm. In short, enhanced resolution authority would go beyond the TARP authority and would apply to a broader swathe of the financial industry without a delay for Congress to exercise its prerogative to consider whether to enact legislation.

As noted above, providing market participants with increased certainty as to the resolution of failing firms could usefully affect risk-taking behavior in a way that helps avoid future crises. But this draft legislation does not provide certainty; instead, the expansive new resolution authority provides complete flexibility. For example, the draft legislation gives an order of priority of expenses and secured claims in Section 1609 (b)(1), but then immediately follows by allowing the receiver to do differently in Section 1609 (b)(4). A better way to provide certainty would be to pursue an improved bankruptcy regime for the financial firms that motivate the resolution proposal. H.R. 3310, the Consumer Protection and Regulatory Enhancement Act of 2009, provides such an approach.

The flexibility provided by the proposed enhanced resolution authority means that it will be difficult to constrain the executive branch to carry out a fair and effective resolution. This is in addition to the well-known downside of moral hazard. Even though the resolution regime can impose losses on creditors, allowing complete flexibility potentially allows creditors to avoid these losses and this possibility will inevitably give rise to some moral hazard.

Moreover, with flexibility to deploy public resources and change contracts outside of a judicial process comes the potential for enormous mischief—and temptation to use the new power in

inappropriate ways. This is especially a concern given the scope of the proposal: the enhanced resolution authority notionally covers bank holding companies and large financial firms, but given the broad use of the TARP over the past year, one can reasonably expect that this authority could be used on any firm (after all, auto companies were covered under the TARP, as were the automobile supply chain, small businesses, consumer lending, and so on). Attempting to rule out certain types of spending and allow only investments is likewise difficult, since financial engineering can easily result in asset purchases being transformed into subsidies. This would be the case with an asset purchase set up intentionally to make losses that are directed as subsidies to the desired targets.[2]

The concerns noted above are not merely theoretical, but can be seen in the actions taken in the recent bankruptcies of Chrysler and General Motors, where the presence of authority to commit public funds allowed the government to interfere with the usual working of the bankruptcy process. Contracts were change in a sense, with the capital structure rearranged to favor junior creditors over senior ones, and the automobile firms were used as conduits to transfer public resources to the auto workers' health care fund. While it is entirely legitimate for the President or others to propose the use of public funds to ensure that workers and retirees maintain access to health insurance, the dedication of such resources should be done through a vote of the Congress and not as an adjunct to a financial rescue. Moreover, the reordering of the capital structure in these government-arranged restructurings has the potential, if this serves as precedent, to lead to higher costs of financing for future projects and thus less investment and slower economic growth and job creation.

It is understandable that it would be difficult for any administration to resist the temptation to transfer public resources to a favored party through regulatory authority rather than new legislation. In these instances, it is noteworthy that the transfer of public resources and rearranging of the capital structure were undertaken even when it must have been clear that these actions would have undesirable implications for the administration's own proposal to obtain non-bank resolution authority by providing an immediate illustration of the ways in which such an authority could be misused. Again, this only serves to illustrate how difficult it will be to constrain any administration from unintended and potentially undesirable uses of the proposed resolution authority. In the event of a future crisis, it would be preferable for Congress to decide to deploy fiscal resources.

[2] For example, a foreclosure avoidance program could be undertaken by purchasing loss-making assets, where the losses are shed via financial engineering in such a way as to provide the desired subsidies that reduce the number of foreclosures (such as by subsidizing lower interest rates for borrowers facing foreclosure).

In the meantime, it would be desirable to pursue improvements in the bankruptcy regime for financial firms. For example, it could be useful to improve the coordination of bankruptcy regimes across countries to address incidents such as with the Lehman bankruptcy where assets of some U.S. investment firms were reported to have been frozen in Lehman's UK branch. And as suggested by David A. Skeel, Jr. in testimony on October 22, 2009 before the House Committee on the Judiciary, another avenue would be to reconsider the exemption of derivatives and certain other financial contracts from the automatic stay in bankruptcy.

Without non-bank resolution authority, policymakers would face a future crisis with powers akin to those that existed in September 2008 when Lehman and AIG failed. The Federal Reserve would be called upon to provide liquidity support if good collateral appeared to be available. This type of situation would be difficult for the Federal Reserve, as it has been over the course of this crisis, since the Federal Reserve would be put in the position of acting as a bridge to an uncertain fiscal action. This would be somewhat moderated by the useful proposal in Subtitle H, Additional Improvements for Financial Crisis Management, to require that the Treasury Secretary provide written approval for the Federal Reserve to invoke its emergency lender powers (the so-called section 13-3 authority under unusual and exigent circumstances). This would lend a formal recognition and acceptance by the government's fiscal authority—the Treasury Department—of Federal Reserve actions that straddle the line between liquidity support and the provision of capital.

Financial Services Oversight Council; Prudential Regulation of Companies and Activities for Financial Stability Purpose; and Improvements to Supervision and Regulation of Federal Depository Institutions

Having the Federal Reserve backstopped by a council of other regulators could be useful, but only the Federal Reserve has the broad macroeconomic overview that is essential for the role of a systemic risk supervisor. Indeed, other government agencies expressly have narrower purviews. The FDIC, for example, focuses to a considerable degree on the state of its deposit insurance fund. This is entirely appropriate, but stands at odds with a broader view of the financial system and the economy.

The ability to designate a bank holding company or a non-bank firm as an identified financial holding company (Subtitle B) is closely linked to enhanced resolution authority and thus suffers from the problems discussed above. Designation of a firm as an identified financial holding company potentially solidifies the idea of a firm being too big to fail, when the alternative of improving the bankruptcy regime would make clear that firms can fail.

An alternative to designation of particular firms as an identified financial holding company would be to focus on the activities that give rise to the fear that a firm is systemically important. If the size of a firm or particular activities give rise to concerns, then capital adjustments can be made to compensate for these activities or attributes. This is easier said than done, but so too will it be difficult to designate the smallest of the identified firms as such and not expect this to become public and thus for the firm to derive some benefit from being seen as "too big to fail."

The idea that firms should maintain plans for their own resolution ("living wills") might be useful (and in any case is not harmful), but it must be kept in mind the limitations of such plans in the face of a crisis when the circumstances facing the firm could be quite different from those envisioned when the plan was drawn up. The same is the case for proposals that rely on forms of contingent capital, such as securities that convert into common equity at pre-arranged terms during a crisis. This could prove fragile in practice—an investor will be required to invest in a firm at just the moment he or she wants to stay away. One can imagine problems arising in terms of legal uncertainty as the investor looks for an escape hatch. Moreover, the terms of such contingent capital might make it deeply unappealing for firms—so much so that a government agency will not force financial institutions to arrange for the contingent capital. While this proposal has some merit, potential difficulties should be kept clearly in mind.

Subtitle F – Improvements to the Asset-Backed Securitization Process

The requirement that securitizers retain an economic interest in the credit risk associated with the underlying assets is meant to align incentives and help avoid the deterioration of credit standards as was the case with subprime lending during the recent housing bubble. In considering regulation of securitization, it should be kept in mind that innovation in financial services is fundamentally good for the U.S. economy. Innovation such as securitization lowers the cost of funds and broadens access to credit, including for low- and moderate-income Americans. Requiring the retention of an economic interest acts as a sort of tax on securitization, and thus necessarily involves a tradeoff between avoiding a deterioration of lending standards and putting a burden on securitization that reduces its utility and thus increases borrowing costs.

With the benefits of financial innovation, however, often comes complexity, and that is certainly the case with mortgage-backed securities (MBS) and other asset-backed securities that have been at the center of the financial crisis. Indeed, complexity was a key source of uncertainty in this crisis, since market participants could not easily tell which firms were

burdened by truly toxic assets and which were in better shape. The resulting uncertainty led to a broad hesitancy to invest new resources in the financial sector.

The requirement in the administration's proposal for the disclosure of loan-level data regarding the assets backing a security provides a potentially less onerous (and less costly) approach to solving the incentive problem. This could be taken a step further to have the federal government support the creation of a mortgage information database that would provide individual loan-level information on the quality of underwriting and subsequent performance of mortgages, and thereby facilitate analysis of complex MBSs and their derivatives. Similarly, this could be done for asset backed securities beyond mortgages.

Such a mortgage information database could directly address the lack of transparency and information behind the lockup of the markets for asset-backed securities that began in August 2007. Investors could use the information in the database to analyze the performance of MBSs and collateralized debt obligations (CDOs) containing the mortgages, allowing analysis to pierce the complexity of these arrangements. Ultimately, such a database could allow investors to assess the performance of mortgages originated by particular firms or even particular loan officers.

This database would create a "reputational tail" so that originators would have a connection to the future performance of mortgages and other types of loans even after they had been offloaded from their books through securitization. This reputational tail could be a less intrusive alternative to requiring lenders to keep a piece of any loans they originate—requiring that they have "skin in the game." While it might be possible for firms to effectively offset their economic exposure to the securitized assets through hedging transactions, it will be more difficult to shed the reputational tail. If an originator or securitizer is inflicting markets with low-quality assets such as mortgage-backed securities consisting of unsustainable loans, the mortgage database will help this to become known and appropriately affect the offending party's business.

Conclusion

This hearing considers the crucial questions at the center of regulatory reform in the wake of the crisis. There are no easy answers, but only tradeoffs. A key goal will be to increase the certainty of market participants as to the actions that will be taken in the face of financial market difficulties. Enhanced resolution authority is appealing for its flexibility, but this flexibility is itself a weakness. An improved bankruptcy regime provides more certainty and will ultimately better affect behavior in a way that helps to diminish the likelihood of a future crisis.

Mr. Chairman and Ranking Member Bachus, thank you again for the opportunity to appear today before the Committee. I would be happy to respond to any questions.

STATEMENT OF

SCOTT TALBOTT

SENIOR VICE PRESIDENT OF GOVERNMENT AFFAIRS

THE FINANCIAL SERVICES ROUNDTABLE

ON

SYSTEMIC RISK, PRUDENTIAL MEASURES, RESOLUTION AUTHORITY, AND SECURITIZATION

BEFORE THE

FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

OCTOBER 29, 2009

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I am Scott Talbott, Senior Vice President of Government Affairs for the Financial Services Roundtable (Roundtable). Thank you for the opportunity to appear today and address the Committee's Discussion Draft (Discusson Draft) of October 27th on systemic risk, prudential standards, failure resolution and securitization.

We support greater systemic risk oversight, a failure resolution mechanism, more effective prudential supervision, and risk retention. As such, we commend the Committee in addressing these necessary reforms through the coordination of a Financial Services Oversight Council (Council), the Federal Reserve Board (Board), and the prudential regulators.

The Discussion Draft is a significant improvement from earlier proposals. The following are some of our initial reactions.

1. No Public List: The Discussion Draft does not call for the public identification of systemically significant financial holding companies. This is a positive change. We were concerned that public identification of such companies would increase moral hazard and raise competitive issues.
2. Coordination with Prudential Regulators: While the Board has significantly enhanced authority over identified financial holding companies, we are encouraged that the Discussion Draft includes coordination between the Board and the prudential regulators. Such coordination should be refined to minimize the potential for regulatory overlap and duplication between the Board and prudential regulators, including state insurance regulators. However, the Discussion Draft does not address the need to have a federal insurance regulator on the Council. Additionally, we believe the Director of the Federal Insurance Office should be a member of the Council.
3. Preservation of ILC and Thrift Charters: The Discussion Draft preserves Thrift Charters and grandfathers Industrial Loan Charters (ILCs) and their lawful affiliations with commercial companies. However, limits on cross marketing between parents and ILCs would restrict activities and the ability to meet consumer needs.
4. Limitation for Foreign Owned Companies: The Discussion Draft limits the extraterritorial reach of U.S. financial regulations to foreign-owned financial companies. However, these provisions should be refined to ensure that U.S. regulations do not conflict with or overlay home country regulation.
5. Actions Based on Size of Identified Financial Holding Company: The Discussion Draft grants excessive authority to the Board to take actions based on the size of an identified

financial holding company. Size alone should not be an indicator of safety and soundness. Large financial institutions remain vital sources of funding in our economy.

6. Excessive Focus on Capital: The Discussion Draft continues to place an excessive focus on capital as the answer to safety and soundness concerns. Higher and higher capital requirements could have a negative impact on economic growth. The better answer to safety and soundness is a combination of capital, activity restrictions where appropriate, prudential supervision, liquidity requirements, and other prudential standards deserve equal focus.
7. Living Wills Requirement: The Roundtable remains concerned that the requirement for identified financial holding companies to create "living wills" could force such companies to adopt an organizational structure based on liquidation rather than the structure that is most efficient for serving consumers and business. That said, there is a legitimate need for firms to discuss their contingency plans with their regulators.
8. Securitization: The Discussion Draft proposes a 10% risk retention requirement for mortgage lenders and securitizers. The Roundtable supports risk retention and endorsed the risk retention provisions in H.R. 1728, which called for a 5% requirement and gave regulators some flexibility in the implementation of that requirement. For example, in H.R. 1728, the regulators could impose the requirement on a first-loss or pro-rata vertical slice. Any risk retention requirement should not apply to prudently underwritten mortgages, including mortgages that meet FHFA, Ginnie Mae, and GSE standards. Moreover, the 10% requirement is unstudied and could have a significant negative impact on mortgage finance. It could have the unintended consequences of significantly limiting the securitization and subsequently the ability of mortgage finance for consumers seeking

to purchase a home. We support requiring some credit risk retention, but there needs to be ability to ensure credit is available for homeowners and other consumers.

9. Derivative Transactions Between Affiliates: The Discussion Draft would subject derivative transactions between the bank and its affiliates to the quantitative limit in Section 23A of the Federal Reserve Act (10% of a bank's capital). Derivative transactions between affiliates did not contribute to the crisis; they are a risk management tool and are already subject to the arms-length standards in 23B of the Federal Reserve Act.
10. Treatment of Unsecured Creditors: The Discussion Draft would mandate haircuts for unsecured creditors affected by systemic failure resolutions. This is a provision that would have a negative impact on the ability of firms to raise operating funds.
11. Supervisory Costs for large financial companies: The Discussion Draft authorizes new assessments for large bank holding companies and systemically significant companies, in addition to the existing assessments that they currently pay to their prudential regulators and the potential assessments that would have to be paid to the proposed Consumer Financial Protection Agency. The combination of these assessments can be quite significant, at times accounting for hundreds of millions of dollars for large institutions and could detract from an institution's ability to increase capital or make new loans.
12. Balance: The Discussion Draft places an overemphasis on financial stability – which is understandable in this current environment. However, we should not lose sight that financial stability should be balanced with the ability of markets to serve consumers and promote sustained economic growth nor should we neglect the need for companies to bring value to their shareholders.

In addition to these concerns, I'd like to highlight some additional issues for the Committee:

1. **Common Objectives and Principles**
2. **Too Big and Too-Big-To-Fail**
3. **Create Financial Services Oversight Council**
4. **Clarify Market Stability Authority**
5. **Ensure Balanced and Better Prudential Standards for All**
6. **Establish Orderly Resolution Regime for Large Nonbank Financial Institutions during Financial Emergencies**
7. **Enact National Insurance Regulation**
8. **Ensure Global Harmonization Standards**
9. **Restart Securitization**
10. **Payment Systems**

1. CODIFY COMMON OBJECTIVES AND PRINCIPLES

The financial crisis revealed that our fragmented financial regulatory system lacks basic common objectives and principles. Regulatory agencies at both the federal and state levels are assigned different, and sometimes conflicting, missions. Common objectives and principles are needed to guide regulatory behavior and achieve desired policy outcomes. Therefore, the Discussion Draft could be strengthened with the enactment by Congress of a set of clear policy objectives and a set of commonly accepted principles to guide financial regulators and the firms they regulate.

Common Policy Objectives

Setting common policy objectives will force us to decide what we collectively — Congress, the Administration, policymakers, and the financial services industry — want our financial system to achieve for the benefit of all consumers and sectors of our economy. We propose three, simple objectives as a starting point for the Committee's deliberations:

1. Enhance the competitiveness of financial services firms to meet the financial and related needs of all consumers and investors;
2. Promote financial market stability and security; and
3. Support sustained economic growth and new job creation in a globally integrated economy.

These are outcomes that would benefit all consumers and sectors of our economy. We recommend that they be added to the statutory mission statement of every financial regulatory agency.

Guiding Principles

Once we agree upon *"what"* we want our financial system to achieve for the benefit of society, we then need to agree on a common set of principles to guide *"how"* all financial regulators and firms behave. Guiding principles can act as a compass for all to follow. They would not replace more detailed regulations. To the contrary, regulations will remain necessary, especially at the retail level for the protection of consumers. However, a set of guiding principles would become a touchstone against which financial regulations could be evaluated in a policy and legal context. Regulations that are not consistent with the principles should be revised or eliminated. Likewise, some laws may need to be changed to be consistent with the principles.

Mr. Chairman, the Roundtable supports six basic principles to guide all financial regulators and all regulated firms going forward; these are attached as Appendix A in my testimony. Whatever

objectives and principles Congress adopts, they should guide the application and review of *all* regulatory policies in the future. They should be designed not only to be responsive to the needs of consumers; but also should ensure that the regulation of financial services and markets is balanced, consistent, and predictable. Principles such as these would help regulators and financial services firms focus on both desired policy outcomes and material risks to markets.

2. TOO BIG AND TOO BIG TO FAIL

There are two parts to this debate. First, some say that some financial institutions are simply too big. Large financial firms remain vital to our economy and our ability as a nation to compete internationally. Today, the top 50 financial holding companies regulated by the Federal Reserve or the Office of Thrift Supervision (OTS) hold 84 percent of all consumer loans made by insured depository institutions, 49 percent of all small business loans[1], and 74 percent of all 1-4 family mortgage loans. If we go down the extreme path of breaking up these institutions or over-regulating them in the name of safety and soundness, who will step in to make these loans and support economic recovery and growth? Small banks simply do not have the capital or the capacity to do so in the current environment.

Who is going to finance the S&P 500 companies? If large U.S. institutions with the capital and capacity can not, then this financing either will not be available or it will move to less regulated parts of our financial markets or, more likely, it will move overseas to our competitors. These same top 50 holding companies finance 56 percent of the total business and farm loans made today by all insured depository institutions.[2] Who finances these loans and makes up "lost" GDP growth in the meantime if the U.S. Government were to force drastic divestitures because "big" is somehow equated with "bad." As Federal Reserve Chairman Ben Bernanke said recently, "We need a more subtle approach without losing the economic benefit of multi-function, international firms."

[1] Commercial and industrial (C&I) loans less than $1 million; source: FDIC Call Reports, June 30, 2009
[2] These figures exclude loans made by nonbank financial institutions or other unregulated lenders.

The more subtle approach is to ensure that no financial institution is "too big to fail." We live in a capitalist society, and letting firms fail is part of an active market system. The way to achieve this is to put in place an orderly resolution mechanism, as envisioned by the Discussion Draft, which allows orderly resolution to occur in ways that do not cause systemic risk or contagion to other parties. While there may be ways to strengthen Subtitle G of the Discussion Draft as the legislative process moves forward, eliminating the notion of firms "too big to fail" is a priority for the Roundtable.

3. FINANCIAL SERVICES OVERSIGHT COUNCIL

The Roundtable has been a consistent advocate of better regulatory coordination and cooperation among financial regulators through an enhanced and expanded President's Working Group on Financial Markets (PWG). Therefore, we support the creation of a new Council, as envisioned in the Discussion Draft.

Membership and Powers of the Oversight Council

We recommend several changes to the structure and the powers of the Council. Specifically, we recommend the following:

1. A new National (or Federal) Insurance Supervisor should have a seat on the new Council. A new national insurance regulator is needed to give the Federal Government a better understanding and role in the systemic supervision of a key part of our nation's financial services sector. In the absence of such a regulator, we recommend that a representative from the proposed Federal Insurance Office should have a seat at the table until such a regulator is created.

2. All agencies represented on the Council should be required to develop "regulatory action plans" for periodically reviewing existing financial regulations to ensure that they are consistent with the statutory objectives and guiding principles, which we have urged Congress to adopt.

3. The Financial Accounting Standards Board (FASB) should be subject to oversight by the Council. Accounting standards are an integral part of ensuring investor confidence in public companies and our financial markets, and, as such, should be overseen by the new body. Moreover, actions by FASB also should be subject to the Administrative Procedures Act (APA). Making FASB subject to the APA will provide a new and fair standard of due process for public comment on current FASB accounting standard setting procedures.

4. A new Subcommittee should be created within the Federal Financial Institution's Examination Council to monitor developments related to information technology, security and privacy and the impact of such developments on financial institutions. This subcommittee should prepare joint regulations or supervisory guidance to address such developments.

Attachment B contains proposed amendments to the Administration's proposed Council, which address the structure and responsibilities of the Council. Attachment C includes proposed amendments to the Federal Financial Institution's Examination Council.

Regulatory consolidation

The financial crisis made clear that we have too many financial regulators. The Roundtable supports further regulatory consolidation. Specifically, we generally support the Discussion Draft

approach to folding the OTS into the OCC. For all intent and purposes, these two national regulators are engaged in the same basic activities when it comes to regulation and supervision of the depository institutions under their purview. Even if there are no net job losses among regulatory staff, a legitimate concern in this economy, there undoubtedly will be other costs savings to be captured by eliminating regulatory gaps and streamlining their operations under a single roof.

4. CLARIFY MARKET STABILITY AUTHORITY

To better manage systemic risk, the Board, in close cooperation with the new Council, should be authorized to act as a market stability oversight authority, as contemplated by the Discussion Draft. In this capacity, the Board should be responsible for looking across the entire financial services sector to identify those activities, practices, and inter-connections that could pose a material systemic risk to the U.S. financial system or economy. It should conduct a rigorous, ongoing assessment of the financial system at large, and it should engage in both scenario and contingency planning with other regulators on the Council. When necessary and appropriate, the Council or the Board should issue public warnings about any given activity or practice that could have a material adverse and harmful impact on consumers.

The Board should not be a super-regulator

The Board, however, should not become a super-regulator with unchecked powers. If the Board finds that a particular activity or practice of a regulated firm poses a systemic risk, then it should be required to work jointly with the Council and other regulators to mitigate and eliminate that risk. Alternatively, if it finds that an unregulated firm is engaged in an activity or practice that presents a systemic risk, then the Board should be required to work with the primary regulators to ensure corrective

actions. If the primary regulators do not agree, then the Board should raise its concerns with the Council. Finally, the Board should retain the power to take extraordinary actions in national or international financial emergencies, with appropriate disclosure to the Congress and the public.

The Council should work closely with the Board to ensure an appropriate balance between greater market stability, systemic risk mitigation, and competitive and innovative financial markets that are able to meet the needs of all consumers of financial services. The Council and the Board should jointly develop new, balanced prudential standards for financial firms, anticipate early crisis warning signs, conduct the necessary contingency planning, and make recommendations to Congress for future reforms.

Designating the Board as the primary financial stability authority is a natural complement to the Board's existing role as the nation's central bank and lender of last resort. However, we recognize that this new role would require the Board to expand its staff to include experts in all types of financial activities, practices, and markets. Also, if the Board is given this new authority, it would need to establish a clear and transparent governance structure internally to minimize any potential conflicts with its other existing responsibilities. Rigorous Congressional oversight of this new role for the Board and the Council will be critical. An expanded version of our views on systemic risk appears in Attachment D.

The purpose of any market stability oversight authority should be to promote the long-term stability and integrity of the nation's financial markets and financial services firms by identifying and addressing significant risks to the financial system as a whole. This new authority should be authorized to oversee all types of all financial markets and all financial services firms, whether regulated or unregulated. The market stability authority, however, should *not* concentrate its efforts on an arbitrary and public list of financial services firms based primarily size. The Discussion Draft strikes the right

balance by keeping the list of identified financial holding companies confidential, just as supervisory ratings are today.

As a nation, we cannot afford another 25 or 30 new Government-Sponsored Enterprises (GSEs). That is exactly the result we would produce if we publicly draw a "bright line" around a class of firms. If the Board focuses exclusively on size in particular and not activities and practices that lead to broad systemic risk in general, then it runs the risk of missing the next problem that could be brewing in smaller, unregulated parts of the system, such as the small, state-licensed mortgage brokers who helped to fuel the fires of this crisis.

Any public designation would only increase the moral hazard, have a destabilizing effect on competition and the pricing of products, services, and funding, and ultimately work to the disadvantage of the long-term competitiveness of U.S. financial services firms and markets. Moreover, with the market stability oversight authority, the Board should work consistently and in coordination with its international counterparts.

The better solution is to ensure that any new, post-crisis capital, liquidity, and risk management requirements are balanced, effective, risk-based, and in tune with evolving international standards for all financial firms. We understand that there may be less leverage in our financial system and higher capital and liquidity requirements in the future for firms that pose greater risks than others, but we do not need a new publicly designated class of firms that could be perceived by consumers, investors, and the markets as the next generation of GSEs or quasi-public utilities.

Companies Should Not Be Required to Divest Lawful Affiliations and Activities

The Roundtable **opposes** any requirement for financial holding companies to divest lawful affiliations and commercial activities. Requiring each financial holding company to comply with the

nonfinancial activity restrictions of the Bank Holding Company Act does not address the causes of the current credit crisis or threats to the safety and soundness of the financial system.

Commercial ownership of financial companies and banks has been a source of strength and capital to their financial affiliates and helped maintain the flow of credit to support the recovery of the nation's economy. These affiliations were in no way connected with the financial crisis.

The Discussion Draft could prevent financial affiliates in a commercial enterprise from doing business with any company that does business with any of their commercial affiliates. If these financial companies are not able to continue to serve and lend to these industrial and commercial customers because of the restrictions in the draft legislation, then small and mid-size businesses and companies in critical sectors of the U.S. economy, as well as their employees, and the economy as a whole, will suffer. For example, if the restrictions on affiliate transactions are enacted as written, companies in the health and clean energy industries could be frozen out of the credit markets because companies that are their current sources of credit could be effectively barred form doing business with them. The effect on small and mid-sized businesses could be particularly severe, shutting off credit to these companies exactly when they need it most.

The Board should not have extraterritorial powers over foreign firms

The Discussion Draft gives the Board the authority to impose prudential standards on foreign companies with U.S. financial operations. This provision should be clarified to ensure that such standards do not conflict with or overlap with home country requirements.

The Board should not be authorized to enforce "living wills"

The Discussion Draft contains a broad grant of authority for the Board to require financial holding companies to develop "rapid resolution" plans in the event of their failure – so-called "living wills" – which also are being discussed in the United Kingdom. Presumably, these would be formal contingency plans contemplating the failure of a firm, which even could be subject to formal disclosure in filings with the Securities and Exchange Commission (SEC). Contingency planning by financial firms is both necessary and prudent. Contingency plans should be robust and reviewed periodically with supervisors so most "surprises" should not surprise either management or their regulators.

However, there are potentially disruptive market confidence impacts, technical concerns, and unintended consequences that need to be considered carefully by Congress before moving forward, especially if these "living wills" were required to be disclosed under the securities laws. Managers at every financial firm adopt organization and operational structures designed to achieve strategic goals and objectives. Tax, accounting, legal and other requirements also impact organizational structures. Care needs to be taken that regulators not be able to use the "living will" requirement to force corporate reorganizations that impair the effective and efficient operation of firms. We should not move forward on this issue until we are assured that market distortions are fully vetted and other nations are moving in the same direction. We want to avoid creating any international competitive disadvantages for U.S. firms.

A better near-term and more practical first step would be to have the regulators and the industry jointly develop a set of principles and best practices for the rapid resolution of failing firms, beyond what the regulators can impose already under their existing "prompt, corrective action" authority. This approach is consistent with the Roundtable's fifth principle, which supports management's flexibility in a market economy to design a competitive strategy and organizational structure that bests fits a firm's

objectives for serving customers and attracting needed capital by providing a competitive return to investors. Moreover, this would give the regulators and the industry the opportunity to identify and resolve critical technical issues (e.g., monitoring and reporting counter-party risk) that impede a rapid resolution, but could result in more consistent and better reporting across all types of firms in the future.

Derivative transactions with affiliates should not be subject to 23A limits

The Discussion Draft would subject derivative transactions between a bank and its affiliates to the quantitative and collateral requirements of 23A of the Federal Reserve Act. These requirements would prohibit a bank from engaging in derivative transactions with an affiliate if the transactions exceeded ten percent (10%) of the bank's capital. This is a requirement that is not necessary and is potentially counterproductive. Derivative transactions between affiliates did not contribute to the financial crisis. They are a risk management tool for financial firms and already are subject to the requirements of 23B of the Federal Reserve Act, which mandates that they be on an arms-length basis. For safety and soundness purposes, institutions also collateralize these transactions. Imposing the qualitative limitations of 23A would increase costs for financial firms and force them to rely on third parties to engage in these transactions. That will only increase interconnectedness at a time when we are trying to mitigate risks caused by interconnectedness.

5. ENSURE BALANCED AND BETTER PRUDENTIAL STANDARDS FOR ALL

Much of the current debate over prudential standards has focused on the need for more capital. While the financial crisis did highlight serious capital deficiencies in some firms, higher and higher capital should not be the sole focus of regulators. Capital requirements should be just one of the

"pillars" upon which sound supervision should be based. Other pillars are prudential supervision and market discipline. Going forward, we need a better balance among all three pillars.

New capital and liquidity requirements.

The conventional wisdom coming out of the crisis is that more capital and higher liquidity requirements could have averted the crisis. There is no doubt that we need new and better capital and liquidity standards as the first pillar of better prudential regulation. However, these standards need to be applied uniformly across firms based upon comparable activities. In other words, firms engaged in the same risks should be subject to the same capital requirements, regardless of charter, location, or state of domicile. Moreover, because financial markets are dynamic and change over time, these standards should be set by the prudential regulators, the parties that can identity both the strengths and weaknesses of the firms due to their constant interaction with them. Congress should not specify such standards in legislation.

Any new capital requirements must be carefully balanced and calibrated to achieve the twin objectives of financial stability *and* sustained economic growth. Unfortunately, much of the commentary to date has called for higher and higher levels of capital, without much consideration of the economic impact of such requirements. Treasury Secretary Geithner, for example, has called for "significantly" higher levels of capital for everyone. The Discussion Draft calls for "heightened standards" for capital, liquidity, risk management, and prompt correction action.

Taken to their extreme, new and tougher capital requirements could produce the safest financial system in modern times. But there also will be unintended consequences – in this scenario of higher capital standards, we could end up with a smaller, higher cost, less innovative financial system precisely at the wrong point in our nascent economic recovery.

The demand for strict, new capital requirements – more capital for the sake of having more capital – could undermine future economic growth more than any single other factor. Federal Reserve Governor Daniel Tarullo, while calling for higher capital levels, also cautioned policymakers to strike the appropriate balance: "In the first place, there is some danger that simply piling on a series of administrative reforms and restrictions intended to constrain the behavior of firms would have unnecessarily adverse consequences for the availability of credit on risk-sensible terms for consumers and businesses alike."[3]

Additionally, regulators are giving consideration to the creation of some type of "contingent capital," which starts out as debt but can be converted quickly to equity when a bank gets into trouble. We should resist any artificial requirement for contingent capital. From a market perspective, the cost of such capital – knowing that a hybrid debt instrument can be transformed into equity and used to cover losses immediately upon the demise of a firm – could be prohibitive and destabilizing in its own right. We have serious reservations with this proposal. Not only is it untested in the real world, but it also could be destabilizing as investors panic and withdraw funds in anticipation of the conversion. In other words, it could trigger the very systemic problems and exacerbate the very crisis it is supposedly intended to prevent. Further study analysis and testing is required before the Council or the Board moves forward on this issue.

As the Group of 20 (G20) and the new Financial Stability Board (FSB) have indicated, any new capital requirements should be fully transparent by the end of this year, fully vetted and tested in 2010, and then finally promulgated in 2011 to ensure that there is no negative impact and no unintended consequences. This approach is still likely to result in higher absolute levels of capital and less leverage in our financial system, which may be appropriate, so long as it carefully weighs the balance of financial market stability and is imperative for continued economic recovery and growth in the future.

[3] Governor Daniel K. Tarullo, "Confronting Too Big to Fail," Exchequer Club, Washington, D.C., October 21, 2009.

Congress should give its guidance, but it should not write hard and fast capital requirements into law. Instead, we should give the financial regulators, in consultation with other international regulators and the financial services industry, the needed leeway to adopt new risk-based, counter-cyclical rules that apply consistently and uniformly across the size of an institution, across sectors within the industry, across financial services charters, and across national borders.

Balanced and better prudential supervision.

The second pillar of safety and soundness should be effective supervision by financial regulators. The financial crisis revealed an inability of our fragmented financial regulatory structure to effectively supervise all types of firms on a consistent basis. There were significant gaps in regulation and clear failures to approach supervision on a comprehensive basis.

The application of balanced and better prudential supervision for all financial firms by all financial regulators is necessary in this market. From our perspective, prudential supervision is a form of supervision in which regulators and regulated entities maintain a constant and constructive engagement to ensure an effective level of compliance with applicable laws and regulations. Prudential supervision promotes the identification and correction of problems at their earliest stage, well before they reach a point of potentially harming consumers. Prudential supervision relies upon regular and open communications between firms and their regulators to discuss and resolve issues of mutual concern as soon as possible. Prudential supervision encourages regulated entities to bring matters of concern to the attention of regulators early and voluntarily. Prudential supervision promotes and acknowledges self-identification and self-correction of control weaknesses, thereby reinforcing continued focus and attention on sound internal controls.

This form of supervision governs much of the banking world today, but is not the case for most of the securities and insurance industry today. Our proposed amendments to Title I (see attachment B) would direct all federal financial regulators to apply this form of supervision.

Market Discipline

The third pillar of safety and soundness should be market discipline. While capital has received much of the attention as the preferred regulatory solution, we should not lose sight of the role that greater market discipline and transparency can play in controlling risks. It gives investors insights into the operations and activities of firms, and it serves as a check on management.

This can be accomplished in three basic ways:

1. Many observers acknowledge the need for better disclosure of critical information across the financial sector. Better market surveillance and better public reporting of risk concentrations and the rapid growth of both asset classes and deposits, especially brokered deposits, can play a vital role in ensuring that markets have the information they need to make informed investments and financial decisions. The frequent "stress tests" by the regulators aid in these market surveillance procedures.
2. The ultimate market discipline is the failure of bankrupt firms, with shareholders and creditors taking their losses as appropriate. As I noted earlier and will discuss in more detail below we need to eliminate "too-big-to-fail" from our vocabulary once and for all. Any firm, regardless of size, complexity, or interconnectedness should be allowed to fail if it can not compete in the marketplace. What we need to ensure, however, is that these failures do not lead to unnecessary instability or unintended consequences for unrelated firms, investors, or consumers. We need an orderly resolution regime for *all* financial firms, regardless of size or complexity.

3. We also must have standards that provide transparent information, but not ones that artificially drive economic activity in one direction or another. Making FASB subject to the APA will provide a new and fair standard of due process for public comment on current FASB accounting standard setting procedures. In the insurance industry, the same should be true for statutory accounting standards, which are essentially created by the NAIC and imposed upon the states and industry.

6. ESTABLISH AN ORDERLY RESOLUTION REGIME FOR LARGE NONBANK FINANCIAL INSTITUTIONS DURING FINANCIAL EMERGENCIES

The United States already has well-tested systems to protect insured bank and thrift depositors, customers of brokers and dealers, and insurance policyholders. Those systems have served us well as a nation, and need to be maintained "as is." However, the recent crisis has demonstrated a need for a resolution mechanism for holding companies. We support the creation of such a system, subject to the following constraints.

This system should be reserved for financial emergencies

Such a system should be reserved for emergency situations. The Discussion Draft proposes a resolution mechanism that requires a finding of systemic risk, following a multi-step process that involves prudential regulators, the Secretary of the Treasury and even the President. In general, we support such a procedural regime. It helps to ensure that this mechanism will be used only in rare, emergency cases that pose a significant material negative impact on our financial system on our economy.

The system should rely upon bankruptcy rules

Such a system also should rely upon the federal bankruptcy rules, to the maximum extent possible. While this resolution authority may be needed to avoid contagion in a systemic crisis, the rights of creditors (both secured and unsecured) should be protected, while creditors also suffer the first losses. The Discussion Draft is based upon the resolution procedures applicable to insured depository institutions. While these procedures may be needed to protect the interests of insured depositors, they are not appropriate in failures of holding companies. Holding company creditors should be given the same rights and protections available under federal bankruptcy law. That includes the ability to challenge valuations of assets and seek judicial review of determinations. Therefore, we recommend that the resolution title be aligned with the rights and procedures applicable under bankruptcy law, to the maximum extent possible.

The Secretary of the Treasury should designate the resolution agency

As the Discussion Draft suggests, we recommend that the Secretary of the Treasury be given the authority to select from various federal regulatory agencies, including the FDIC for depository institutions and the SEC for securities firms. Subsidiaries of financial holding companies should be resolved by existing regimes. We should explore the extent to which this new regime could rely upon existing bankruptcy courts.

Existing funds should be protected

Under this regime it should be explicit that the existing Deposit Insurance Fund (DIF) for banks and thrifts cannot be tapped to cover costs incurred in connection with nonbank resolutions. Any costs incurred by the Federal Government that exceed the residual assets of the failed nonbank firm (after

shareholders are wiped out and creditors take their losses) should be repaid through post-event assessments on a fair and equitable basis. State insurance guaranty funds also should be protected.

7. ENACT NATIONAL INSURANCE REGULATION

Serious reform of our financial sector must include federal supervision for the insurance industry. Insurance is a national and international business, and an important factor in the health of our domestic economy. Federal regulation of insurance is one of the key gaps in our current financial regulatory system. As a newly designated market stability authority interacts with other regulators, there is an evident need to create a national insurance regulator for the insurance industry.

Insurance is a national and global business that has over $5 trillion under management, including municipal and corporate securities. Yet, it lacks a national insurance prudential regulator. Only through coordination with a national insurance regulator will a market stability regulator have the ability to both detect and act on risky market activity and business practices in a timely, uniform, and comprehensive fashion. Asking the market stability regulator to seek coordinated actions by multiple state insurance regulators is not an option that will effectively address systemic risk due to the different state and territorial insurance regulators, with varying legal and budget authority, and varying levels of expertise.

A national insurance regulator should have the authority to charter insurance companies –to establish and enforce prudential standards for those firms that chose a national charter, and to represent the U.S. internationally on behalf of federally chartered institutions. The national insurance regulator's authority should be an independent bureau within a federal agency headed by a Presidential appointee.

Some may say that creating a national insurance regulator creates regulatory redundancy. The Roundtable does not believe this is accurate. As long as the system is optional, it should function just as the dual banking system has functioned for the past 160 years. It would provide companies the ability to

decide which system works best to serve their customers, a state or a national system. Furthermore, it will give consumers the choice. Consumers will choose whether to purchase insurance from nationally chartered or state chartered insurance companies. Regardless, there should be common principles in the national and state insurance systems. We commend Congresswoman Melissa Bean and Congressman Ed Royce for their tireless work on this specific issue, and we look forward to working with this Committee toward the creation of the national insurance regulator to enhance stability in our national insurance markets and reduce systemic risk in the future.

For starters, to address the lack of insurance expertise at the federal level, a Federal Insurance Office should be established within the Treasury Department as proposed in the current version of H.R. 2609 which we support. This is an important first step toward federal insurance regulation and Chairman Kanjorski and members of the Subcommittee should be applauded for this current version. However, this new Office should be authorized to charter and regulate national insurers, reinsurers, and insurance agents. State insurance regulation should remain intact and available for those firms, agents, and consumers that prefer state regulation. Insurance firms and agents that operate in multiple states should be able to select uniform, national regulation by the Federal Government.

Because insurance is a national and international business, it is in our own economic self interest to recognize it as such, especially for those insurance companies that choose to serve their customers' needs with a nationwide or global strategy. Omitting such an important part of our financial system from needed reforms would be like committing to strengthen a football team, but leaving the defense on the sidelines.

8. ENSURE GLOBAL HARMONIZATION OF STANDARDS

The United States cannot afford to act in a vacuum when it comes to regulatory reform, especially when it comes to new capital and liquidity standards or the creation of a new regime for systemically important firms. The ascendancy of the G20 is the single most significant international financial event since the creation of the Bretton Woods Agreements after World War II. We have moved from the old G7 world, to a more diverse and representative group – the G20 – accounting for roughly 80 percent of the world's GDP.

The recent G20 Leaders Summit in Pittsburgh stressed again the need for new and harmonized international regulatory standards and supervisory procedures among all nations. The G20 leaders also reaffirmed their support for open and competitive global markets that are well regulated and supervised as a precondition for sustained, stable economic growth. They also endorsed better coordination and cooperation at the international level, and opposed regulatory fragmentation among individual countries. Significant differences in regulatory regimes can undermine the safety and soundness of the financial system and produce competitive disparities across countries that will impede international trade, finance, and investment.

It is critical that the Administration play a visible and assertive leadership role within the G20 and the new FSB, which the G20 created specifically to oversee the transition to new international standards and rules for global financial markets. Specifically, the U.S. government needs to ensure that the proper structures and frameworks are implemented to achieve internationally consistent standards as well as the consistent enforcement of those standards by every nation.

Moreover, the Treasury Department needs to ensure – and Congress needs to oversee – that U.S. firms are not disadvantaged when competing globally under any new international regulatory structures or standards. New international regulatory standards for supervision, capital, liquidity, and risk

management should not only be balanced, effective, and risk-based, but also recognize the benefits of globally competitive financial markets. Congress needs to ensure that any change in U.S. financial laws and regulations must be consistent with these evolving new international norms, and regulatory fragmentation among nations should be opposed as a matter of U.S. government policy. Failure to do so will put U.S. firms and our national economy at a distinct competitive disadvantage.

Accounting standards also are an integral part of ensuring investor confidence in public companies and our financial markets. We need to move ahead with the convergence of U.S. and international accounting standards as soon as possible. This includes moving forward with the proposed SEC roadmap that will permit all global and U.S. based publicly-traded firms to file their accounting statements according to the International Financial Reporting Standards, without having to reconcile such statements to the U.S.GAAP. Since financial institutions are different than other types of publicly traded companies, we also need to consider the recommendations of financial regulators on accounting related issues that have a potential impact on financial stability. Financial reporting needs to be accurate and maintain its integrity, but we grant financial regulators the ability, for example, to impose new rules governing loan loss reserving for financial institutions that may depart from current U.S.GAAP, so long as their methodology is fully disclosed and financial institutions are supervised on a continuous basis to ensure the integrity of their accounting methodology for loan losses.

9. RESTART SECURITIZATION

Securitization has helped millions of Americans obtain mortgage loans. It has facilitated a broad and liquid market for many traditional mortgage products, including the 30-year fixed rate mortgage loan. At the same time, securitization contributed to the recent financial crisis. It served as a means for

lenders to pass along risky loans to investors who placed excessive reliance on credit rating agencies and failed to conduct their own due diligence.

Restarting prudent securitization should be part of financial reform. We believe that this can be achieved in two ways: (1) through risk retention policies that encourage each participant in the chain between a borrower and the investor to make independent credit risk management decisions, and (2) reform of the housings GSEs, Fannie Mae and Freddie Mac, in the next session of Congress.

Risk Retention

In hindsight, it is clear that in the years and months before the financial crisis many lenders deviated from prudential underwriting standards. One proposed policy response to this lapse is a requirement that all lenders retain some of the credit risk associated with riskier loans. Such a risk retention requirement was incorporated in section 213 of H.R. 1728, which your Committee wrote and which passed the House of Representatives earlier this year. We supported that provision. It set a 5% risk retention level and gave regulators the ability to implement that requirement, taking into consideration a variety of factors designed to minimize any negative impact on housing finance. In contrast, the Discussion Draft imposes a 10% requirement that would be imposed jointly by the SEC and banking regulators. Including the SEC in this process does seem appropriate especially for securitizers. However, the 10% requirement is untested and we are concerned that it could have a significant negative impact on the availability of mortgage finance for consumers.

Reforming the GSEs

Fannie Mae and Freddie Mac have been integral to securitization. They provide a market for mortgage loans, and have standardized many of the systems and procedures involved in securitization.

It is now clear, however, that the structure and mission of the GSEs were inherently at odds. The interests of private shareholders came into conflict with the public mission of the GSEs. One manifestation of this conflict was the expansion of the GSE portfolios, beyond the levels necessary to provide market liquidity. The portfolios became engines for earnings, not securitization. Another manifestation of this conflict was the purchase of lower quality mortgages by the two GSEs as they attempted to compete with other securitization markets. We urge the Congress to take up GSE reform after it completes its work on Financial Regulatory Reform.

GSE reform should be designed to eliminate the inherent conflict in the current structure and mission of Fannie Mae and Freddie Mac. The Housing Policy Council (HPC) of the Roundtable formed a task force of lenders, services and mortgage insurers to address this challenge. While that task force has not settled on a specific organizational structure for the GSEs, it has identified certain key principles upon which GSE reform should be based. (See Attachment E). The principles are intended as a framework for evaluating the appropriate role and structure of the GSEs going forward. They are high-level. Yet, they do identify some features of the GSEs that should be retained, and some that should be reformed.

The principles recognize a continuing need for the GSEs, or some successor entities, to facilitate the securitization of mortgages. Securitization has been critical to the development of the 30-year fixed mortgage and other traditional mortgage products, and the GSEs, or some successor entities, are needed to continue to perform this function.

However, the principles envision certain changes in the operations of the GSEs or their successors that would substantially reduce the risk profile of the GSEs or their successors:

- A return to the core mission – While the GSEs were created to support the conventional mortgage market, purchases of higher-risk mortgages contributed to their financial problems.

The GSEs or their successors should return to the core mission of providing liquidity for prudently underwritten, conventional mortgages. This would be fixed-rate mortgages and adjustable rate mortgages underwritten to their fully indexed rate at the time of origination

- An explicit federal guarantee – Confusion over federal support for the securities issued by the GSEs reduced the demand for these securities and increased mortgage costs for consumers. This confusion would be eliminated by an explicit federal guarantee on the securities issued by the GSEs or their successors. The federal guarantee should be the minimum amount necessary to provide investors with confidence in the securities, and should not be a guarantee of the entities themselves.
- Limited portfolios – The portfolios amassed by Fannie Mae and Freddie Mac were a major contributing factor in their financial collapse. Going forward, any portfolios maintained by the GSEs or their successors should be limited in size and held for liquidity purposes only.

The principles envision a continuing role for the GSEs, or their successors, in affordable housing, but not through specific housing goals. The statutorily-mandated affordable housing goals had the unintended effect of motivating practices by the GSEs that harmed many borrowers as well as the financial condition of the GSEs. Going forward, HPC member companies believe that the GSEs or their successors should support safe and sustainable mortgage products for all categories of borrowers regardless of income level, including first-time homebuyers with lower down-payments, and for multifamily properties. However, the GSEs or their successors should not be required to meet specific housing goals. Liquidity support for special categories of borrowers should be provided by FHA and other federal and state programs specifically designed for that purpose.

Our GSE task force continues to deliberate on how these basic principles could be incorporated into specific organizational structures for the GSEs or some successor entities. Our task force is looking at both public and private ownership structures. At this juncture, most of the members of the task force favor some continued role for private shareholders, but that view is not unanimous.

The other issue that our task force is discussing is the transition from the current conservatorship arrangement to some new structure for the GSEs. It is increasingly clear that the transition will take some time – possibly a period of years. Maintaining the integrity and continuity of the secondary market during this transition process will be important. We will share the results of our GSE task force deliberations with you as soon as they are final.

10. PAYMENT SYSTEMS

Payment systems are an integral part of our nation's financial system. They are the conduit for funds to flow between and among domestic and international businesses, consumers, and government agencies at all levels. The Roundtable supports regulatory improvements that ensure the integrity, security and availability of these payments systems. The Roundtable believes that the Congress and regulators should not inhibit the ability of the private sector to sponsor and operate various payments systems. The Roundtable encourages the U.S. financial regulatory agencies to engage other federal agencies with oversight of telecommunications providers and consumer protection responsibilities to address safety and soundness and consumer protection concerns with emerging mobile financial services products.

CONCLUSION

The Discussion Draft is an improvement over prior proposals. The Roundtable believes that the reforms to our financial regulatory system that we propose would substantially improve the protection of consumers by reducing existing gaps in regulation, enhancing coordination and cooperation among regulators, ensuring greater regulatory accountability for commonly desired regulatory outcomes, and identifying systemic risks. Broader regulatory reform – including all proposals to mitigate systemic risk in the future – is important not only to ensure that financial institutions continue to meet the needs of all consumers but to restart economic growth and much needed job creation.

Financial reform and ending the recession soon are inextricably linked – we need both. We need a financial system that provides market stability and integrity, yet encourages innovation and competition to serve consumers and meet the needs of a vibrant and growing economy. We need better, more effective regulation and a modern financial regulatory system that is unrivaled anywhere in the world. We deserve no less. The Roundtable stands ready to work closely with this Committee, the Congress, and the Administration to achieve our common goals to better serve all consumers of financial services and provide a stronger financial market foundation for our economy.

Attachment A

Six Guiding Principles for Regulators and Regulated Firms

1. Fair treatment for consumers (customers, investors, and issuers). *Consumers should be treated fairly and, at a minimum, should have access to competitive pricing; fair, full, and easily understood disclosure of key terms and conditions; privacy; secure and efficient delivery of products and services; timely resolution of disputes; and appropriate guidance.*

Treating consumers fairly is a stated objective for most financial services firms today, and typically it is a critical component of a firm's strategy for doing business in all consumer segments. Fair treatment should occur throughout a financial transaction. At the beginning of a transaction, it involves the meaningful disclosure of terms. Meaningful disclosure, especially to the retail consumer, goes hand in hand with effective competition. After a consumer relationship is established, fair treatment includes maintaining the privacy of consumers' confidential personal information and providing a safe and secure environment in which to conduct financial business. Fair treatment includes facilitating all consumer transactions – payments, transfers, credit applications, setting up new accounts, sales, and purchases – to ensure that they are conducted in the most efficient and timely manner possible given available technology. Fair treatment includes the establishment of transparent, effective, and timely mechanisms in place for consumers and firms to resolve potential disputes. Fair treatment also requires a financial firm to consider the needs of a consumer in any interaction and to make sure that a consumer understands how the interaction will affect him or her. While effective disclosure often will constitute appropriate guidance, in some instances, it may be important to help a consumer to understand the purpose and function of a particular product or service by providing financial literacy training.

2. Competitive and innovative financial markets. *Financial regulation should promote open, competitive, and innovative financial markets domestically and internationally. Financial regulation also must support the integrity, stability, and security of financial markets.*

Open, competitive, and innovative markets benefit consumers and are preferable to financial markets that are closed or restricted and new products and services that are subject to unnecessary regulatory hurdles and delays. To ensure a competitive U.S. environment, domestic and international firms doing business here should compete equally and not be subject to any form of discrimination based upon national origin. Unreasonable barriers to entry should be eliminated, but minimum capital levels, fit-and-proper tests for management, reasonable strategic plans, and appropriate internal controls should be required. Innovations in financial products and services should be encouraged, consistent with safety and soundness and consumer protection. A vigilant and forward-looking regulatory system that supports the integrity and security of our financial markets will help the U.S. maintain its competitive advantage as a productive and secure place to engage in the full spectrum of financial services. In this context, both policymakers and regulators will need to ensure that the competitiveness of U.S. financial markets relative to other international markets is considered fully in their deliberations and rulemaking.

3. Proportionate, risk-based regulation. *The costs and burdens of financial regulation, which ultimately are borne by consumers, should be proportionate to the benefits to consumers. Financial regulation also should be risk-based, aimed primarily at the material risks for firms and their consumers.*

Financial regulation should be proportionate and risk-based. Regulatory efforts and resources should be targeted to the actual material risks of specific activities and material risks to the financial

system as a whole. Market discipline should play a key role in helping to ensure that risk management is effective and proportionate. Government oversight should be risk-focused as well, with appropriate and proportionate responses to correct real deficiencies that inevitably occur from time to time as markets evolve, new products are introduced, and new players enter the markets.

4. Prudential supervision and enforcement. *Prudential guidance, examination, supervision, and enforcement should be based upon a constructive and cooperative dialogue between regulators and the management of financial services firms that promotes the establishment of best practices that benefit all consumers. In short, prudential supervision should be prudent rather than arbitrary and preventative rather than "after the fact" enforcement.*

The foundation of prudential supervision is an open and professional dialogue between regulators and regulated firms. When corrective measures are required of regulated firms, prudential supervision is predicated on a spectrum of corrective measures that begins with voluntary remedial actions by management and then escalates progressively, culminating ultimately in formal enforcement action. Prudential supervision is not grounded in a black-and-white world of either compliance or noncompliance where noncompliance results in immediate penalties and public enforcement actions. Moreover, prudential supervision is not based on a predicate of a presumption of guilt prior to a discussion of facts and circumstances or an examination. Prudential supervision does not eliminate need for enforcement when appropriate. It includes swift regulatory action, public enforcement, and tough penalties for willful misconduct, fraud, and similar crimes that can lead to a firm's failure or seriously harm consumers.

5. Options for serving consumers. *Providers of financial services should have a choice of charters and organizational options for serving consumers, including the option to select a single national charter and a single national regulator. Uniform national standards should apply to each charter.*

Managers of financial services firms use a variety of competitive strategies to meet all of the financial product and service needs of their consumers locally, regionally, and globally. Most corporate strategies are designed after a thoughtful and ongoing assessment of market forces, competitive threats and opportunities, demographic trends, consumer needs, institutional capabilities, and core competencies. While there is a wide range of national and state charters and organizing structures available to management today, many strategies require multiple charters and licenses and an equal if not greater number of regulators, at both the national and state levels. Requiring financial services firms to use multiple charters and multiple regulators increases operating costs for those firms and some of those costs ultimately are borne by both consumers and investors. National standards should be applied when a product or activity is truly national in scope. Our consumer credit system, which includes products such as mortgages, credit cards, and auto loans, is a national one. Therefore, institutions that offer those products should be subject to uniform supervisory and consumer protection regulations. In addition, those entities, products and activities that are regulated by the federal government should be preempted from duplicative state regulation. Granting state authorities the power to conduct inquiries and enforcement actions for state and federal consumer protection laws will have a chilling affect on the products offered to consumers and increase the costs of providing those products.

6. Management responsibilities. *Management should have policies and effective practices in place to enable a financial services firm to operate successfully and maintain the trust of consumers.*

These responsibilities include adequate financial resources, skilled personnel, ethical conduct, effective risk management, adequate infrastructure, complete and cooperative supervisory compliance as well as respect for basic tenets of safety, soundness, and financial stability, and appropriate conflict of interest management. Management also should ensure the establishment of compensation plans that are based upon long-term performance, not short-term risk.

Capable and well qualified management is critical for financial services firms that aspire to serve their consumers effectively and efficiently. Discipline imposed by the marketplace and government supervision is also critical in assuring that consumers are well served. Senior management is responsible for key elements of corporate success, including assuring adequate financial and human resources, appropriate and effective risk management and internal controls, accurate reporting, and consumer protection. An experienced management team with skilled personnel at all levels of the organization is important as is continuous training for all employees. Management should have in place a transparent code of conduct based on best practices observed through the industry to ensure ethical behavior of employees at all levels of the organization; education in ethics and good business conduct should be mandatory.

These are important issues that go to the heart of the financial crisis. Addressing these issues in a coherent and consistent manner will rebuild public trust in the financial services industry, and prevent a repeat of the crisis we have just experienced. Indeed, our economy will remain at great risk if we do not pursue coherent and consistent reforms in these areas. In his recent speech at Federal Hall in New York City, President Obama called for clearer rules of the road for financial regulation, but he also warned against legislation that stifles innovation and enterprise. Mr. Chairman and members of the Committee, it is in that spirit that the Roundtable pledges to work with you to reform our financial system to serve all consumers in ways that balance financial stability and sustained economic growth.

ATTACHMENT B

Amendments to Title I

1. Renumber existing section 102 as "103" and renumber the remaining sections accordingly;

2. Insert the following new section 102:

"SEC. 102. OBJECTIVES. – The objectives of this Act are to –

(a) Support sustained economic growth and new job creation in a globally integrated economy;

(b) Promote financial market stability and security; and

(c) Enhance the competitiveness of financial services firms to meet the financial and related needs of consumers and investors.

3. Strike the word "and" at the end of section 103(c)(1)(D) [as renumbered by amendment 1, above], strike the period at the end of section 103(c)(1)(E), and insert the following:

"; and

(F) issue interpretations of the principles established in Section 110 of this Act;

(G) oversee the implementation of regulatory action plans required by Section 111 of this Act; and

(H) develop a model policy statement on prudential supervision consistent with the requirements of Section 113 of this Act."

4. Add the following new sections at the end of the Act:

"SEC. 110. PRINCIPLES.

(a) Five-Year Phase-in Period. – Each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall make its regulations, interpretations, guidelines, advisories and other supervisory actions consistent with the principles set forth in subsection (b) as soon as practicable, but not later than five (5) years after the date of enactment of this Act.

(b) Principles. –

(1) Fair Treatment for Consumers. – Consumers and investors shall receive fair treatment through uniform standards that ensure–

(A) protection from unfair or deceptive acts and practices;

(B) clearly written disclosure of key terms and conditions;

(C) protection of non-public personal information;

(D) secure and efficient delivery of financial products and services;

(E) timely and fair resolution of disputes; and

(F) relevant guidance regarding financial products and services.

(2) Stability and Security. – Financial regulation and supervision shall support the integrity, stability, and security of financial markets and financial services firms.

(3) Competitive and Innovative Financial Markets. – Financial regulation and supervision shall support open, competitive and innovative financial markets.

(4) Proportionate, Risk-Based Regulation. – Financial regulation and supervision shall be proportionate to the benefits and risks of the product or service offered, and shall take into consideration the cost of such regulation and supervision to consumers, investors, financial services firms, and the economy.

(5) Prudential Supervision and Enforcement. – The examination, supervision, and enforcement policies and procedures of a financial regulator shall be informed by an open and on-going engagement with the managers of financial services firms and shall seek to encourage all segments of the financial services industry to utilize the best practices to ensure the safety and soundness of financial services firms, consumer and investor protection.

(6) Management Responsibilities. – The managers of a financial services firm shall take appropriate actions to promote –

(A) the maintenance of adequate financial and managerial resources and skilled personnel;

(B) ethical conduct at all levels of the firm;

(C) effective risk management and controls;

(D) complete and cooperative compliance with all applicable laws, regulations, and supervisory mandates;

(E) respect for, and compliance with, the basic tenets of safety, soundness and financial stability; and

(F) appropriate conflict of interest standards.

(c) Interpretations and Compliance Guidance. – Any firm supervised or regulated by a federal financial regulatory agency that is represented on the Financial Services Oversight Council may seek interpretations of these principles from the Council under the terms of section 103(c)(1)(F) of this Act.

SEC. 111. REGULATORY ACTION PLANS.

(a) Process for Reviewing Regulations and Supervisory Activities. – Each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall establish a continuing process for assessing the consistency of its regulatory and supervisory activities with the principles established in section 110 of this Act. Such process shall provide for –

(1) a continuous review of the consistency of the agency's regulations, interpretations, guidelines, advisories, and other supervisory actions with the principles;

(2) an opportunity for public comment on the consistency of such regulations, interpretations, guidelines, advisories, and other supervisory actions during the review described in paragraph (1); and

(3) the preparation of an annual regulatory action plan, as described in subsection (b).

(b) Annual Regulatory Action Plans. – Beginning one year after the date of enactment of this Act, and continuing annually thereafter, each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall issue a regulatory action plan that –

(1)

(A) identifies the regulations, interpretations, guidelines, advisories and other supervisory actions reviewed by the regulator during the preceding year pursuant to the process required by subsection (a),

(B) summarizes any public comments received as part of that review, and

(C) explains whether or not such public comment should be adopted;

(2)

(A) describes how its regulations, interpretations, guidelines, advisories and supervisory actions are consistent or inconsistent with the principles established in section 112, and

(B) explains how the agency plans to resolve any inconsistencies;

(3) makes, to the extent necessary, recommendations for changes in Federal law necessary to allow the agency regulator to eliminate any inconsistencies between its regulations, interpretations, guidelines, advisories and other supervisory actions and the principles; and

(4) outlines a schedule for reviewing other regulations, interpretations, guidelines, advisories and other supervisory actions in order to comply with the five-year cycle required by subsection (a).

(c) Submission of Plans. – Each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall submit the regulatory action plan described in subsection (b) to –

(1) the Chairman of the Financial Services Oversight Council who shall –

(A) provide a copy to all other members of the Financial Services Oversight Council; and

(B) cause such plan to be published in the Federal Register; and

(2) the Committee on Financial Services of the U.S. House of Representatives and the Committee on Banking, Housing and Urban Affairs of the U.S. Senate.

SEC. 112. PRUDENTIAL SUPERVISION.

(a) Required. – No later than three years following the date of enactment of this Act, each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall apply prudential supervision in the exercise of its responsibilities with respect to financial services firms.

(b) Compliance. – A federal financial regulatory agency shall be deemed to have complied with the requirement in subsection (a), if such agency has –

(1) adopted and implemented the policy statement specified in section 113 of this Act,

(2) taken the administrative actions specified in section 114 of this Act, and

(3) appointed the ombudsman required by section 115 of this Act.

SEC. 113. POLICY STATEMENT ON PRUDENTIAL SUPERVISION.

(a) Policy Statement on Prudential Supervision Required. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall develop and publish a policy statement on prudential supervision.

(b) Contents of Policy Statement. – The policy statement required by subsection (a) shall address the following matters. –

(1) Internal Controls. – The policy statement shall encourage financial services firms regulated or supervised by the agency to establish and implement internal risk control practices and procedures that are designed to detect and prevent violations of laws, regulations, and other supervisory requirements.

(2) Open and On-Going Engagement. – The policy statement shall encourage an open and on-going engagement between the agency and the financial services firms regulated or supervised by the agency, and shall include transparent regulatory incentives for compliance with applicable law and regulations by financial services, as well as penalties for non-compliance, that are based upon the risk posed by, and performance of, a financial services firm.

(3) Self-Reporting. – The policy statement shall encourage financial services firms regulated or supervised by the agency to self-report violations of applicable laws, regulations, or other supervisory requirements, and shall include appropriate incentives for a financial services firm to self-report an apparent violation of law, regulation, or other supervisory requirement.

(4) Self-Correction. – The policy statement shall encourage financial services firms regulated or supervised by the agency to self-correct violations of applicable laws, regulations, or other supervisory requirements, and, subject to such limitations as the agency deems necessary to protect the safety and soundness of a financial services firm and the interests of consumers, the policy statement shall provide for the agency to give a financial services firm a notice of the violation and an opportunity to take corrective action before the agency decides to bring an enforcement action.

(5) Continuum of Actions. – The policy statement shall identify the range of enforcement actions the agency may bring in response to a violation of law, regulation, or other supervisory requirement, and, subject to such limitations as a regulator deems necessary to protect the safety and soundness of a financial services firm and the interests of consumers, the policy statement shall provide that the agency shall impose enforcement actions in a continuum that begins with the least severe sanction or penalty and gradually escalates to the most severe sanction or penalty.

(6) Mitigating Factors. – The policy statement shall identify the factors the agency will consider in determining whether to bring an enforcement action against a financial services firm regulated or supervised by the agency.

(7) Fair Notice. – The policy statement shall ensure that a financial services firm regulated or supervised by the agency has sufficient prior notice of any law, regulation, or other supervisory requirement upon which an enforcement action may be based;

(8) Investigations. – The policy statement shall specify the agency's practices and procedures related to investigations, shall require the agency to notify a financial services firm within 10 days of completing an investigation, and shall require the agency to review the status of all open investigations on a semi-annual basis and determine if such matter should remain open or be closed.

(c) Public Comment. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall seek public comment in developing the policy statement required by this section.

(d) Prudential Supervision Defined. – For purposes of this Act, the term "prudential supervision" means a form of supervision that –

(1) is designed to ensure compliance by a financial services firm with applicable laws, regulations, and other supervisory requirements;

(2) is based upon an open and on-going engagement between a financial regulatory agency and a financial services firm;

(3) encourages a financial services firm to establish and maintain sound internal controls;

(4) promotes and acknowledges self-identification and self-correction of compliance problems by a financial services firm;

(5) recognizes and distinguishes among financial services firms based upon their risk profile; and

(6) includes transparent regulatory incentives designed to promote compliance with laws, regulations, and other supervisory requirements by financial services firms.

SEC. 114. ADMINISTRATIVE MATTERS.

(a) Communications Between Divisions. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall establish practices and procedures that encourage the enforcement and non-enforcement personnel of such agency to communicate and coordinate actions so that financial services firms regulated or supervised by the agency are encouraged to self-report violations of applicable laws, regulations, and other supervisory requirements and to self-correct those violations.

(b) Training and Incentives. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall establish –

(1) a training program for enforcement and non-enforcement personnel that explains and promotes the application of prudential supervision by such personnel; and

(2) incentive programs for all personnel to apply prudential supervision in the exercise of their duties.

(c) Publication of Supervisory Policies and Procedures. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall make its examination manual and other supervisory policies and procedures available to the public, and shall post such materials on its web site.

SEC. 115. OMBUDSMAN FOR PRUDENTIAL SUPERVISION.

(a) Ombudsman. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall appoint an Ombudsman for prudential supervision who shall report directly to the head or board of such agency, as applicable.

(b) Duties of Ombudsman. – The Ombudsman appointed under subsection (a) shall –

(1) ensure that the agency has adopted practices and procedures that encourage financial services firms supervised or regulated by such agency to present compliance questions to the agency and to self-identify and self-correct violations of laws, regulations or other supervisory requirements;

(2) advise and guide financial services firms regulated or supervised by the agency through the process of self-reporting violations of applicable laws, regulations or other supervisory requirements;

(3) act as a liaison between the agency and a financial services firm regulated or supervised by the agency with respect to any problem the firm may have in dealing with the agency;

(4) ensure that a financial services firm that engage in the self-reporting of violations of laws, regulations and other supervisory requirements are given due credit by non-enforcement and enforcement personnel of the agency;

(5) ensure that the agency has adopted practices and procedures to train enforcement and non-enforcement personnel to apply prudential supervision in the exercise of their duties, and to provide incentives for doing so;

(6) ensure that the agency has established practices and procedures that promote communications between the enforcement and non-enforcement personnel of the agency; and

(7) maintain the privilege of confidential communications between a financial services firm and the Ombudsman, unless such privilege is waived by the firm.

(c) Limitation. – In carrying out the duties under subsection (b), the Ombudsman shall utilize personnel of the agency to the extent practicable, and nothing in this section is intended to replace, alter or diminish the activities of any other ombudsman or similar office that otherwise exists within such agency.

(d) Report. – Each year, the Ombudsman for a federal financial regulatory agency shall submit a report for inclusion in the annual report of such agency. Such report shall –

(1) describe the activities of the Ombudsman during the preceding year; and

(2) include solicited comments and evaluations from financial services firms regulated or supervised by the agency with respect to the effectiveness of the Ombudsman's activities."

Attachment C

FFIEC Subcommittee

111th CONGRESS
2nd Session

H.R. XXXX

To provide for the establishment of a Subcommittee on Financial Services Information Technology, Security, and Privacy within the Federal Financial Institutions Examination Council, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

September ___, 2009

_____ introduced the following bill; which was referred to the Committee on Financial Services.

A BILL

To provide for the establishment of a Subcommittee on Financial Services Information Technology, Security, and Privacy within the Federal Financial Institutions Examination Council, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Sec. 1. Short Title.—This Act may be cited as the "Financial Services Information Technology, Security and Privacy Act of 2009".

Sec. 2. Amendments to the Federal Financial Institutions Examination Council Act of 1978 – The Federal Financial Institutions Examination Council Act of 1978 (12 U.S.C. 3301 et seq.) is amended by adding the following new sections at the end thereof:

"Section 3312. Establishment, Purpose, and Operations of the Subcommittee on Financial Services Information Technology, Security, and Privacy. –

"(a) Establishment of the Subcommittee. -- There shall be established, within the Council, a subcommittee to be known as the "Subcommittee on Financial Services Information Technology, Security, and Privacy," which shall consist of the members of the Council, the Chair of the Federal Trade Commission, and the Chair of the Securities and Exchange Commission.

"(b) Purpose-- The purpose of the Subcommittee shall be to ensure –

"(1) that regulations and supervisory guidance related to information technology, security, and privacy are uniform in design and application, and

"(2) that financial institutions have sufficient opportunity to provide input on the development of such regulations and supervisory guidance.

"(c) Chairmanship. -- The Chairmanship of the Subcommittee will rotate among the members of the Subcommittee on an annual basis, with the Chair of the Federal Trade Commission serving as the initial Chair of the Subcommittee.

"(d) Rules of Operation. -- The Subcommittee will establish rules of operation and administration. Such rules shall provide that –

"(1) any proposed and final regulations and any supervisory guidance developed by the Subcommittee may not be issued without the approval of a majority of the members of the Subcommittee, and if so approved, such regulation or guidance shall be issued jointly by all of the agencies represented on the Subcommittee;

"(2) the Chairs of the Federal Trade Commission and the Securities and Exchange Commission shall be full voting members of the subcommittee with rights and authority equal to all other members of the Subcommittee, but will have no authority with respect to any other matter within the scope of the Council's authority, unless such authority derives from other laws of the United States; and

"(3) in developing any regulation, guidance, or manual, the Subcommittee shall seek input from the legal, compliance, examination, and consumer protection divisions of each of the agencies represented on the Subcommittee, and from the Advisory Working Group, described in Section 3314.

"(e) Staff – The Subcommittee shall appoint such staff as may be necessary to carry out the function of this Act, consistent with the appointment and compensation practices of the Council.

"Sec. 3313. Functions of the Subcommittee on Financial Services Information Technology, Security, and Privacy.

"(a) Monitor. – The Subcommittee shall monitor developments related to information technology, security and privacy and the impact of such developments on financial institutions.

"(b) Regulations –

"(1) Advance Notice of Proposed Rulemaking -- The Subcommittee shall be responsible for developing regulations on information technology, security and privacy matters affecting financial institutions. Any proposed regulation shall be issued in the form of an advance notice of proposed rulemaking.

"(2) Final Regulation – Following a review of comments received in response to an advance notice of proposed rulemaking, the Subcommittee may issue a final rule.

"(c) Supervisory Guidance. – The Subcommittee may issue supervisory guidance on information technology, security and privacy matters affecting financial institutions.

"(d) Compliance – Enforcement of the regulations and supervisory guidance approved by the Subcommittee shall remain within the jurisdiction of each of the agencies represented on the Subcommittee, and the Subcommittee shall have no independent enforcement or supervisory authority.

"Sec. 3314. Advisory Working Group.

"(a) Establishment. – The Subcommittee shall establish an Advisory Working Group to advise and consult with the Subcommittee in the exercise of its functions.

"(b) Membership and Term. -- The Advisory Working Group shall consist of no more than 12 members selected by the Subcommittee. In selecting the members of the Advisory Working Group, the Subcommittee shall seek to assemble experts in information technology, security and privacy. Membership shall be equally divided between individuals who represent consumers, financial institutions, and providers of services to financial institutions. Members shall serve for a period of two years.

"(c) Meetings. -- The Advisory Working Group shall meet from time to time at the call of the Subcommittee, but, at a minimum, shall meet at least four times a year.

"(d) Compensation and Travel Expenses. – Members of the Advisory Working Group shall –

"(1) be entitled to receive compensation at a rate fixed by the Subcommittee while attending meetings of the Advisory Working Group, including travel time; and

"(2) be allowed travel expenses, including transportation and subsistence, while away from their homes or regular places of business.

"Sec. 3315. Manuals and Training.

"(a) Training Manual -- Utilizing relevant personnel from the agencies represented on the Subcommittee, the Subcommittee shall prepare a training manual for examiners and other supervisory personnel to ensure that regulations and supervisory guidance on information technology, security and privacy are uniformly enforced by all agencies.

"(b) Compliance Manual -- Utilizing relevant personnel from the agencies represented on the Subcommittee, the Subcommittee shall prepare a compliance manual whenever any regulation or supervisory guidance related to information technology, security and privacy is finalized, and shall ensure that such manual is readily available to financial institutions.

"(c) Examiner Training Programs. -- The Subcommittee shall establish joint training programs for supervisory personnel responsible for enforcing compliance with information technology, security and privacy regulations and supervisory guidance."

Sec. 3. Definitions. – For purposes of this Act, the term –

(1) "financial institution" means –

(A) an institution that is engaged in an activity that is financial in nature, as that term is defined in Section 4(k)(4) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)), or

(B) an institution that provides services to an institution engaged in an activity that is financial in nature; and

(C) such institution is supervised or regulated by one or more of the agencies represented on the Subcommittee on Financial Services Information Technology, Security, and Privacy of the Federal Financial Institutions Examination Council.

(2) "information technology" means the use of computers and software to manage financial information maintained by a financial institution;

(3) "privacy" means the freedom from unauthorized intrusion into financial information maintained by a financial institution; and

(4) "security" means the protection afforded the confidentiality, integrity, and availability of financial information maintained by a financial institution.

Sec. 4. Rule of Construction. – Nothing in this Act shall be construed to exempt any agency represented on the Subcommittee on Financial Services Information Technology, Security, and Privacy of the Federal Financial Institutions Examination Council from complying with the Administrative Procedures Act (5 U.S.C. 1001 et seq.)

Attachment D

Conceptual Framework for a
Market Stability Oversight Authority

Need for a Market Stability Oversight Authority: The U.S. financial markets are interconnected, nationally and internationally. Banks, broker-dealers, insurance companies, finance companies, hedge funds, and other regulated and unregulated financial services firms are continuously and mutually engaged in a variety of lending, investment, trading, and other financial transactions. Yet, under our existing financial regulatory structure, no single agency has the authority to look across all sectors of the financial services industry and all markets to evaluate risks posed by these interconnections.

Our existing financial regulatory system is based upon the model of "functional" regulation, in which separate agencies are responsible for separate parts of the financial services industry. We have separate national regulators for banks, savings associations, credit unions, broker-dealers, and futures firms. We have fifty plus insurance regulators at the state level, but no federal regulator for the insurance industry. We also have some financial services firms, such as state licensed mortgage lenders, that are subject to different regulation.

The on-going crisis in our nation's financial markets has demonstrated the limitations of our functional regulatory system in today's highly interconnected financial system. Critical gaps in regulation and the inconsistent regulation and supervision of firms engaged in comparable actions permitted the development of activities and practices that undermined the stability and integrity of our nation's financial system.

Accordingly, the Financial Services Roundtable supports the creation of a federal market stability oversight authority to oversee our nation's financial services firms and financial markets and identify and address risks that could threaten the stability and integrity of our financial system and the economy. The following is our proposed conceptual framework for a market stability oversight authority.

Part of Comprehensive Reform: A market stability oversight authority should be established as part of the comprehensive restructuring our of nation's financial system. The market stability oversight authority should not be just another layer of regulation added to the existing system; it should not be a "super-regulator". Absent an immediate, systemic threat, the market stability oversight authority should be required to work with and through other financial regulators, including a national insurance regulator. A national insurance regulator is needed to give the federal government a better understanding and role in the supervision of this key part of our nation's financial services sector.

Long-term Stability and Integrity of Financial System: The purpose of a market stability oversight authority should be to promote the long-term stability and integrity of the nation's financial markets and financial services firms by identifying and addressing significant risks to the financial system as a whole.

Oversight of All Financial Markets and Firms: A market stability oversight authority should be authorized to oversee all types of all financial markets and all financial services firms, whether regulated or unregulated. A market stability oversight authority should not focus on financial services firms based upon size. The designation of "systemically significant financial services firms" would have unintended competitive consequences and increase moral hazard as these firms would be deemed too big to fail.

Systemic Risk Defined: Systemic risk should be defined as an activity or practice that crosses financial markets or financial services firms, and, which if left unaddressed, would have a significant, material adverse effect on financial services firms, financial markets, or the U.S. economy.

Balance Risk and Innovation: A market stability oversight authority should balance the identification of activities or practices that pose a systemic risk against the need for continuing market innovation and competitiveness. A market stability oversight authority should not stifle innovation, or preclude isolated failures. Innovation is a key to economic growth and new job creation.

Risk-Based Focus: A market stability oversight authority should focus attention on factors that present the greatest potential for systemic risk, such as excessive concentrations of assets or liabilities, rapid growth in assets or liabilities, high leverage, a mismatch between long-term assets and short-term liabilities, currency mismatch, and regulatory gaps. A market stability oversight authority should not focus attention on products or practices that pose little or no systemic risk.

Designation of the Federal Reserve Board as Market Stability Oversight Authority: The Federal Reserve Board should be designated as the nation's market stability oversight authority. Such a designation is a natural complement to the Board's existing role as the nation's central bank and lender of last resort. To perform this responsibility, the Board should be –

- **Staff.** Authorized to expand its staff to include experts in all types of financial activities, practices, and markets;
- **Governance.** Required to establish a governance structure for this new role to minimize any potential conflicts with its existing responsibilities; and
- **Advisory Board.** Authorized to establish an Advisory Council on Market Stability to review activities and practices that may pose a systemic risk, balanced against the need for continuing market innovation and competitiveness. The Advisory Council should include representatives of domestic and international financial services firms doing business in the United States as well as representatives of consumers of financial services.

Functions of Market Stability Oversight Authority: To identify, prevent, and mitigate systemic risk, the Board should be authorized to –

- **Data collection and analysis.** Collect and analyze data from other financial regulators and individual financial services firms to understand potential or existing systemic risks in the financial system. Data on individual firms should be treated as confidential supervisory information.
- **Market surveillance**. Establish a surveillance system for activities and practices to detect early crisis warning signs and vulnerabilities, conduct scenario planning, and develop contingency planning with other prudential financial regulators across all financial markets.

- **Examinations.** Examine individual financial services firms. If a firm is regulated by another national or state financial regulator, such examinations should be coordinated with such regulator. Examination results should be treated as confidential supervisory information.
- **Reports and notices.** Issue, as necessary, reports and public notices on activities or practices that may pose a systemic risk.
- **Non-emergency actions.** Make recommendations to other regulators and Congress to address activities and practices that could pose a systemic risk, but do not pose an immediate systemic risk.
- **Recommendations to other regulators.** Whenever the Board identifies a practice or activity that could pose a systemic risk and such practice or activity is within the jurisdiction of another national or state financial regulator, the Board should issue a finding and recommend appropriate preventive actions to the other regulator. The Board also should submit any such findings and recommendations to the Congress and the Financial Markets Coordinating Council (FMCC). If the other regulator disagrees with the Board's finding and recommendation, then the regulator can submit its own findings and recommendations to the Congress and the FMCC.
- **Recommendations to Congress.** If the Board identifies an activity or practice that could pose a systemic risk, and such activity or practice is not subject to regulation or supervision by another regulator, the Board should make a recommendation to Congress on how best to regulate and supervise such activity or practice in the future.
- **Emergency actions.** Take unilateral actions to address activities or practices, which the Board determines pose an immediate, systemic risk, and which could not be addressed in a timely fashion if the Board were to recommend actions by any other regulator. Such unilateral actions would include the power to issue orders or regulations affecting actions or practices of individual firms or categories of firms. Such unilateral actions should be approved by a super majority of the Board, and they should be agreed to by the Secretary of the Treasury, who must consult with the President. Such unilateral actions also should be reported immediately to Congress. This authority would be in addition to the Board's existing authority under section 13(3) of the Federal Reserve Act to extend credit to financial or non-financial institutions in "unusual and exigent" circumstances. The Board should retain that authority.
- **Regulatory consultation.** Maintain an on-going dialogue with other domestic and international financial regulators.
- **Reports to Congress.** Issue a report to Congress on a semi-annual basis that describes how it has performed the functions enumerated above.

ATTACHMENT E

HPC GSE PRINCIPLES

Principle 1. In the near-term, the Federal Government should continue to support Fannie Mae and Freddie Mac and the secondary mortgage market.

In order to ensure liquidity for mortgage finance during the financial crisis, Congress, the Treasury Department, and the Federal Reserve have provided an unprecedented level of support for the GSEs and the secondary mortgage market. FHA has provided liquidity for the origination and sale of loans targeted to low- and moderate-income borrowers. The Federal Government's support for the GSEs and the secondary market should continue for the near-term to ensure the strength of the mortgage market and the uninterrupted availability of mortgage finance.

Principle 2. All participants in the secondary mortgage market should take actions to maintain the integrity of the market.

The financial crisis has demonstrated the need for all participants in the secondary mortgage market to take appropriate actions to maintain the integrity of the market. Additionally, the crisis has reinforced the need for each participant in the chain between the borrower and the investor to be responsible for making independent credit risk management decisions.

Principle 3. The secondary mortgage market and a securitization process are vital to mortgage finance, and the GSEs, or some successor entities, are needed to perform this function.

The securitization of mortgage loans created a broad and liquid market for many traditional mortgage products including the 30-year, fixed-rate mortgage. Historically, securitization of these mortgage loans has been conducted by the GSEs, which developed the programs and expertise required to convert individual mortgage loans into mortgage backed securities. While some recent activities of the GSEs related to non-traditional mortgage loans resulted in large losses, their traditional securitization models are successful in providing low-cost mortgage funds in a safe and sound manner. In order to

meet the demand for traditional mortgage products going forward, it is essential that the GSEs, or some successors to the GSEs, continue to facilitate the securitization process for such mortgage loans.

Principle 4. Consideration should be given to separating the functions performed by the GSEs.

Traditionally, the GSEs have performed four functions in the secondary mortgage market: (1) they have facilitated the process of efficiently transforming mortgage loans into standardized and highly liquid mortgage back securities (securitization); (2) they have facilitated an active market in mortgage backed securities by acting as credit risk guarantor of these instruments (credit enhancement); (3) they have invested in whole loans and mortgage backed securities to help maintain liquidity in the mortgage markets (portfolios); and (4) they have supported a secondary market in mortgage loans to borrowers in certain income categories and locations (housing goals). Reform of the structure of the GSEs should consider the potential advantages and disadvantages of separating these functions in different entities. However, because these functions are interconnected, any such separation should be approached carefully. Additionally, separate functions could be subject to different ownership structures.

Principle 5. Separation of the functions of the GSEs should accommodate different ownership structures.

In recent years, the interests of shareholders came into conflict with the mission of the GSEs. Yet, private sector investors can provide a layer of financial protection for the government, promote market discipline, attract management talent, and promote innovative practices. Therefore, it may be appropriate to have different ownership structures for the different functions performed by the GSEs. Depending on the specific function, the ownership structure may be most appropriately addressed through private capital or public ownership. Privately owned entities should be subject to comprehensive, prudential regulation and supervision by an independent federal agency in order to ensure that management balances its duty to shareholders with appropriate risk management.

Principle 6. The core mission of the GSEs, or their successors, should be to provide liquidity for traditional mortgage products.

Multiple and conflicting missions contributed to the current financial problems of the GSEs. Going forward, the core mission of the GSEs, or their successors, should be to provide liquidity, in a safe and sound manner, for prudently underwritten conventional mortgage products. These products include various forms of fixed-rate mortgages (e.g., 15- or 30-year loans), and adjustable rate mortgages underwritten to their fully indexed rate at the time of origination. Support for such traditional products is critical to maintain a flow of mortgage credit to consumers that is understandable to borrowers and investors, and less prone to default. Any additions to this core mission should be authorized by the regulator only after the securitization of traditional products has been running smoothly for some period of time, and only after careful consideration of any possible conflicts with the core mission of the GSEs, or their successors.

Principle 7. The GSEs should not be required to meet specific housing goals.

The statutorily-mandated affordable housing goals had the unintended effect of motivating practices by the GSEs that harmed many borrowers as well as the financial condition of the GSEs. Nonetheless, the GSEs or their successors should be required to support safe and sustainable mortgage products for all categories of borrowers, including low- and moderate-income borrowers, first-time homebuyers with lower cash down payments, and multifamily properties, as long as such loans are subject to prudent underwriting standards. Liquidity support for other categories of borrowers should be provided by FHA and other federal and state programs specifically designed for that purpose.

Principle 8. The Federal Government should provide explicit support for securities issued by the GSEs or their successors.

To ensure that consumers have uninterrupted access to reasonably priced mortgages, the Federal Government should explicitly guarantee the performance of GSE issued mortgage backed securities.

Federal support for these securities should be the minimum amount necessary to provide investors with confidence in these securities without creating perverse incentives. Consequently, any Federal Government guarantee should be placed directly on the mortgage backed securities, and not on the general liabilities of the GSEs or their successors. Careful consideration should be given as to where in the credit capital structure this guarantee should be placed (i.e., in a first-, mezzanine-, or remote-loss position) and the federal guarantee should be triggered only after private capital has been exhausted. To further reduce investor confusion, once an appropriate guarantee is established for any particular security, it should be in the form of a binding contractual agreement and not be subject to unilateral modification or repeal.

Principle 9. The process of securitization does require the maintenance of a limited portfolio of mortgages or mortgage backed securities.

However, it is important that such a portfolio not detract from the core securitization functions of the GSEs, or create any unnecessary financial risks to these entities. Therefore, any portfolios maintained by the GSEs, or their successors, should be limited in size and held only for liquidity purposes or to facilitate the development of new products, and not for profit purposes.

Principle 10. The Federal Government should act as the ultimate liquidity backstop for the mortgage market.

It is important to maintain the liquidity of the mortgage market in periods of economic stress. During the recent financial crisis the ability of the GSEs to perform this function was constrained by their financial condition. Going forward, the Federal Government should acknowledge that it will continue to act as the "ultimate liquidity backstop" for the mortgage markets in periods of severe economic stress by stepping into the market and absorbing the losses.

Principle 11. A single mortgage backed security should be considered.

Differences in some of the key terms of the mortgage backed securities issued by Fannie Mae and Freddie Mac fragmented the market pricing for such securities and may have unnecessarily increased the cost of mortgage loans for some borrowers. Therefore, consideration should be given to the creation of a common form of MBS for loans guaranteed by the GSEs or their successors. Under this construct, securities collateralized by FHA insured loans should remain separate and distinct from the securities issued by the GSEs or their successors.

Principle 12. The securities issued by the GSEs or their successors should be transparent.

Transparency is important to shareholders and investors. Therefore, going forward, the securities issued by the GSEs or their successors should be subject to appropriate public disclosure requirements. However, care must be taken not to disrupt the "to be announced" (TBA) market, which lenders use to control risk. One of the efficiencies of the TBA securities is exemption from SEC registration requirements and we would advocate that this exemption be retained.

For release on delivery
9:30 a.m. EDT
October 29, 2009

Statement of

Daniel K. Tarullo

Member

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

October 29, 2009

Chairman Frank, Ranking Member Bachus, and other members of the Committee, thank you for the invitation to testify this morning on systemic regulation, prudential matters, resolution authority, and securitization. The financial crisis was the product of many factors, including the tight integration of lending activities with the issuance, trading, and financing of securities; gaps in the financial regulatory structure; widespread failures of risk management across a range of financial institutions; and, to be sure, significant shortcomings in financial supervision. More fundamentally, though, it demonstrated that the regulatory framework had not kept pace with far-reaching changes in the financial sector, and the concomitant growth of new sources of risk to both individual institutions and the financial system as a whole.

Because the roots of the crisis reached so deeply into the very nature of the financial system, a broad program of reform is required. Much can be, and needs to be, done by supervisors--under their existing statutory authorities--to contain systemic risk generally and the too-big-to-fail problem in particular. As the discussion draft released by Chairman Frank recognizes, there is also a clear need for the Congress to provide significant additional authority and direction to the regulatory agencies.

Essential elements of this legislative agenda include: ensuring that all financial institutions that may pose significant risk to the financial system are subject to robust consolidated supervision; establishing a systemic risk oversight council to identify, and coordinate responses to, emerging risks to financial stability; directing all financial supervisors to take account of risks to the broader financial system as part of their normal oversight responsibilities; establishing a new special resolution process that allows the government to wind down in an orderly way a failing financial institution that threatens the entire financial system while also creating a credible process for imposing losses on the firm's shareholders and

creditors and assuring that the financial industry, not taxpayers, ultimately bears any additional costs associated with the resolution process; providing for consistent and robust prudential supervision of key payment, clearing, and settlement arrangements; and addressing weaknesses in the securitization process that came to light during the crisis.

Chairman Frank's discussion draft addresses each of these areas and, in the Board's view, provides a strong framework for achieving a safer, more stable financial system. In addition to addressing these areas for legislative change, I will discuss some of the actions the Federal Reserve and our supervisory colleagues are taking under existing authorities to strengthen the supervision and regulation of financial institutions--particularly large, complex institutions--and to prevent regulatory arbitrage.

Consolidated Supervision of Systemically Important Financial Institutions

The current financial crisis has clearly demonstrated that risks to the financial system can arise not only in the banking sector, but also from the activities of other large, interconnected financial firms--such as investment banks and insurance companies--that traditionally have not been subject to the type of mandatory prudential regulation and consolidated supervision applicable to bank holding companies. Chairman Frank's discussion draft would close this important gap in our regulatory structure by providing for all financial institutions that may pose significant risks to the financial system to be subject to the framework for consolidated prudential supervision that currently applies to bank holding companies. As I will discuss shortly, it also provides for these firms to be subject to enhanced standards, reflective of the risk they pose to the financial system. These provisions should prevent financial firms that do not own a bank--but that nonetheless pose risks to the overall financial system because of the size,

risks, or interconnectedness of their financial activities--from avoiding comprehensive supervisory oversight.

In one sense, a requirement that all systemically important firms be subject to prudential supervision would not lead to a major change in our regulatory system. During the financial crisis, a number of very large financial firms became bank holding companies. Thus, the Federal Reserve has already become the consolidated supervisor of most of the nation's large, interconnected financial institutions. Yet a critical part of a reform agenda directed at systemic risk and the too-big-to-fail problem is ensuring that *other* financial firms that may pose a systemic threat also are subject to robust consolidated supervision. Such a measure would allow the regulatory system to adapt if activities migrate from supervised institutions to other firms, leading those firms to become very large and interconnected, or in response to other developments in the financial system. Moreover, such a provision would serve as a kind of insurance policy against the possibility of a firm that opted for the benefits of being a bank holding company during the financial crisis deciding to exit that status during calmer times.

The discussion draft also would require the development of enhanced regulation and supervision, including robust capital, liquidity, and risk-management requirements, to address and mitigate systemic risks. Enhanced requirements, particularly for large, interconnected firms, are needed not only to protect the stability of individual institutions and the financial system as a whole, but also to counteract any incentive for financial firms to become very large in order to be perceived as too big to fail. This perception can materially weaken what should be the normal market incentive of creditors to monitor the firm's risk-taking and appropriately price these risks in their transactions with the firm. When this incentive is weakened, moral hazard increases, allowing the firm to raise funds at a price that may not fully reflect the firm's risk profile. As a

result, the firm is likely to choose a level of risk that is excessive both for itself and, potentially, for society at large. Moreover, this distortion creates a playing field that is tilted against smaller firms not perceived as having the same degree of government support. Development of a mechanism for the orderly resolution of nonbank financial firms that threaten financial stability, which I will discuss later, is an important additional tool for addressing the too-big-to-fail problem.

The discussion draft would reinforce the changes in supervision already under way at the Federal Reserve and the other banking agencies. As already announced, we have strengthened capital requirements for trading activities and securitization exposures. We continue to work with other regulators to strengthen the capital requirements for other types of on- and off-balance-sheet exposures and to improve the quality of capital overall.[1]

Beyond these generally applicable capital requirements, we must develop capital standards and other supervisory tools addressed specifically to the systemic risks of large, interconnected firms. One possible approach is a special charge--possibly a special capital requirement--that would adjust based on the risks posed by the firm to the financial system. Ideally, this requirement would be calibrated to become more stringent as the firm's systemic risks increase, although developing a metric for such a requirement would be highly challenging. Another potentially promising option is to require that selected financial institutions issue specified amounts of contingent capital. Such capital could take the form of debt instruments that convert to common equity during times of macroeconomic stress or when losses erode the institution's capital base. Such instruments would pre-position capital on the balance sheets of each of these institutions, ready to be converted into the form that provides the best loss-

[1] See Bank for International Settlements (2009), Basel II Capital Framework Enhancements Announced by the Basel Committee, press release, July 13; and Basel Committee on Banking Supervision (2009), *Enhancements to the Basel II Framework* (Basel, Switzerland: Basel Committee, July).

absorption capacity precisely when that capacity is most needed. And, if well devised, it would inject an additional element of market discipline into large financial firms, because the price of those instruments would reflect market perceptions of the stability of the firm.

The financial crisis also highlighted weaknesses in liquidity risk management at major financial institutions, including an overreliance on short-term funding. To address these issues, the Federal Reserve helped lead the development of revised international principles for sound liquidity risk management, which have been incorporated into new interagency guidance now out for public comment.[2] Together with our U.S. and international counterparts, we are also considering quantitative standards for liquidity exposures similar to those for capital adequacy, with the goal of ensuring that internationally active firms can fund themselves even during periods of severe market instability. With supervisory encouragement, large banking organizations have, for the most part, already significantly increased their liquidity buffers and are strengthening their management of liquidity risks.

Beyond modifying applicable rules and standards, the Federal Reserve is revamping its approach toward supervising the largest financial institutions. In doing so, we have drawn on our experience earlier this year in conducting the special Supervisory Capital Assessment Program (SCAP), which involved forward-looking, cross-firm, aggregate analyses of 19 of the largest bank holding companies. While the SCAP itself was an extraordinary exercise for an extraordinary time, we are incorporating into our ongoing supervisory process the essential SCAP approach of bringing firm-specific assessments of on-site examiners together with

---

[2] See Basel Committee on Banking Supervision (2008), *Principles for Sound Liquidity Risk Management and Supervision* (Basel: Basel Committee, September). Information about the proposed guidance is available at Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration (2009), Agencies Seek Comment on Proposed Interagency Guidance on Funding and Liquidity Risk Management, joint press release, June 30, www.federalreserve.gov/newsevents/press/bcreg/20090630a.htm.

systematic analyses of industry experience, economic trends, and possible stress scenarios. Thus, we have increased our emphasis on horizontal examinations, which focus on particular risks or activities across a group of banking organizations, and we have broadened the scope of the resources we bring to bear on these reviews.

For example, we currently are conducting a horizontal assessment of internal processes for evaluating capital adequacy at the largest U.S. banking organizations, focusing in particular on how shortcomings in fundamental risk management and governance for these processes could impair firms' abilities to estimate capital needs. This exercise is central to the goal of having each firm maintain adequate capital to provide a buffer against possible losses associated with its particular set of activities and exposures. Using findings from these reviews, we will work with firms over the next year to bring their processes into line with supervisory expectations. Supervisors will use the information provided by firms about their processes as one factor in the assessment of the adequacy of firms' overall capital levels. For instance, if a firm cannot demonstrate a strong ability to estimate capital needs, then supervisors will place less credence on the firm's own internal capital evaluation and may demand higher capital cushions, among other things.

As part of this overall approach to large institution supervision, we are creating an enhanced quantitative surveillance program for large, complex organizations that would use supervisory information, firm-specific data analysis, and market-based indicators in an effort to identify emerging risks to specific firms as well as to the industry as a whole. This work will be performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and other experts within the Federal Reserve System. In addition, periodic scenario analysis will be used to enhance our understanding of the

consequences of changes in the economic environment for both individual firms and for the broader system. Finally, to support and complement these initiatives, we are working with the other federal banking agencies to develop more-comprehensive and more-frequent information-reporting requirements for the largest firms.

The crisis also has highlighted the potential for compensation practices at financial institutions to encourage excessive risk-taking and unsafe and unsound behavior--not just by senior executives, but also by other managers or employees who have the ability, individually or collectively, to materially alter the risk profile of the institution. Bonuses and other compensation arrangements should not provide incentives for employees at any level to behave in ways that imprudently increase risks to the institution, and potentially to the financial system as a whole.

Last week, the Federal Reserve issued proposed guidance on incentive compensation practices to promote the prompt improvement of incentive compensation practices throughout the banking industry.[3] This guidance, which is consistent with the international principles and standards issued by the Financial Stability Board earlier this year, will be supplemented by supervisory initiatives to spur and monitor the industry's progress toward the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.[4] One of these initiatives involves a special horizontal review of incentive compensation practices at 28 large, complex banking organizations under the Federal Reserve's supervision.

---

[3] See Board of Governors of the Federal Reserve System (2009), "Federal Reserve Issues Proposed Guidance on Incentive Compensation," press release, October 22, www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm.

[4] See Financial Stability Forum (2009), *FSF Principles for Sound Compensation Practices*, April, available on the Financial Stability Board's website at www.financialstabilityboard.org/publications/r_0904b.pdf. (The Financial Stability Forum has subsequently been renamed the Financial Stability Board.) Also see Financial Stability Board (2009), *FSB Principles for Sound Compensation Practices: Implementation Standards*, September, www.financialstabilityboard.org/publications/r_090925c.pdf.

To be fully effective, consolidated supervisors must have clear authority to monitor and address safety and soundness concerns and systemic risks in all parts of an organization, working in coordination with other supervisors wherever possible. As the crisis has demonstrated, large firms increasingly operate and manage their businesses on an integrated, firmwide basis, with little regard for the corporate or national boundaries that define the jurisdictions of individual functional supervisors, and stresses at one subsidiary can rapidly spread within the consolidated organization. A consolidated supervisor thus needs the ability to understand and address risks that may affect the risk profile of the organization as a whole, whether those risks arise from one subsidiary or from the linkages between depository institutions and nondepository affiliates. Chairman Frank's proposal would make useful modifications to the provisions added to the law by the Gramm-Leach-Bliley Act in 1999 that limit the ability of a consolidated supervisor to monitor and address risks within an organization and its subsidiaries on a groupwide basis.

Systemic Risk Oversight

For purposes of both effectiveness and accountability, the consolidated supervision of an individual firm, whether or not it is systemically important, is best vested with a single agency. However, the broader task of monitoring and identifying systemic risks that might arise from the interaction of different types of financial institutions and markets--both regulated and unregulated--may exceed the capacity of any individual supervisor. Instead, we should seek to marshal the collective expertise and information of all financial supervisors to identify and respond to developments that threaten the stability of the system as a whole.

The discussion draft released by Chairman Frank would advance this objective in two important ways. First, it would establish an oversight council--composed of representatives of the agencies and departments involved in the oversight of the financial sector--that would be

responsible for monitoring and identifying emerging systemic risks across the full range of financial institutions and markets. In addition, the council would have the ability to coordinate responses by member agencies to mitigate identified threats to financial stability. And, importantly, the oversight council would have the authority to recommend that its member agencies, either individually or collectively, adopt heightened prudential standards for the firms under the agencies' supervision in order to mitigate potential systemic risks. Examples of such risks could include rising and correlated risk exposures across firms and markets; significant increases in leverage that could result in systemic fragility; and gaps in regulatory coverage that arise in the course of financial change and innovation, including the development of new practices, products, and institutions. The council also would identify those financial firms that should be subjected to enhanced prudential standards and supervision on a consolidated basis.[5]

Second, the discussion draft would reinforce the authority of individual financial agencies to take macroprudential considerations into account in exercising their supervisory and regulatory functions. A macroprudential outlook, which considers interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis, provides an important complement to the current microprudential focus of financial supervision and regulation. Each supervisor's participation in the oversight council would greatly strengthen that supervisor's ability to see and understand threats to financial stability and craft appropriate responses for the institutions and markets under their supervision.

The Federal Reserve already has begun to incorporate a systemically focused approach into our supervision of large, interconnected firms. Doing so requires that we go beyond

[5] To fulfill these responsibilities, the discussion draft would provide the council access to a broad range of information from its member agencies regarding the institutions and markets that the agencies supervise and, when the necessary information is not available through that source, the authority to collect such information directly from financial institutions and markets.

considering each institution in isolation and pay careful attention to interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis. For example, the failure of one firm may lead to runs by wholesale funders of other firms that are seen by investors as similarly situated or that have exposures to the failing firm. These efforts are reflected, for example, in the expansion of horizontal reviews and the quantitative surveillance program I discussed earlier.

Improved Resolution Process

Another critical element of an agenda to contain systemic risk is the creation of a new regime that would allow financial firms to fail without posing risks to the broader financial system or the economy. In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after the Lehman Brothers and AIG experiences, there is little doubt that we need an alternative to the existing options of bankruptcy and bailout for such firms.

The discussion draft released by Chairman Frank would provide the government with important new tools to restructure or wind down a failing firm in a way that passes on losses to shareholders and creditors of the firm while mitigating the risks to financial stability and the economy. For example, it would allow the government to sell assets, liabilities, and business units of the firm; transfer the systemically significant operations of the firm to a new bridge entity that can continue these operations with minimal disruptions; and repudiate contracts of the firm, subject to appropriate recompense.

This proposal would not guarantee the survival of any financial firm, nor is it designed to aid shareholders or creditors of a failing firm. To the contrary, the proposal would establish the expectation that shareholders and creditors of the firm will bear losses as a result of the firm's failure. And any assistance provided in the course of the resolution process to prevent severe disruptions to the financial system would be repaid by the firm or the financial services industry. Establishing credible processes for imposing losses on the shareholders and creditors of a failing firm is essential to restoring a meaningful degree of market discipline and addressing the too-big-to-fail problem. Indeed, restoring discipline through changes directed at the behavior of investors and counterparties would be an important complement to the regulatory and supervisory changes that I discussed earlier, which seek to address the too-big-to-fail problem through actions directed at the firms themselves.

Financial firms of any size should be resolved under the bankruptcy code whenever possible. Thus, this new regime should serve only as an alternative to the bankruptcy code, available when needed to address systemic concerns, and its use should be subject to high standards and checks and balances. The discussion draft would allow the new regime to be invoked with respect to a particular firm only with the approval of multiple agencies, and only upon a determination that the firm's failure and resolution under the bankruptcy code or otherwise applicable law would have serious adverse effects on financial stability and the U.S. economy. These standards, which are similar to those governing the use of the systemic risk exception to least-cost resolution in the Federal Deposit Insurance Act, appear appropriate and should help ensure that these new powers are invoked only when circumstances dictate their use.

The discussion draft provides that the ultimate costs of any assistance needed to facilitate the orderly resolution of a large, highly interconnected financial firm be recouped through the

sale or dissolution of the troubled firm, supplemented by assessments on financial firms over an extended period of time if necessary. We believe this approach provides a path to resolution for financial firms in a way that both mitigates risk to the financial system and protects taxpayers. The availability of a workable resolution regime with appropriate funding would eliminate the need for the Federal Reserve to use its emergency lending authority under section 13(3) of the Federal Reserve Act to prevent the disorderly failure of specific failing institutions.

It is important, however, that the Federal Reserve, as the nation's central bank, retain our long-standing authority to address broader liquidity needs within the financial system under section 13(3) when necessary to maintain financial stability. During the recent crisis, our ability to establish broad-based liquidity facilities proved critical in containing the severe pressures that threatened the financial system as a whole and in reopening key financial markets. We used this authority only when the need for action was evident to both the Federal Reserve and the Treasury, a practice that could be formalized by the Congress.

Payment, Clearing, and Settlement Arrangements

As I mentioned at the outset, in revising the financial regulatory system, we must look beyond the causes of the current crisis and seek to address areas of *potential* systemic risk in the future. Such areas include critical payment, clearing, and settlement arrangements, which are the foundation of the nation's financial infrastructure. These arrangements include centralized market utilities for clearing and settling payments, securities, and derivatives transactions, as well as the decentralized activities through which financial institutions clear and settle such transactions bilaterally. While these arrangements can create significant efficiencies and promote transparency in the financial markets, they also may concentrate substantial credit, liquidity, and operational risks. In addition, many of these arrangements have direct and indirect

financial or operational linkages and, absent strong risk controls, can themselves be a source of contagion in times of stress. Thus, it is critical that systemically important payment, clearing, and settlement systems and activities be subject to strong and consistent prudential standards designed to ensure the identification and sound management of credit, liquidity, and operational risks.

Unfortunately, the current regulatory and supervisory framework for systemically important payment, clearing, and settlement arrangements is fragmented, creating the potential for inconsistent standards to be adopted or applied. In light of the increasing integration of global financial markets, it is important that these arrangements be viewed from a systemwide perspective, and that they be subject to strong and consistent prudential standards and supervisory oversight.

The Federal Reserve has direct supervisory responsibility for some of the largest and most critical systems in the United States and has a role in overseeing several other systemically important systems. But a coherent framework for supervision of these systems does not exist, and our current authority depends to a considerable extent on the specific organizational form of these systems. Chairman Frank's discussion draft would provide the Federal Reserve with additional authorities to ensure that appropriate standards and oversight are applied to systemically important payment, clearing, and settlement arrangements.

Improving the Securitization Process

The financial crisis revealed a number of significant shortcomings in the securitization process that contributed importantly to the stresses experienced by the markets as well as to the outsized losses some firms faced once markets began to deteriorate. The ability of brokers and lenders to readily securitize and sell to third parties loans that they were making, regardless of

their risks, contributed to the overall decline in underwriting standards in the years leading up to the crisis. Moreover, capital requirements failed to provide adequate incentives for firms to maintain capital and liquidity buffers sufficient to absorb extreme systemwide shocks without taking actions that could tend to amplify the effects of the shocks. In addition, institutional investors of all sorts--including financial institutions, pension funds, and overseas investors--put excessive reliance on the rating agencies' assessment of the risks associated with a range of structured products. In part, investors' reliance on ratings reflected the lack of transparency of many structured products, which made independent assessments of risk difficult. However, it subsequently became clear that the rating agencies had not themselves understood the extent of the risks associated with complex structured instruments, particularly those related to subprime mortgages. Once those risks were realized, the ratings of many of these securities were downgraded sharply, with investors taking very large and unexpected losses.

Addressing these weaknesses will require action on several fronts. As I noted earlier, the Basel Committee has announced improvements to bank capital standards for securitization-related exposures, thereby better aligning these standards with the risks presented by securitizations. Improved transparency regarding the individual loans backing a securitization, as well as regarding the originators of such loans, also is needed to reduce the opacity that has impeded effective discipline in the market for asset-backed securities (ABS) and encouraged undue reliance on credit rating agencies. Chairman Frank's discussion draft would advance this goal by authorizing the Securities and Exchange Commission (SEC) to develop enhanced disclosure requirements for ABS, including loan-level information and information identifying

the originators or brokers of the underlying loans.[6] Using authority granted by the Congress in 2006, the SEC already has adopted or proposed several rules to improve the transparency, quality, and integrity of the credit rating process for securitizations and other structured finance products.[7]

Requiring that originators or securitizers of loans packaged for securitization retain some exposure to the credit risk associated with the loans also could help restore confidence in the securitization market and encourage the application of sound underwriting criteria to all loans, including those intended for securitization. The details of such a requirement are probably best left to rulemaking by the implementing agencies. Complexities are created by the broad range of assets that are, or may be, securitized, as well as by the different approaches that may be taken to securitization. A credit exposure retention requirement may thus need to be implemented somewhat differently across the full spectrum of securitizations in order to properly align the interests of originators, securitizers, and investors without unduly restricting the availability of credit or threatening the safety and soundness of financial institutions.

Charter Conversions and Regulatory Arbitrage

Finally, I am pleased to note that one potential gap, which I know is of interest to this Committee, already has been addressed by the joint efforts of the banking agencies. The dual banking system and the existence of different federal supervisors create the opportunity for insured depository institutions to change charters or federal supervisors. While institutions may engage in charter conversions for a variety of sound business reasons, conversions that are

---

[6] Encouraged by the Federal Reserve and others, the American Securitization Forum already has taken important steps along these lines, developing model disclosures for residential mortgage-backed securities that would provide investors standardized loan-level information.

[7] Increased transparency regarding the pricing of ABS also can support enhanced market discipline by providing investors important signals regarding other market participants' assessments of the quality of individual issues. Along these lines, the Financial Industry Regulatory Authority recently proposed including ABS in its post-trade reporting system, a step that deserves the support of policymakers.

motivated by hopes of *escaping* current or prospective supervisory actions by the institutions' existing supervisors undermine the efficacy of the prudential supervisory framework.

Accordingly, the Federal Reserve welcomed and immediately supported an initiative led by the Federal Deposit Insurance Corporation to address such regulatory arbitrage. This initiative resulted in a recent statement of the Federal Financial Institutions Examination Council reaffirming that a charter conversion or other action by an insured depository institution that would result in a change in its primary supervisor should occur only for legitimate business and strategic reasons.[8] Importantly, this statement also provides that conversion requests should *not* be entertained by the proposed new chartering authority or supervisor while serious or material enforcement actions are pending with the institution's current chartering authority or primary federal supervisor. In addition, it provides that the examination rating of an institution and any outstanding corrective action programs should remain in place when a valid conversion or supervisory change does occur.

Conclusion

In closing, let me reiterate the importance of moving ahead with the elements of the administrative and legislative reform agenda that I have discussed. These reforms, taken together, will enhance financial stability, increase market discipline in transactions involving large financial firms, and reduce both the probability and severity of future crises. The Federal Reserve looks forward to continuing work with the Congress and the Administration as the legislative process moves forward.

---

[8] See Federal Financial Institutions Examination Council (2009), "FFIEC Issues Statement on Regulatory Conversions," press release, July 1.

Testimony of Richard L. Trumka

President

AFL-CIO

House Financial Services Committee

Hearing on Systemic Regulation, Prudential Matters,

Resolution Authority and Securitization

October 29, 2009

Good morning Chairman Frank and Ranking Member Bachus. My name is Richard Trumka, and I am the President of the AFL-CIO. The AFL-CIO is a federation of 57 unions representing 11.5 million members. Our members were not invited to Wall Street's party but we have paid for it with devastated pension funds, lost jobs, and public bailouts of private sector losses. Our goal is a financial system that is transparent, accountable and stable—that is the servant of the real economy rather than its master.

The AFL-CIO is a member of the Americans for Financial Reform coalition. We share the Coalition's four core goals:

1) Create a consumer financial protection agency

2) Reregulate the shadow financial markets—derivatives, hedge funds and private equity

3) Create a strong fully public systemic risk regulator

4) Address the housing crisis.

We strongly commend the Committee for your work on the Consumer Protection Agency.

However, we are deeply concerned that the Committee's work thus far on the fundamental issues of regulating shadow financial markets and institutions will allow the

very practices that led to the financial crisis to continue. The loopholes in the derivatives bill and the failure to require any public disclosures by hedge funds and private equity funds fundamentally will leave the shadow markets in the shadows. We urge the Committee to work with the leadership to strengthen these bills before they come to the House floor.

With respect to systemic risk regulation, the Americans for Financial Reform and the AFL-CIO strongly support the concepts in the Treasury Department White Paper that a systemic risk regulator must have the power to set capital requirements for all financial institutions that are large enough or connected enough to affect the stability of the financial system. We also strongly support the Treasury's proposal to give the systemic risk regulator the power to place such an institution in a resolution process run by the FDIC.

However, these powers must be given to a fully public body, and one that is able to benefit from the information and perspective of the routine regulators of the financial system. We believe a new agency, with a board made up of a mixture of the heads of the routine regulators and direct Presidential appointees would be the best structure. However, if the Federal Reserve were made a fully public body, it would be an acceptable alternative.

But we cannot support the discussion draft made public earlier this week because it gives dramatic new powers to the Federal Reserve without reforming its governance so that the banks themselves are removed from the governance of the Federal Reserve System. Even more alarmingly, the discussion draft would appear to give power to the Federal Reserve to preempt a wide range of rules regulating the capital markets—power which could be used to gut investor and consumer protections. If this Committee wishes to give more power to the Federal Reserve, it must make clear this power is only to strengthen safety and soundness regulation and it must simultaneously reform the Federal Reserve's governance. Reform cannot be put off until another day.

The Federal Reserve currently is the regulator for bank holding companies. In that capacity, it was responsible throughout the period of the bubble for regulating the parent companies of the nation's largest banks. While regulatory authority rests in the Board of Governors of the Federal Reserve in Washington, routine responsibility for regulatory oversight has been delegated by the Board of Governors to the regional Federal Reserve Banks. The Federal Reserve System's regulatory expertise resides in these regional banks.

The problem is that these regional Federal Reserve Banks are actually controlled by their member banks—the very banks whose holding companies the Fed regulates. The member banks control the selection of the majority of the regional bank boards, and the boards pick the regional bank presidents, who are effectively the CEO's of the regulatory staff.

These arrangements may explain why the Federal Reserve has never given any account of how it allowed bank holding companies like Citigroup and Bank of America to arrive at a point where they required tens of billions of dollars of direct equity infusions from the public purse to avoid bankruptcy.

Giving the Federal Reserve with its current governance control over which financial institutions are bailed out in a crisis is effectively giving the banks the ability to raid the Treasury for their own benefit.

We are also deeply troubled by provisions in the discussion draft that would allow the Federal Reserve to use taxpayer funds to rescue failing banks, and then bill other non-failing banks for the costs. The incentive structure created by this system seems likely to increase systemic risk.

We believe it would be more appropriate to require financial institutions to pay into an insurance fund on an ongoing basis. Financial institutions should be subject to

progressively higher fee assessments, and stricter capital requirements, as they get larger. This would be a way of actually discouraging "too big to fail."

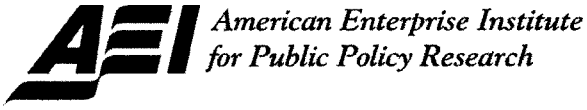
In addition, language in the draft that appears to limit taxpayer bailouts of bank stockholders actually does no such thing, rather it simply ensures that when stockholders are rescued with public funds, bondholders and other creditors are rescued with them.

With regard to the provisions related to asset-backed securities, we are pleased that the legislation would require loan originators and securitizers to retain a portion of the risk in the securitizations they originate and pool. We are concerned, however, that the draft continues to allow the SEC to suspend or terminate disclosure requirements. The authority given to the SEC to require disclosures does not appear to be substantially different from those that exist under current law.

Finally, and not least, the discussion draft appears to envision a process for identifying and regulating systemically significant institutions, and for resolving failing institutions, that is secretive and optional—in other words, the Federal Reserve could choose to take no steps to strengthen the safety and soundness regulation of systemically significant institutions. In these respects, the discussion draft appears to take the most problematic and unpopular aspects of the TARP and makes them the model for permanent legislation.

Instead of repeating and deepening the mistakes associated with the bank bailout, Congress should be looking to create transparent, fully publicly accountable mechanisms for regulating systemic risk and for acting to protect our economy in any future financial crises.

On behalf of the AFL-CIO, I thank you for the opportunity to testify today, and look forward to your questions.



Statement before the House Financial Services Committee

On Systemic Regulation, Prudential Matters, Resolution Authority, and Securitization

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies

American Enterprise Institute

Thursday, October 29, 2009

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Summary

The Discussion Draft of October 27 contains an extremely troubling set of proposals which, if adopted, will bring economic growth in this country to a standstill, essentially turn over the control of the financial system to the government, and seriously impair competition in all areas of finance.

Rather than ending too big to fail, the Draft makes it national policy. By designating certain companies for special prudential regulation, the Draft would signal to the markets that these companies are too big to fail, creating Fannies and Freddies in every sector of the economy where they are designated. This will impair competition by giving large companies funding and other advantages over small ones.

The idea that the designation of these companies will be kept secret is, with all due respect, absurd; securities laws alone will require them to disclose their special status; simple truthfulness will do the rest.

The government will also have extraordinary power to control the operations of those companies that are designated for special regulation. New activities, innovations, and competitive initiatives will all be subject to government approval. Companies already in a business can be told to divest it. These authorities go well beyond the powers that the Fed now has over bank holding companies. The financial system would, in effect, be managed and directed from Washington.

The Draft would separate operating or commercial companies from financial activities, even though these activities are never separated in the real world. All companies—retailers, manufacturers, and suppliers—finance their sales. In the Draft, operating companies would have to separate their financial activities into separate affiliates, and their financial affiliates will not even be able to finance the parent company or its sales without restriction. Has anyone thought how U.S. companies will compete with foreign companies when they can't finance their own sales?

No one can draw a line between finance and commerce. Yet, to protect the Realtors against competition from banks, Congress has stopped the Fed from declaring that real estate brokerage is a financial activity. If this legislation is passed, every industry will be in Washington, asking for special treatment or exemption. Competition in the market will become competition before this committee or in the halls of the Fed, lobbyist-to-lobbyist and lawyer-to-lawyer.

The government resolution authority in the Draft is based on the faulty assumption that anyone can know, in advance, whether a particular company will—if it fails—cause a systemic breakdown. In reality, this is unknowable, but the Draft authorizes government officials to make this determination—this guess—without any standards for doing so. In other words, the Draft gives government officials unfettered discretion to take over companies they believe will cause a systemic breakdown.

Officials who have this authority will almost certainly follow a "better safe than sorry" policy—taking over companies that would only create economic disruptions of some kind, rather than a full-scale systemic breakdown. General Motors and Chrysler are examples of this. They were not systemically important, but they were politically important. Their failure would not have caused a systemic breakdown, but would have caused a loss of jobs and other economic disruption. Politically powerful companies like these will be rescued while those that are not will be sent to bankruptcy. The markets will have to guess which will be saved and which will not.

Worse than giving government officials this enormous discretionary authority is what the Draft authorizes them to do with it.

They can rescue some companies and liquidate others; they can pay off some creditors and not others; and using government funds, they can keep failing companies operating for years—and competing with healthy companies. This will not only create uncertainty and moral hazard, but it will give the large and powerful companies special advantages over small ones. Those that seem likely to be taken over by the government will have easier access to credit, at lower rates, than those likely to be sent to bankruptcy.

In other words, the Draft proposes nothing more or less than a permanent TARP, using government money to bail out the large or politically favored companies, and then taxes the remaining healthy companies to reimburse the government for its costs of competing with them.

Full Statement

The October 27 Discussion Draft is a very troubling proposal. In the name of preventing another financial crisis and "protecting" the taxpayers against more unnecessary government spending, it would take control of the financial industry in the United States, stifle risk-taking and initiative, and change competitive conditions in every sector of the economy so that they favor large, government-backed, too big to fail enterprises.

In this written statement, I will discuss only the sections of the Draft that deal with systemic risk, prudential regulation, and a resolution authority.

The Draft would create a Financial Services Oversight Council. It would have limited authority to monitor developments in the market that might threaten the stability of the financial system, and the power to designate financial companies and activities that should be subject to heightened prudential standards.

The heightened prudential standards would be applied principally by the Federal Reserve Board. The Board gets this authority in the Draft through a revision of the Bank Holding Company Act. Under that act, the Fed has regulatory power over all companies that control banks. The purpose of this authority was to assure the separation of banking and commerce. In the Gramm-Leach-Bliley Act of 1999 bank holding companies were permitted to control financial activities such as securities dealers and insurance underwriters. In order to permit this, the act was modified so that in effect it separated finance and commerce, not just banking and commerce. Companies that

controlled nonbank financial institutions such as securities forms were then called financial holding companies. The purpose and policy behind of the act, however, was still to assure that the risks taken by the holding company and its subsidiaries did not jeopardize the financial condition of the bank and that the nonbank affiliates of the bank did not gain any access to the bank safety net—insured deposits and the discount window.

The Draft moves completely away from this purpose, and would now give the Fed authority to regulate any financial company that the Council determines should be subject to "heightened prudential standards," even if there is no insured bank in the group. This designation would be based on the Council's belief that the failure of such a company would cause instability in the U.S. financial system—in other words, a systemic breakdown of some kind.

Separating finance and commerce

Any company subjected to heightened prudential regulation (which I will call a Designated Company) that is *solely* engaged in financial activities will be regulated by the Fed as though it is a financial holding company under the Bank Holding Company Act. Designated Companies that are engaged in non-financial activities are required by the Draft to split off their financial activities into a separate holding company, which will then be regulated by the Fed.

One of the most serious problems with this approach is that there is no way to define a difference between a financial and a nonfinancial activity. The result is that the question becomes one of political clout, with industries fighting in Congress for the competitive result they want. Some industries want to invade others' turf; the invaded industry uses the law to fend off the competition; consumers are the losers. Congress becomes the battleground. It's not just unseemly; it's a frightening example of what happens when the government starts picking winners. There is already a clear example of this. Shortly after the GLBA was passed, the banking industry asked the Fed to declare real estate brokerage to be an activity that is "financial in nature." This would have enabled financial holding companies to compete with real estate brokers. The brokers of course went to Congress and got a warning to the Fed not to declare real estate brokerage a financial activity. The Realtors had won.

This bizarre event makes two points about the Draft. First, and most important, it shows that there is no principled way to decide what is a financial activity and what is not. How can securities brokerage be a financial activity, but real estate brokerage is not? The second is that Congress will be injecting itself into competitive fights between firms and industries, further politicizing what should be economic or financial decisions. Questions like the real estate brokerage issue will come up endlessly if the Draft is ever enacted into law, with industries fighting one another in Congress and at the Fed about whether a particular activity is financial or not. Some will try to use it as a shield to protect themselves against competition; others will try to use it as a sword to damage competitors.

In addition, the idea that a company will have to separate its financial activities—whatever they turn out to be—from its normal operations is bizarre, and reflects the triumph of government convenience (and perhaps a complete ignorance of the nature of commercial activity) over

common sense. Companies of all kinds, from manufacturers to retailers, finance their sales. The Draft suggests that Designated Companies must now separate their financing activities and place them in a separate company. The costs of this will be substantial.

Then, incredibly, the separate holding companies that the Draft requires will not be able to finance their own affiliates without complying with the restrictions in Sections 23A and 23B of the Federal Reserve Act, which requires that such financing be limited in size and subject to collateralization. Under 23A and 23B, a loan to a third party that assists an affiliate's business is considered a loan to the affiliate, so that the financing arms of Designated Companies will not be able to finance their affiliates' sales. So, for example, GE Capital would not be able to finance GE's sales of aircraft engines. Did anyone who drafted this legislation consider how U.S. companies are supposed to compete with foreign companies?

Prudential regulation, too big to fail, and the Fannie/Freddie problem

Apart from its bizarre effort to separate finance and commerce—so financial companies can be more easily regulated and controlled—the Draft imposes costly and intrusive new regulations on Designated Companies that have never been required of bank holding companies in the past. Thus, in the Draft the Fed's prudential regulatory authority includes the usual items—such as risk-based capital requirements, leverage limits, and liquidity requirements—but would also include overall risk management requirements and "any other prudential standards that the Board deems advisable." These could include requiring a company subject to the requirements to "sell or otherwise transfer assets of off-balance sheet items to unaffiliated firms, to terminate one or more activities, or to impose conditions on the manner in which the identified financial holding company conducts one or more activities."

In other words, the Designated Companies are under the complete control of the Fed. They will not be able to initiate new activities without the Fed's approval, or enter new competitive fields, or perhaps even open new offices in new places. This is a degree of political control of business that has never been attempted before. Not only will it place the dead hand of government on the activities of financial companies, but it will almost certainly drive many financial companies out of the United States before they submit to these restrictions.

The effect of these restrictions for the U.S. economy will be dire. First, Designated Companies will clearly have been labeled as too big to fail. In effect, the government has notified the capital markets that these firms will not be allowed to go into bankruptcy—they will be rescued in the ways I will describe below. This means they will be less risky borrowers than smaller companies that are not going to be controlled in the same way. As less risky borrowers, the Designated Companies will have lower costs of funding and will be able to drive smaller competitors from the markets they enter. Sound familiar? Yes, it's Fannie Mae and Freddie Mac all over again. The existence of these Designated Companies will impair competition in every market they are allowed to enter, and will force the consolidation of competitors so that markets become dominated by government-backed giants like themselves.

In addition, while driving out smaller competitors, these large companies will not be permitted to innovate because this would create unacceptable risks for the Fed or any other regulator that has control of their activities. The U.S. financial markets will stagnate, consumers and businesses will have to pay more for their credit, and competition—except among those lumbering and government-backed giants—will be stifled.

The rationale for the foregoing restrictions is that they are designed to prevent a systemic breakdown—or, as the Draft describes it, "instability in the U.S. financial system." But one must ask whether it is possible to determine, in advance, whether a particular company will cause a systemic breakdown. It's important to understand what is going on here. Government officials, who would have no idea whether a company on the brink of failure would in fact cause a systemic breakdown if it failed, are going to have the power to declare that certain companies—because of attributes these government officials believe are significant —could, at some time in the future, under circumstances no one can know, cause instability in the financial system if they fail. And this possibility is so likely to occur that our entire financial system must be subjected, today, to far-reaching control by the Federal Reserve Board. With all due respect, this is absurd, and certainly disastrous for economic growth in the future.

The Draft also contains language that suggest some of the problems of identifying Designated Companies in advance—and thus creating the Fannie/Freddie too big to fail problem—can be avoided if the designation of these companies is not disclosed to the public. This, too, with all due respect, is absurd. Securities disclosure alone will require these companies to reveal their special status, and it will be in their interests to do so because of the advantages it will give them.

Finally, it is necessary to question the whole notion that any regulatory agency can regulate banks, bank holding companies, insurance companies, hedge funds, finance companies and any other kind of company that might be selected as a Designated Company. Not only would this require an extraordinary range of expertise in the staff of the Fed—detailed knowledge of how companies in each of these industries operate—but also a knowledge of how decisions with respect to one kind of company will affect the others. The Draft seems blissfully unaware that all these companies and industries compete with one another. A change in the capital requirements of, say, hedge funds, will affect how they compete with bank holding companies or securities firms, or finance companies. In other words, the Fed would have to take into account in deciding such thing as capital requirements what adjustments it would be required to make for all the companies in all the industries involved, so that it is not giving any one industry an advantage. Once again, if the Draft proposals are ultimately adopted, all these issues will be fought out in Washington—lobbyist-to-lobbyist and lawyer-to-lawyer—as the industries fight to get the political organs of government to help them and hurt their competitors.

Resolution authority

The question whether it is possible to know whether a particular company's failure will cause a systemic breakdown or instability also becomes relevant when reviewing the Draft's provisions for a resolution authority. Those who developed the Draft should be asked how anyone can possibly know whether a particular company—when on the brink of failure—will cause a

systemic breakdown if it fails. As in the case of firms selected as Designated Companies, The honest answer, if it ever comes, is that there is no way to know this, and the fact has great significance for what the resolution authority outlined in the Draft authorizes a government agency to do.

That authority would go mostly to the FDIC, but the decision to take over a particular company is a corporate one under the Draft, involving the company's regulator as well as the Secretary of the Treasury (who must consult with the President). Is it reasonable to believe that the decision will ever be no? This is highly unlikely. Since no one knows what will happen if a large financial company fails—clearly Hank Paulson and Ben Bernanke did not anticipate what would happen after Lehman failed—the tendency of all regulators and other officials will be to rescue any Designated Company. That is true because, by hypothesis, Designated Companies are so designated because their failure is likely to cause instability or a systemic breakdown. If such a company's failure doesn't have that result, it calls into question the necessity for the entire regulatory structure outlined in the Draft. On the other hand, if the failure of a Designated Company results in some serious disruption, the regulators and the administration will be blamed. After all, why were they given the power to take over failing companies if they were not going to use it when necessary? So if there is actually a debate about the subject, all of the weightiest arguments will favor rescuing one of these Designated Companies if it looks likely to fail.

In addition, there is very little incentive for the government *not* to rescue failing Designated Companies, because the Draft provides that the surviving members of the financial industry larger than $10 billion in assets—whether Designated Companies or not—will be taxed to reimburse the government for its costs in the bailout.

What would such a rescue look like? The Draft is quite specific that the FDIC of any other agency handling a resolution will have tremendous discretion. Companies that are rescued can be saved from failure and resuscitated as going concerns, or they can be liquidated or broken up. Although the Draft says that management will be replaced and the shareholders wiped out, the significant question is whether the creditors will take losses. Here the Draft becomes highly unspecific. Yes, the unsecured creditors will take losses, but which creditors and when is not specified. Unlike a bankruptcy—where the losses of creditors are determined by the orderly way in which a bankruptcy court works through creditors' priorities—in the resolutions contemplated by the Draft politics will play a large part. As in the GM and Chrysler bailouts, preferences are going to go to favored groups, and disfavored groups will suffer disproportionate losses. It will be a political free for all, with important legislators pressing the FDIC to treat their constituents better than someone else's constituents.

What we know is that no losses will be taken immediately by creditors. This is because the objective of the resolution authority is to prevent a "disorderly" failure, which actually means a failure in which creditors suffer immediate losses. That's what happens in bankruptcy, and if immediate losses to creditors are what is contemplated in the Draft, there would be no point having a resolution authority. The Draft provides that the company taken over will be operated for as long as two years, with possible extensions for up to three years, while the "orderly"

liquidation or the return to financial solvency is gradually worked out. It's important to recognize what is really happening here. A company that—despite (or perhaps because of) heavy regulation—has failed is then to be supported by government infusions of cash so it can continue operating and competing with the healthy companies that did not fail. Then, after this competition weakens the companies that have not failed, the failed company is either returned to the market in healthy condition or liquidated. In either case the healthy companies that survived will then have to pay for the government's costs in keeping their competitor in operation. It's hard to see the logic of this, let alone the equity.

There are several other issues associated with the resolution authority, all of them important. The first is the creation of competitive inequity, especially for smaller companies. As noted above, designating certain companies as too big to fail creates the Fannie/Freddie problem. But even if the Draft did not create competitive inequity in this way, it would surely be created through the operation of the resolution authority. By rescuing failing companies and returning them to health, or by taking them over and liquidating them over time—both of which are contemplated in the Draft—creditors have in effect been told that if they lend to one of the companies likely to be taken over they will have less risk of loss than if they lend to the smaller companies that are not eligible for takeover (the Draft actually does not limit the potential takeover targets to Designated Companies). Indeed, if there were no Designated Companies, the market would be left to guess which companies will be likely to be taken over and which will not, and smaller companies would not be in the running.

It also introduces again the specter of politicization. Lobbyists and experts will be well paid to get the outcome from the government that their clients desire. Given the fact that they will eventually have to pay for the takeover, the financial industry will probably try to get the failing company sent to bankruptcy, but the company itself, its creditors, employees, suppliers and patrons in the political process will be fighting on the other side. Again, this is the spectacle that the legislation in the Draft will provoke, another confirmation that Washington and the political system—rather than competition and effective financial performance—will have become central to what happens in the financial industry.

As takeovers of companies continue, the Lehman problem will develop. That is the belief in the market that failing companies will be taken over because others before them have been taken over. The Lehman problem arose from the Bear Stearns rescue; after Bear Stearns, market participants believed that all larger companies would be rescued. When that didn't happen with Lehman, there was a market breakdown as all major participants realized that they had to look at the financial condition of counterparties that they had assumed, before Lehman, would be rescued by governments. The pernicious element of the Lehman problem is that it feed on itself. Once the market comes to expect that takeovers will occur, they will have to occur, or nasty surprises will cause severe market disruptions.

There are also questions about the competence of the FDIC. No one questions the ability of the FDIC to resolve small banks. They do it steadily and without apparent incident (although, despite prompt corrective action, they have been losing about 25 percent on average in the assets of the banks they close). But does the FDIC know anything at all about how to resolve a hedge fund, or

an insurance company, or finance company—especially a large and complex one that is the archetype of the Designated Company? The answer to this question is no. They have no more knowledge about how to close down a large nonbank financial institution than the any other agency of government. The expertise exists nowhere in the government, yet the Draft blithely hands this important authority to the FDIC as though its work with small banks is a qualification.

In general, in the two areas covered in this statement, the proposals in the Draft reflect very bad policy—far more likely to be destructive of the financial system and damaging to the economy than an improvement on what exists today.

October 29, 2009

Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Financial Services

United States House of Representatives

Testimony of Edward L. Yingling

On Behalf of the American Bankers Association
Before the
Committee on Financial Services
United States House of Representatives
October 29, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Edward L. Yingling. I am President and CEO of the American Bankers Association (ABA). ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

Thank you for the opportunity to present the views of ABA on the Financial Services Committee's and Treasury Department's draft legislation to address the issue of systemic risk and "too big to fail" financial institutions. We believe that deficiencies in our current system must be corrected. The ABA supports reforming the regulations that govern our financial system. Almost exactly one year ago today, ABA first testified before this committee on changes that are needed. We advocated that reform legislation create a systemic oversight body, provide a strong mechanism for resolving troubled systemically important firms, and fill the gaps in the largely unregulated shadow banking industry. Since that first hearing, a consensus has been building in support of reform in these areas. We believe, as many others do, that such significant legislation will address the principal causes of the financial crisis and constitute major reform. Though differences still exist regarding how some goals are best accomplished, we believe that there is a broad consensus to address the primary issues.

While there are many elements in the draft legislation, in the rest of my statement today, I would like to focus on the key recommendations that we believe are critical to reforming our financial system and avoiding future financial crises. ABA has not had sufficient opportunity to fully analyze the new draft at the time of the submission of this testimony. Where possible, we have included some preliminary comments in this statement, and we will provide further views to the Committee as quickly as possible.

In generally, we believe any reform legislation should:

- ***Establish a Council to oversee and address systemic risk.*** This council should search for and identify potential systemic problems and put forth solutions. It should not be involved in day-to-day regulation, nor regulate individual institutions, but should have carefully calibrated backup authority when issues are not being addressed by the primary regulator. While we have some specific concerns with the authorities of the council in this draft legislation, in general ABA supports the approach in the draft. *However, ABA strongly recommends that this Council should also have oversight authority over accounting rulemaking.*

- ***Establish an agency to handle the failure of non-bank financial institutions that threaten systemic risk.*** Too-big-to-fail should not be allowed to continue, as it has profound moral hazard implications and competitive effects that must be addressed. In this testimony, we provide a more detailed approach for resolving systemically important institutions and addressing too-big-to-fail. The draft legislation appears to create a strong approach to resolution and to address too-big-to-fail. *However, ABA strongly opposes using the FDIC directly as the resolution authority.*

- ***Preserve all FDIC-insured charters and protect the dual banking system.*** In particular, *ABA has strongly advocated that the federal thrift charter be preserved and that mutual institutions not be negatively impacted by any changes made regarding regulatory agencies.* We appreciate greatly that the draft legislation does preserve the thrift charter and provides support for the mutual charter. We do have some specific concerns, however, particularly with respect to the treatment of holding companies.

- ***Close the gaps in regulation.*** Gaps between highly regulated banks and less regulated non-banking firms should be eliminated. These gaps have proven to be major factors in the crisis, particularly the role of largely unregulated mortgage lenders. Credit default swaps, credit rating agencies, and hedge funds also should be addressed in legislation to close gaps.

I would like to touch briefly on each of these themes to highlight the issues that underlie them. In addition, I suggest some additional recommendations in the areas of accounting oversight and regulation of bank holding companies that are not a part of the draft legislation and that should be considered.

I. There Should Be a Council to Oversee and Address Systemic Risk

As I have stated in other hearings before this committee going back for a year, ABA supports the formation of a council to oversee systemic risk. Under the current system, each agency was looking within its piece of the puzzle, but no one was explicitly charged with looking at the overall picture. This needs to be changed.

There are many aspects to consider related to the authority of this council. The council's role should be one of searching for and identifying potential systemic problems and then putting forth solutions. This process is not about regulating specific institutions, which should be left primarily to the prudential regulators. It is about looking at information and trends on the economy, sectors within the economy, and different types of institutions within each sector. Such problematic trends from the recent past would include: the rapid appreciation of home prices far in excess of income growth; proliferation of "affordability" mortgages that ignored long-term ability to repay; excess leverage in some Wall Street firms; the rapid growth and complexity of mortgage-backed securities and how they were being rated; and the rapid growth of the credit default swap market.

The council should generally not regulate individual institutions and should primarily use information gathered from institutions through their primary regulators, together with broader economic information. In fact, involving it in day-to-day regulation could be a distraction. However, the systemic council should have some carefully calibrated and limited backup authority when systemic issues are not being addressed by the primary regulator. This council should be focused and nimble, with a small dedicated staff.

In general, the draft appears to be similar to ABA's recommendations. However, we will have further comments on the role of the council and, in particular, its role in relationship to the primary regulator.

The Systemic Risk Oversight Council Should Oversee Accounting Policy

A Systemic Risk Oversight Council could not possibly do its job if does not have oversight authority over accounting rulemaking. ***This is a major deficiency in the draft legislation.*** Accounting policies are increasingly and profoundly influencing financial policy and the basic structure of our financial system. Thus, accounting standards must now be part of any systemic risk calculation. To do anything less creates the potential to undermine any action taken to address a systemic risk. The Financial Accounting Standards Board (FASB) should continue to function as it does today, but it should no longer report only to the Securities and Exchange Commission (SEC). The SEC's view is simply too narrow. Accounting policies contributed to the crisis, as has now been well documented, and yet the SEC is not charged with considering systemic and structural effects. Moving oversight to the systemic risk council, which includes the SEC, will address this problem.

We have testified to this point on several occasions before this committee over the last year. Many others are now calling for change. Even FASB acknowledged that "the financial crisis has revealed a number of significant deficiencies and points of stress in current accounting standards."[1] ABA strongly advocates that the

[1] Financial Accounting Foundation 2008 *Annual Report.*

Congress follow the general recommendations of the Group of 30 report, chaired by Paul Volcker, the G-20 report, and the Administration's financial regulatory reform proposal relating to accounting policy.[2]

ABA has strongly supported H.R. 1349, introduced by Representatives Perlmutter and Lucas, as an approach to accomplish the goals of better oversight of accounting practices. While H.R. 1349 predates specific proposals for creating a systemic oversight council, the approach it embodies is consistent with having FASB report to the systemic risk oversight council. We thank Representatives Perlmutter and Lucas for their foresight and leadership on this critical issue.

In light of FASB's current plans to expand mark-to-market accounting, let me make one final comment on accounting policy: For the last year, ABA has continued to make this fundamental point: the broad use of mark-to-market accounting is simply incompatible with a banking system that provides long-term credit to businesses, consumers, and others. This is a point that has been made by many others in recent months, and in particular, by the Group of 30 study chaired by Paul Volker. It is critical that banks remain committed to the long-term. For banks to provide long-term loans to, and investment in, businesses, communities, and consumers' futures, banks must not have their loans and investments marked to prices set in markets that are panicked or are over-exuberant. These are long-term investments, not day-to-day trades. Simply put, if FASB continues its effort regarding mark-to-market, the lesson learned from this financial disaster will be that long-term loans and investments will have their valuations destroyed, and therefore the bank will be destroyed, by mark-to-market accounting during financial panics.

Despite this, FASB currently is proposing to expand mark-to-market accounting so that individual loans will be reflected on the balance sheet at their so-called market value. Loans currently make up over 60 percent of bank assets and are, by their nature, illiquid. Given the problems faced this past year with illiquid securities, such changes would wreak havoc in the markets due to the enormous volatility being introduced to bank capital. This volatility will increase the cost of funding and, as a result, banks simply will not be able to make loans and investments with the idea that they will work through hard times with customers and communities.

Accounting policy is arcane and difficult, but it was a critical factor in turning a bubble and a recession into a full-fledged panic. If Congress does not address this issue as part of reform, it will not have addressed one of the significant causes of the problems.

---

[2] The Group of 30, for example, suggests that accounting standards be reviewed: (1) to develop "more realistic guidelines for dealing with less-liquid instruments and distressed markets"; (2) by "prudential regulators to ensure application in a fashion consistent with safe and sound operation of [financial] institutions"; and (3) to be more flexible "in regard to the prudential need for regulated institutions to maintain adequate credit-loss reserves." See in particular the U.S. Treasury Department's *Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation*, June 2009; the G30's *Financial Reform – A Framework for Financial Stability*, January 15, 2009, the G20's *Declaration on Strengthening the Financial System*, London, April 2, 2009, and the Financial Stability Forum's *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System*, April 2, 2009.

II. Establish an Agency to Handle the Failure of Non-bank Institutions That Threaten Systemic Risk

ABA also strongly supports creating a mechanism for the orderly resolution of systemically important non-bank firms. Our regulatory authorities should never again be in the position of making up a solution on the fly to a Bear Stearns or an AIG, or of not being able to resolve a Lehman Brothers. The inability to deal with those situations in a predetermined way greatly exacerbated the crisis. The system for resolving bank failures is well-developed and continues to work during these difficult times. Thus, what is needed is a system to resolve the failures of non-bank financial firms.

A critical issue in this regard is too-big-to-fail. Whatever is done on the systemic oversight agency and on a resolution system will set the parameters of too-big-to-fail. No institution should be too-big-to-fail, and that is ABA's goal; but we all know how difficult that is to accomplish, particularly with the events over the last year. This too-big-to-fail concept has profound moral hazard implications and competitive effects that are very important to address. We note Chairman Bernanke's statement: "Improved resolution procedures…would help reduce the too-big-to-fail problem by narrowing the range of circumstances that might be expected to prompt government action…."[3]

The structure and protocols for systemic risk resolutions enacted for the future will determine in many respects the structure and fairness of the financial system. Thus, a systemic risk resolution process should:

1. create a workable resolution regime that will stand up through a full scale financial crisis;
2. protect the taxpayer;
3. end too-big-to-fail;
4. be fair to financial firms that would never be considered too-big-to-fail – in terms of both competitiveness and cost; and
5. not impair the ability of financial markets to function effectively.

Building upon ABA's previous, long-held position that no institution should be too-big-to-fail, and also building upon the Administration's proposal, recent testimony by Federal Reserve Chairman Bernanke, and statements by key members of Congress, ABA recently proposed the following approach to systemic risk resolution:

[3] Federal Reserve Chairman Ben Bernanke, speech to the Council on Foreign Relations, Washington, D.C. , March 10, 2009.

- The regulations implementing the new law on resolution would be written by the newly-created Systemic Risk Oversight Council ("SROC"). These would include specific criteria for when systemic resolution would be invoked.

- Those institutions subject to potential systemic resolution would not be named in advance. Regulators would impose more rigorous supervisory requirements on some institutions based on their specific characteristics (e.g., size, interconnectivity, etc.); but such institutions, or others, would be subject to systemic risk resolution only under the terms of the resolution rules. Only financial companies should be eligible for systemic resolution. Failed banks and insurance companies that are subsidiaries of holding companies would be resolved through the current FDIC and state insurance rules, respectively.

- The primary regulator of an institution, the Federal Reserve, or the Treasury could make a confidential recommendation to trigger resolution. That recommendation would be considered by a subgroup of the SROC, which would consist of the primary regulator for this specific case, the Federal Reserve, and the Treasury. This subgroup would forward its recommendation to the President (or the Secretary of the Treasury) for final determination as to whether the systemic resolution process would be invoked.

- A systemic resolution agency ("SRA") would be created. It would not have a permanent staff, but rather consist, in normal times, of a stand-by staff from the FDIC. The FDIC would be given the role of running the SRA, but it would be kept separate from the FDIC to avoid public confusion with FDIC insurance.

- Once the President authorizes a systemic resolution, the institution would be turned over to the SRA for resolution. The FDIC would implement a predetermined plan, approved by the SROC, to staff the SRA for that type of resolution, delegating existing FDIC staff and hiring additional expertise to fit the particular resolution.

- The Secretary of the Treasury, with the advice of the relevant subgroup of the SROC (noted above), plus the FDIC, would be charged with making major policy decisions involving the resolution. Those limited policy items would be specified by Congress, and the FDIC would be in charge of day-to-day resolution issues.

- Congress would clearly identify in the legislation those items for an institution being resolved – such as management, board make-up, and equity investors – where strong action would be required so that the result is a "controlled" bankruptcy of the institution and an end to too-big-to-fail. These outcomes would be identified in advance by the regulations from the SROC in order that markets, potential stakeholders, and potential counterparties would know their risk. The SRA would be authorized to

create a "bridge bank" mechanism where appropriate to resolve the institution in an orderly fashion, limit contagion, and protect the taxpayers. Rules for creditors of the institution would be developed in advance based on existing bankruptcy principles, which would provide clarity and predictability to financial markets on transactions.

- Through enhanced regulation and supervision, the likelihood and cost of future failures should be significantly reduced. If a resolution does result in a loss, the costs would be covered by the Treasury and reimbursed by assessments over time on all financial firms. Institutions with subsidiaries that have insured deposits would be given credit to reflect the fact that deposits are already covered by insurance premiums. Insured institutions below a threshold should be exempt. There would, however, need to be recognition that there are practical limits to such assessments in a catastrophic financial meltdown and that the pro-cyclical nature of assessments could overwhelm the system and be counterproductive.

In many ways, the draft is very similar to this ABA proposal. The details are very important, however, and we will submit more specific comments to the Committee. ***Nevertheless, at this point, we must express our strong objection to the approach in the draft legislation of using the FDIC – directly – to resolve non-banks.*** As ABA has stated in previous testimony, we believe such an approach is unnecessary and will create huge problems; these problems are easily avoided by following our recommendations to create a Systemic Resolution Agency that would be run largely by the FDIC.

First and foremost, putting the FDIC in charge of such resolutions would greatly undermine public confidence in the FDIC insurance for bank deposits. This confidence is critical, and it is the reason we have seen no significant runs on banks since the 1930s. The importance of this public confidence should not be underestimated, nor should its existence be taken for granted: witness the lines in front of the British bank Northern Rock at the beginning of this crisis. Yet our own research and polling shows that, while consumers trust FDIC insurance, their understanding of how it works is not all that deep. Headlines saying that "FDIC in charge of failed XYZ non-bank" would greatly undermine that trust. Just imagine if the FDIC were trying to address the AIG situation for the past year. We urge Congress not to do anything that would confuse consumers or undermine confidence in the FDIC.

Our second concern, frankly, is that the banking industry has supported the FDIC with tens of billions of dollars in premiums. During these most difficult of times, the industry is committed to paying for all FDIC insurance costs. Thousands of banks have paid premiums since the FDIC was first created. We are concerned that our premiums will be used to pay for the infrastructure of the resolution mechanism, and furthermore, if our fund is strong and a major non-bank fails, there will be a strong temptation to unfairly raid the bank FDIC fund to pay for it.

Nevertheless, we recognize there can be an important role for the FDIC in this resolution process. In addition, within the bank resolution process itself, the FDIC does appear to be handicapped by the inability to address the holding company of the failed bank, which may be very much linked to the bank. ABA would support a carefully structured approach to permit the FDIC to address holding company issues when a bank fails.

Moreover, the FDIC does have expertise and an existing structure that can be helpful in resolving non-banks. As detailed above, ABA would support tapping that expertise, but only in a manner that protects the public's perception of, and confidence in, the FDIC and that fully walls off the FDIC insurance fund. Merely making the non-bank resolution authority a separate part of, or subsidiary of, the FDIC would not be enough. ***The resolution agency should be entirely separate from the FDIC and have attributes that make it clear that the "Systemic Resolution Agency" is its own agency, with its own funding, while it does use FDIC expertise.***

III. Preserve all FDIC-Insured Charters and Protect the Dual Banking System

Having choices of charters enables a bank to match the best charter to its philosophy and business strategy. This also allows regulation and supervision to be targeted to meet the particular risks that may arise. This helps preserve the diversity of financial institutions without sacrificing safety and soundness.

Charter choice also remains an important consideration as financial institutions' business models evolve. For instance, while a community bank may conclude that a state charter is best when the bank first begins operations, it may conclude later that its expansion plans would best be facilitated by a national bank or federal thrift charter. Or a large institution may conclude that some services are best met with a mix of charters, perhaps concentrating mortgage business in one, commercial lending in another, credit card activities in yet another, and trust activities in still another. The combinations are as diverse as the markets and customers to be served.

The ABA strongly supports retaining the federal thrift charter. The thrift charter was created to provide a focus on home lending and building communities. This focused charter has provided the foundation for building and restoring communities and promoting savings. Thus, there is a solid case for keeping such thrift charters and their holding companies, which include stock federal savings associations, mutual federal savings associations, savings and loan holding companies, and mutual holding companies. These institutions are generally smaller banks that have outstanding community relationships. In fact, the median size of a mutual thrift is $100 million and the median size of a stock thrift is $250 million.

We also want to emphasize the importance of the mutual structure. Mutual institutions have stood the test of time and continue to serve their communities in exemplary fashion. ***As Congress looks at restructuring regulatory agencies or charters, it is critical that mutual institutions not be negatively impacted.***

We are very pleased that the discussion draft does not follow the Administration's original proposal to eliminate the thrift charter, nor does the draft negatively impact mutuals. We particularly thank Chairman Frank for his leadership on this issue. The process of moving the thrift charter to the new combined OCC-OTS does raise significant technical issues. We believe the draft does a good job as a first cut in addressing these issues, but we will have further recommendations in this area on important transition issues.

Consolidation of Agencies into a Single Regulator is Not Needed

We are pleased that the draft legislation does not include the concept of merging the bank regulatory functions into one regulator. As we stated in a recent joint letter with ICBA[4], the current system of bank supervision, while complex, provides a healthy check against any one regulator neglecting its duties, overlooking important issues, focusing on one part of the industry to the detriment of others, growing overly bureaucratic and ineffective, or otherwise falling short in meeting its full set of responsibilities. One recent example – the FDIC's insistence on retaining a leverage capital ratio when other regulators were inclined to eliminate it as part of Basel II – illustrates well the benefits of having variety in regulatory perspective. A single regulator is only good when it is right; when wrong, the outcome could be catastrophic. It is noteworthy that Great Britain adopted a single regulator model, and the problems in its banking sector were deeper than in the U.S.

Regulatory consolidation would inevitably undermine the dual banking system, which has served our nation well for nearly 150 years. Experience in other countries shows that a new monolithic federal regulator, responsible for the supervision of all of the nation's depository institutions, could be expected to focus first and foremost on the largest institutions. With regulatory power concentrated in Washington, it is natural that bank regulation will favor programs supervised from Washington. With 5,490 state chartered banks today (67 percent of all banks), we are deeply concerned that state-chartered institutions would take a back seat over time. A state-chartered bank would find that regulatory burdens disadvantage state banks and conclude that it is more efficient to operate as a national bank. Having separate bureaus for state and federal charters would not solve this fundamental problem.

Our diverse banking system has served our country well. Unlike any other country, we have a broad range of small, mid-size, and large banks that meet different market needs. We believe strongly that this diverse system would be greatly undermined by the creation of one, large regulatory agency.

Moreover, regulatory consolidation would eliminate the benefits gained by the Federal Deposit Insurance Corporation and the Federal Reserve Board from their knowledge of the banking industry. As these

[4] Joint letter from ABA and ICBA to Chairman and Ranking Member of House Financial Services Committee and Chairman and Ranking member of Senate Banking Committee, dated October 19, 2009.

agencies have stated repeatedly[5], their ability to insure deposits and conduct monetary policy (respectively) is enhanced by their deep understanding of the banking markets obtained from hands-on bank supervision.[6]

Changes in our regulatory system are needed. Consumers, banks, and the country at large would benefit from better systemic supervision, and having input from several regulators will increase the chances that we can overcome the danger of systemic supervision suffering from blind spots. As noted above, there also should be a system capable of unwinding any financial institution regardless of size or complexity, and drawing upon the specialized expertise of the existing banking regulators will play an essential role in that effort. None of these changes requires or would benefit from the dramatic and distracting consolidation of all the regulatory functions of the agencies into one.

We strongly support the fact that the draft legislation does not contain a single regulator. We also support the language designed to protect explicitly against the possibility of charter shopping by a troubled bank, which largely codifies existing policy.

Holding Company Regulation

The draft legislation gives the Federal Reserve a broadened authority over certain holding companies that may raise systemic issues. In general, the overall structure in the draft legislation of the regulation of such entities seems appropriate and is central to a strong new regulatory regime. The ABA, however, will need to analyze the specifics of the greatly expanded regulatory authority given to the Federal Reserve, as well as the interaction between the Federal Reserve and the primary regulator.

However, as the Federal Reserve is given broader powers over some holding companies, ABA urges Congress to take the logical step of moving the regulation of other bank holding companies to the primary prudential regulator. For example, there is no sound reason for the Federal Reserve to continue to regulate and examine the holding companies of community banks that are not members of the Federal Reserve. Many community banks have holding companies that are virtually shells, and yet the Federal Reserve comes in and examines them. It is an unnecessary duplicative regulatory cost to banks and a distraction to the Federal Reserve,

[5] *See, e.g.*, Statement of Sheila C. Bair Chairman, Federal Deposit Insurance Corporation, on Strengthening and Streamlining Prudential Bank Supervision, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, August 4, 2009 ("Senate Hearing"); Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System, in response to questions of Senator Dodd at the Senate Hearing.

[6] One argument that is used to support this regulatory consolidation is that charter switching was a major contributor to the financial crisis. This argument, we submit, is simply not supported by the facts. Fannie Mae, Freddie Mac, Lehman Brothers, and AIG did not switch charters. Subprime lending, the runs on money market mutual funds, problems with derivatives and rating agencies, and excess leverage in Wall Street firms had nothing to do with charter choice. With respect to the two institutions often cited as having switched charters – Countrywide and Colonial – their switch of charter had no material impact on their problems. If the Congress is concerned about problem institutions switching charters in order to avoid strong regulation, that should be addressed directly and simply through a provision prohibiting such switching for institutions under special supervisory scrutiny, and, in fact, the regulators have already adopted rules designed to achieve that goal.

particularly given its proposed expanded powers. This is an opportunity to streamline regulation, save banks and regulators unnecessary costs, and have clearer lines of regulatory authority and responsibility. There are a number of issues raised by the holding company provisions in the draft legislation, including the practical implications of the very broad new authority given the Federal Reserve and the treatment of certain thrift holding companies and grandfathered ILC holding companies. ***ABA has serious concerns in these areas and believes these issues need a good deal more work.***

IV. Closing the Gaps in Regulation of Non-banks is Critical to Preventing Any Recurrence of the Current Problems

A major cause of our current problems is the regulatory gaps that allowed some entities to escape effective regulation. An obvious, but often ignored truth is this: where similar activities are not similarly regulated, business naturally flows to the poorly regulated sector, in part because of lower costs. This flow undermines the regulated sector, making it weaker. Too often, the poorly regulated sector then has a blow-up, which even further weakens the regulated sector. It is now apparent to everyone that a critical gap occurred with respect to the lack of regulation of independent mortgage brokers. Legitimate questions have also been raised with respect to derivatives, hedge funds, and others.

Consumer confidence in the financial sector as a whole suffers when non-bank actors offer bank-like services while operating under substandard guidelines for safety and soundness. Thus, the fundamental principle for closing the gaps in regulation is that similar activities should be subject to similar regulation and capital requirements. For example, capital requirements should be universally and consistently applied to all institutions offering bank-like products and services. Credit default swaps and other products that could pose potential systemic risk should be subject to supervision and oversight that increase transparency, without unduly limiting innovation and the operation of markets.

Another example is the payments system. Banks have long been the primary players in the payments system, ensuring safe, secure, and efficient funds transfers for consumers and businesses. Banks are subject to a well-defined regulatory structure and are examined to ensure compliance with the standards. Unfortunately, the current regulatory scheme does not apply comparable standards of performance and financial soundness for non-banks that participate in the payments system. Nor are non-banks subject to regular examinations to ensure the reliability of their payments operations. In other words, this is yet another gap in our regulatory structure, and one that is growing.

The Administration's reform plan envisioned granting more authority to the Federal Reserve for the oversight of systemically important payments systems. We believe such additional authority is appropriate to assure smooth functioning of the critical payments infrastructure should any disruption occur in the future. Such authority does not necessarily fully close the gaps that exist between regulation of banks and non-banks offering payments products.

In recent years, non-banks have begun offering "non-traditional" payment services in greater numbers. Internet technological advances combined with the increase in consumer access to the Internet have contributed to growth in these alternative payment options. The rapid technological growth and increasing consumer use of mobile telephones capable of accessing the Internet for the purpose of making or receiving payments demonstrates how fast the marketplace is changing. These activities introduce new risks to the system. Another key difference between banks and non-banks in the payments system is the level of protection granted to consumers in case of a failure to perform. It is important to know the level of capital held by a payment provider where funds are held, and what the effect of a failure would be on customers using the service. This information is not always as apparent as it might be. Customers using these payments systems are unlikely to understand their risk – that in the event of a failure, they could be uninsured creditors, for example.

ABA believes that standards for reliability of the payments system should apply to all payments services providers, comparable to the standards that today apply to payments services provided by banks. As part of expanding the oversight authority of the Federal Reserve for systemically important payments systems, Congress should clarify the authority of the Federal Reserve to set basic payments system integrity standards that would apply to all payments system services, bank as well as non-banks. Such standards should cover operational controls and could also extend to other relevant matters, such as adequate capitalization.

We appreciate that the draft takes a broad and comprehensive approach to these payments system issues, and ABA will provide the Committee with detailed comments on the new draft legislation.

The ABA also has deep interest in the securitization language in the draft legislation, and we will provide further comments on that subject. We understand the legitimate public policy issue of wanting lenders to have "skin in the game." Certainly the recent history of the securitization of bad subprime loans has demonstrated that there can be problems when the originator has no incentive to underwrite safely. However, we continue to be very concerned about proposals that do not fully take into account the accounting treatment that applies to securitization.

V. Conclusion

For over a year, the ABA has testified in support of reforming the regulations that govern our financial system. As we have done consistently over the course of the last year, we reiterate today our support for creating a systemic oversight body, for providing a strong mechanism for resolving troubled systemically important firms, and for filling the gaps in the largely unregulated shadow banking industry.

The draft legislation contains many positive provisions and, in general, the ABA supports the direction taken on the major issues. However, we do have serious concerns about the impact of the proposal on the

FDIC and depositors' view of the FDIC, the approach to holding companies, and the failure to address the critical accounting issues. We also want to express our appreciation for the retention of the thrift charter.

We will quickly provide the Committee with more detailed input on this complex legislation, and we stand ready to work with this Committee to enact meaningful reform that truly corrects the underlying deficiencies in our current system.

The Feasibility of Systemic Risk Measurement

Written Testimony of Andrew W. Lo*

Prepared for the U.S. House of Representatives

Financial Services Committee

October 19, 2009

Chairman Frank, Ranking Member Bachus, and other members of the House Financial Services Committee, I would like to start by thanking you for giving me an opportunity to submit this written testimony regarding the feasibility of systemic risk measurement. In the interest of full disclosure, I wish to inform the committee that I am a principal investigator in a project funded by the National Science Foundation, and in addition to my academic position at MIT, I am affiliated with an asset management company that manages several hedge funds and mutual funds.

I believe that establishing the means to measure and monitor systemic risk on an ongoing basis is the single-highest priority for financial regulatory reform, and am grateful for the Committee's interest in this issue.

Even the most cautious policymaker would agree that attempting to eliminate all systemic risk is neither feasible nor desirable—risk is a necessary ingredient to real economic growth. Moreover, individual financial institutions do not have the means or the motivation to address systemic risk themselves. In competing for market share and revenues, each entity will typically take on as much risk as its shareholders will allow, without considering the consequences for the financial system as a whole. In much the same way that manufacturing companies did not consider their impact on the environment prior to pollution regulation, we cannot fault financial institutions for ignoring the systemic implications of their risk-taking in the absence of comprehensive risk regulation. Unless we are able to measure systemic risk objectively, quantitatively, and regularly, it is impossible to determine the appropriate trade-off between such risk and its rewards and, from a policy perspective and social welfare objective, how best to contain it. This is the current challenge that faces the House Financial Services Committee.

Before turning to the substance of my testimony, parts of which are drawn from my previous testimony to the House Oversight Committee (Lo, 2008b), I would like to summarize four of the most important themes here:

---

*Harris & Harris Group Professor, MIT Sloan School of Management, and Chief Investment Strategist, AlphaSimplex Group, LLC. Please direct all correspondence to: Andrew W. Lo, MIT Sloan School of Management, 50 Memorial Drive, E52–454, Cambridge, MA 02142. The views and opinions expressed in this article are those of the author only, and do not necessarily represent the views and opinions of AlphaSimplex Group, MIT, any of their affiliates and employees, or any of the individuals acknowledged below. I am grateful to Tobias Adrian, Morten Bech, Claudio Borio, Jerry Chafkin, Phil Cooper, Arnout Eikeboom, Jacob Goldfield, Brenda Gonzalez-Hermosillo, Dale Gray, Jerrold Grochow, Joseph Haubrich, Greg Hayt, Andreas Jobst, Dennis Kass, Paul Kukuruza, Deborah Lucas, Saman Majd, Marc Menchel, Robert Merton, Eric Rosenfeld, Manmohan Singh, and Kimmo Soramäki, Donald Sussman, and Phil Vasan for helpful comments and discussion, and I thank AlphaSimplex and the MIT Laboratory for Financial Engineering for research support.

1. Before we can hope to reduce the risks of financial crises, we must be able to define and measure those risks explicitly. Therefore, a pre-requisite for effective financial regulatory reform is to develop dedicated infrastructure for defining, measuring, monitoring, and investigating systemic risk on a standardized, ongoing, and regular basis.
2. Systemic risk measurement and regulation will likely require new legislation compelling systemically important entities to provide more transparency on a confidential basis to regulators, e.g., information regarding their assets, liabilities, holdings, leverage, collateral, liquidity, counterparties, and aggregate exposures to key financial variables and other risks. These requirements are much less intrusive than position transparency—which is both impractical and unnecessary for purposes of systemic risk regulation—and should already be available from any systemically important entity's enterprise risk management system.
3. The infrastructure required to collect, clean, analyze, organize, and store this data in a secure and robust fashion will be substantial, but this is true for any worthwhile national-level data-rich undertaking such as the Bureau of Economic Analysis, the Bureau of Labor Statistics, and the National Weather Service. Given the complexity and importance of the financial system to real economic growth—and the recessionary impact that systemic events can have on the real economy—measuring systemic risk is arguably as vital to our national interest as measuring economic productivity and weather patterns. This data-collection effort can be expedited by leveraging existing organizations and data sources including the CFTC, DTCC, Federal Reserve, FDIC, FINRA, NFA, OCC, OTS, SEC, and the credit bureaus and credit-rating agencies.
4. Because systemic risk cuts across multiple regulatory bodies that do not necessarily share the same objectives and constraints, it may be more efficient to create an independent and agency patterned after the National Transportation Safety Board (NTSB), solely devoted to measuring, tracking, and investigating systemic risk events in support of—not in competition with—all regulatory agencies. In addition to managing the data and research infrastructure described above, this agency would also be staffed by full-time and "virtual" teams of expert and experienced forensic accountants, lawyers, economists, and financial engineers who sift through the wreckage of every major financial blow-up, collect the "black boxes", and produce publicly available reports with their findings and recommendations. Like the NTSB, this agency would assist the appropriate regulators by establishing regular lines of communication with the media as financial crises unfold to manage the flow of information and reduce the likelihood of panic, which is one of the main catalysts of crisis and much easier to prevent than they are to extinguish once ignited.

I would like to add two caveats to the discussion that follows. The first is that while the need for regulatory reform may seem clear in light of the current financial crisis, the underlying causes are complex, multi-faceted, and not yet completely understood. Therefore, I would urge the Committee and other parts of government to refrain from reacting too hastily to market events, but to deliberate thoughtfully and broadly to craft new regulations for the financial system of the 21st century. We do not need more regulation; we need more effective regulation.

Second, since this testimony will become part of the public record, I wish to emphasize that this document is not a formal academic research study, but is a summary of some of the policy implications that I have drawn from my interpretation of such research, and is intended for a broader audience of policymakers and regulators.

Measures of Systemic Risk

The well-known adage that "one cannot manage what one cannot measure" is particularly relevant for the notion of *systemic risk*, a term that has come into common usage but which does not yet have a standardized definition or a universally accepted method for gauging its magnitude. Systemic risk is usually taken to mean the risk of a broad-based breakdown in the financial system, often realized as a series of correlated defaults among financial institutions—typically banks—that occurs over a short period of time, i.e., a "bank run" that spreads quickly and leads to multiple bank failures. The events of 2007–2009 have taught us that runs can affect non-bank entities as well, such as money market funds, insurance companies, hedge funds, government-sponsored enterprises, and broker/dealers. Moreover, in a recent study commissioned by the G-20, the IMF determined that systemically important institutions are not limited to those that are the largest, but also includes others that are interconnected and that can impair the normal functioning of financial markets, including the provision of credit to households.[1]

The starting point for regulatory reform is to develop formal measures of systemic risk, measures that capture the linkages and vulnerabilities of the entire financial system—not just those of the banking industry—and with which we can monitor and regulate the overall level of risk to the system and its interconnectedness to the real economy. Given the complexity of the global financial system, it is unrealistic to expect that a single measure will suffice. For example, in a recent study on systemic risk in the U.S. residential housing market, it is shown that systemic events can arise from the simultaneous occurrence of three trends: rising home prices, falling interest rates, and increasing efficiency and availability of refinancing opportunities.[2] Individually, each of these trends is benign, and often considered bellwethers of economic growth. But when they occur at the same time, they inadvertently cause homeowners to synchronize their equity withdrawals via refinancing, ratcheting up homeowner leverage simultaneously without any means for reducing leverage when home prices eventually fall, ultimately leading to waves of correlated defaults and foreclosures. While excessive risk-taking, overly aggressive lending practices, pro-cyclical regulations, and government policies may have contributed to the recent problems in the U.S. housing market, this study shows that even if all homeowners, lenders, investors, insurers, rating agencies, regulators, and policymakers behaved rationally, ethically, and with the purest of intentions, financial crises can still occur.

Given its complexity, monitoring systemic risk requires better data collection and a variety of measures that capture the following seven broad characteristics of the entire financial system: (1) leverage; (2) liquidity; (3) correlation; (4) concentration; (5) sensitivities; (6) implicit guarantees; and (7) connectedness.

Leverage refers to the ability to invest amounts larger than one's capital base by borrowing, and liquidity refers to the ease and speed with which funds can be raised or investments can be liquidated. The mechanisms by which these two characteristics combine to produce systemic risk are now well understood. Because many financial institutions make use of leverage, their positions are often considerably larger than the amount of collateral posted to support those positions. Leverage has the effect of a magnifying glass, expanding small profit opportunities into larger ones, but also expanding small losses into larger losses. And when unexpected

[1] See IMF (2009a).
[2] See Khandani, Lo, and Merton (2009).

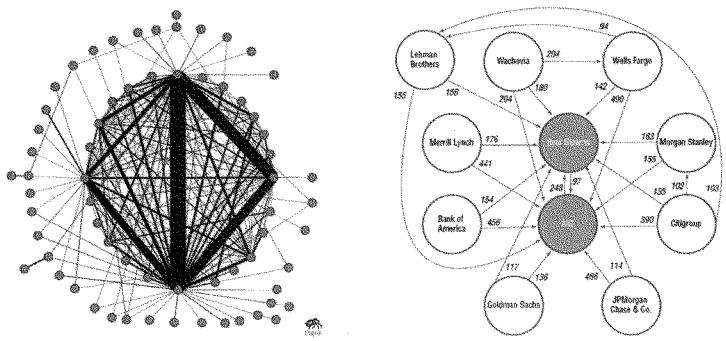
adverse market conditions reduce the value of that collateral, such events often trigger forced liquidations of large positions over short periods of time to reduce leverage, which can lead to systemic events as we have witnessed over the past two years. In particular, the more illiquid the positions, the larger the price impact of forced liquidations, leading to a series of insolvencies and defaults and, ultimately, increased unemployment and recession as financial institutions deleverage. This is systemic risk. Of course, the likelihood of a major dislocation also depends on the degree of correlation among the holdings of financial institutions, how sensitive they are to changes in market prices and economic conditions, how concentrated the risks are among those financial institutions, whether there are any implicit guarantees that promote excessive risk-taking behavior, and how closely connected those institutions are with each other and the rest of the economy.

By looking at the financial system as if it were a single portfolio, several useful measures of systemic risk can be derived from existing financial models. For example the well-known framework of contingent claims analysis can be applied to the macroeconomy, which yields several potentially valuable early warning indicators of systemic risk that include aggregate asset-liability mismatches, nonlinearities in the risk/return profile of the financial sector, implicit government guarantees, and default probabilities for various types of sovereign debt.[3] Illiquidity and "crowded trades" can be measured using various statistical tools and simulation techniques, and aggregate measures can be derived by combining the results from individual sectors and corporations.[4] Sensitivities, correlations, and concentration risks can also capture important aspects of systemic risk,[5] and it is worth noting that some of these measures did provide early warning signs of potential dislocation in the financial industry from 2004 to 2006.[6]

But the increased complexity and connectedness of financial markets is a relatively new phenomenon that requires a fundamental shift in our linear mode of thinking with respect to risk measurement. Small perturbations in one part of the financial system can now have surprisingly large effects on other, seemingly unrelated, parts of that system. These effects have been popularized as so-called "Black Swan" events—outliers that are impossible to predict—but they have more prosaic origins: they are the result of new connections between sectors and events that did not exist a decade ago, thanks to financial innovation, increased competition, and technological progress.[7] In fact, a more accurate rendition of "too big to fail" is "too connected to fail", and with the proper information, we can identify black swans while they are still cygnets. For example, a network map of the Fedwire inter-bank payment system (Figure 1a) has yielded a number of new insights about the risk exposures of this important network, including a current snapshot of where the most significant vulnerabilities are concentrated, and the IMF's (2009) conditional credit risk estimates for major U.S. financial institutions for March 2008

[3] See Bodie, Gray, and Merton (2007), Gray and Malone (2008), and Gray.
[4] See Getmansky, Lo, and Makarov (2004), Khandani and Lo (2007, 2008), and Khandani, Lo, and Merton (2009).
[5] See Acharya and Richardson (2009), Adrian and Brunnermeier (2008), Chan et al. (2006, 2007), Gray (2009), Huang, Zhou, and Zhu (2009), IMF (2009b), Lo (2008a), and Rajan (2006).
[6] For example, see Gimein (2005) and Rajan (2006).
[7] One example is apparent correlation among quantitative equity market neutral managers that led to the Quant Meltdown of August 2007 (see, for example, Khandani and Lo, 2007, 2008, and Rothman, 2007a,b). See Singh and Aitken (2009) for an analysis of counterparty risk, which is another manifestation of connectedness.

(Figure 1b) highlighted AIG, Bear Stearns, and Lehman as institutions with particularly significant exposures.[8]



(a) (b)

Figure 1. (a) Core of the Fedwire Interbank Payment Network, from Soramäki et al. (2007, Figure 2); and (b) conditional co-risk measures among major U.S. financial institutions for March 2008, from IMF (2009, Figure 2.6).

However, while many tools exist for measuring systemic risk, these measures have, at best, yielded indirect indications of the build-up of systemic risk over the last few years because regulators lack the necessary data to generate definitive, timely, and actionable measures. Imagine deciding on fiscal stimulus policies in the absence of GDP and unemployment figures over the last few quarters, or formulating environmental protection policies without ecological impact estimates of urban development. The required inputs to systemic risk measures are dispersed across many institutions, jurisdictions, and information-technology platforms, and a significant portion of this data is private. Moreover, a private-sector solution to measuring systemic is unlikely to emerge because, like national defense, environmental protection, and public works, systemic risk may affect everyone but no individual entity has the ability, the information, or the incentive to manage it properly. It will take an act of Congress to create the required infrastructure, and this is the task facing the House Financial Services Committee.

Data Requirements

The quality and management of relevant data from bank and non-bank financial institutions is an integral part of decoding impending systemic risks. While banks and other regulated financial institutions provide certain information to their regulators, not all systemically important entities are covered, and those that are may not be required to provide the kind of information most relevant for systemic risk monitoring and regulation. For example, hedge funds registered with the U.S. Securities Exchange Commission under the Investment Advisers Act of 1940 are not

[8] See Soramäki et al. (2007). Recent advances in the mathematical theory of networks, e.g., Watts and Strogatz (1998) and Watts (1999), may be particularly relevant for analyzing such vulnerabilities in the financial system.

required to disclose the amount of leverage they employ, the nature of their holdings, or the identities of their credit counterparties. The insurance industry is regulated only at the state level, hence there is currently no formal disclosure of information by insurance companies to federal regulators. Even the highly regulated banking industry's information flows are not ideally suited for systemic risk transparency, with some banks reporting state regulators, others to the FDIC, many to the Office of the Comptroller of the Currency, and the state-member banks and bank holding companies reporting to the Federal Reserve.

Without access to the appropriate data, systemic risk cannot be measured accurately. For the same reason that national income accounts are a pre-requisite to formulating sound fiscal policies, the first and most significant step in the process of financial regulatory reform is to require all systemically important entities—including banks, bank holding companies, hedge funds, mutual funds, insurance companies, broker/dealers, mortgage lenders, government-sponsored enterprises, exchanges, ECNs, and others—to provide regulators with the necessary inputs for measuring systemic risk. This will likely include the following information on a regular (at least monthly), timely, and strictly confidential and anonymized basis:[9]

- Assets and liabilities (on- and off-balance-sheet, marked to market)
- Leverage and contractual terms
- Aggregated portfolio holdings, including OTC derivatives and contractual terms
- Current list of significant shareholders, investors, counterparties, and bilateral exposures
- Portfolio sensitivities to changes in major market indexes and other scenarios

The last item requires further explanation. For the most complex and illiquid securities—which also happen to be among the most relevant securities for systemic risk—it will be virtually impossible for any third party to value them. However, it is a simple matter to require owners of those securities to provide, on an aggregate basis, estimates of their losses or gains in response to, say, a 5% increase in crude oil prices, a 25-basis-point decline in the Fed Funds rate, or a 10% drop in the S&P 500. By asking all systemically important entities to provide such sensitivities for a pre-specified set of scenarios, and also by inviting these entities to propose their own scenarios, regulators need not analyze position-level data, nor do they need to develop pricing models for universe of assets held by financial institutions. These sensitivities can then be aggregated across institutions to yield systemic scenario analyses. If such aggregate scenarios were available in 2006, they would likely have shown the enormous build-up of systemic risk in the U.S. housing market and its derivatives.

These data requirements may seem onerous, but they are less exacting than the inputs of any systemically important financial institution's existing enterprise-wide risk management system. A side benefit of imposing such requirements is that whether or not a financial institution can provide such data may be a useful screening mechanism to identify institutions with potentially inadequate risk controls, which, for systemically important entities, poses systemic risk in its own right. Also, for purposes of systemic risk measurement, aggregated values are sufficient for many of the required data items, eliminating the need for large amounts of data at the individual-transaction level. After all, by definition, only the most significant aggregate exposures will be relevant to systemic risk measurement. However, there is no disputing that these new reporting

[9] Borio and Drehmann (2009) and Johnston et al. (2009) provide a more complete account of the "information gap" identified by the recent financial crisis and how systemic risk measurement may be accomplished.

requirements for systemically important entities will be costly—this may be an unavoidable consequence of building a more robust financial system.

Of course, the regulatory need for risk transparency must be balanced against the necessity of preserving the intellectual property that financial institutions possess. Unlike other technology-based industries, the vast majority of financial innovations are protected through trade secrecy, not patents.[10] For example, hedge funds are among the most secretive of financial institutions because their franchise value is almost entirely based on the performance of their investment strategies, and this type of intellectual property is perhaps the most difficult to patent. Therefore, such entities have an affirmative obligation to their investors to protect the confidentiality of their investment products and processes. If forced to reveal their strategies, the most intellectually innovative entities will simply cease to exist or move to other less intrusive regulatory jurisdictions. This would be a major loss to U.S. capital markets and our economy, hence it is imperative that policymakers tread carefully with respect to this issue and coordinate with foreign regulators. But several government agencies such as the Federal Reserve, OCC, NSA, and SEC already handle highly confidential information with reasonable success, so the public sector does have the capability of managing sensitive financial data.

Implementation Issues

Collecting, cleaning, integrating, archiving, analyzing, monitoring, and securely storing such data is, of course, a significant technological undertaking, and may require the establishment of a new government agency dedicated solely to this function. Although several regulators such as the CFTC, FDIC, Federal Reserve, OCC, OTS, and the SEC already collect data related to systemic risk, they do not necessarily share the same regulatory objectives, constraints, and institutional purview. Also, the global nature of financial markets and institutions implies that the regulatory landscape is even more complex, with competing agendas and objectives of foreign regulators such as the BIS, ECB, and FSA. While the existing regulatory bodies have overlapping perspectives, they are neither redundant nor all-encompassing, hence a new agency focused solely on systemic risk measurement will serve a different and useful purpose. This option does not seem so radical in light of the fact that a well-functioning financial system is critical to general economic growth and stability. The complexities of today's financial system require more focused resources to fully comprehend and regulate its risks.

A significant portion of the data-collection process can be expedited by leveraging existing data sources and technologies such as those of the CFTC, DTCC, Federal Reserve, FDIC, FINRA, NFA, OCC, OTS, SEC, and credit bureaus and credit-rating agencies. Having one single agency responsible for this data will greatly streamline its collection, maintenance, and analysis. Once populated, this systemic-risk database will serve as a general utility for all regulatory agencies, yielding potentially significant cost savings by allowing other agencies to outsource some or all of their data-collection and maintenance functions to this organization. Also, by charging this new agency with the ongoing responsibility of creating high-level risk analytics such as a network map of the financial system, estimates of illiquidity exposure, concentration, and excessive leverage, and publicizing redacted and aggregate indicators of systemic risk, we will enhance the self-correcting tendencies of the private sector while helping regulators and the public better prepare for systemic events. Although the initial set-up cost is likely to be

[10] See Lerner (2002) for a discussion of financial patents.

significant, this amount pales in comparison to the potential savings that an effective financial "early warning system" for monitoring systemic risk can generate for taxpayers. One proposal is to defray these costs by asking producers of systemic risk to underwrite them through a "systemic risk capacity charge" (assuming that a standardized metric of systemic risk can be constructed), in much the same way that the environmental impact of industrial activities is regulated through pollution rights and taxes.[11]

It should be emphasized that systemic risk measurement and monitoring is distinct from systemic risk regulation. The latter function is already being served to differing degrees by regulators such as the CFTC, FDIC, Federal Reserve, OCC, OTS, and SEC for their respective sectors of the financial industry, and there are some compelling arguments for maintaining decentralized regulatory authority across agencies with specialized mandates and skills. Whether or not these agencies require greater powers and broader mandates, or if they should be combined to yield a smaller number of regulators, or if we need an entirely new systemic-risk regulator are questions that require thoughtful deliberation and may not be resolved quickly. But regardless of how the regulatory responsibilities for the financial system are ultimately divvied up, all parties should be able to agree on the need to develop reliable, timely, and regular measures of systemic risk.

This separation of measurement and regulation is, in fact, the model for the National Transportation Safety Board (NTSB), an independent government agency focused on promoting transportation safety through forensic investigations of airplane crashes and other accidents, and maintaining a public searchable database of their accident reports. The NTSB has no regulatory authority (in particular, the FAA regulates the airline industry), but through its authoritative analyses of literally thousands of crashes and near misses, the NTSB has had a significant impact on air safety as well as the growth of the airline industry. Financial crashes are, of course, considerably less dire, generally involving no loss of life. However, the current financial crisis, and the eventual cost of the Fannie Mae, Freddie Mac, and TARP rescue packages, should be sufficient motivation to create a "Capital Markets Safety Board" (CMSB) dedicated to investigating, reporting, and archiving the "accidents" of the financial industry.

By maintaining "virtual" teams of experienced professionals—forensic accountants, lawyers, economists, and financial engineers from industry and academia, and securities and tax attorneys—that are "on demand" and work together on a regular basis over the course of many cases to investigate every single financial disaster, a number of new insights, common threads, and key issues would emerge from their analysis. The publicly available reports from the CMSB would yield invaluable insights to individuals and institutions seeking to protect their investments and organizations from similar fates, eventually driving the financial industry (and their regulators) to improve their "safety record".[12] Like the NTSB, the CMSB would also assist

[11] See Acharya et al. (2009). Tarashev, Borio, and Tsatsaronis (2009) propose an elegant method for apportioning such charges among those institutions deemed to be systemically important.

[12] Of course, formal government investigations of major financial events do occur from time to time, as in the April 1999 *Report of the President's Working Group in Financial Markets on Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*. However, this inter-agency report was put together on an ad hoc basis with committee members that had not worked together previously and regularly on forensic investigations of this kind. With multiple agencies involved, and none in charge of the investigation, conclusions and recommendations must be reached by consensus, which may reduce the scope and impact of the analysis. Although any thorough investigation of the financial services sector must involve the SEC, the OCC, the CFTC, the U.S. Treasury, and the Federal Reserve, there are important operational advantages in tasking a single office with the responsibility for leading such

the appropriate regulators as crises unfold by establishing regular lines of communication with the media to manage the flow of information and reduce the likelihood of panic, which is one of the main catalysts of crisis and much easier to prevent than they are to extinguish once ignited.

Perhaps the most significant feature of the NTSB model is its independence, which has, on occasion pitted the NTSB against the FAA. Far from being dysfunctional, this tension has benefitted the public through the natural checks and balances that NTSB investigations and recommendations have had on regulatory behavior. Regulators are human, and therefore subject to the same psychological influences that generated irrational exuberance among homeowners, investors, mortgage lenders, broker/dealers, and policymakers during the housing boom. An independent CMSB providing data, analysis, and monitoring of various potential systemic events—with no agenda other than to generate the most accurate risk measures and forecasts—may serve as a useful and objective point of reference, even for regulatory bodies that have their own analytical capabilities.[13]

The establishment of a CMSB will not be inexpensive. The lure of the private sector poses a formidable challenge to government agencies to attract and retain individuals with expertise in these highly employable fields. Individuals trained in forensic accounting, financial engineering, and securities law now command substantial premiums on Wall Street over government pay scales, even in the aftermath of the recent crisis. Although the typical government employee is likely to be motivated more by civic duty than financial gain, it would be unrealistic to build an organization on altruism alone. However, the cost of a CMSB is trivial in comparison to the losses that it may prevent. If regulators had fully appreciated the impact of the demise of Lehman Brothers—which a fully operational CMSB with the proper network map would likely have been able to forecast—the savings from this one incident would likely be sufficient to fund the CMSB for half a century. Moreover, the benefits provided by the CMSB would accrue not only to the wealthy, but would also flow to pension funds, mutual funds, and individual investors in the form of more stable financial markets, greater liquidity, reduced borrowing and lending costs as a result of decreased systemic risk exposures, and a wider variety of investment choices available to a larger segment of the population because of increased transparency, oversight, and ultimately, financial stability.

As long as human behavior is coupled with free enterprise, it is unrealistic to expect that market crashes, manias, panics, collapses, and fraud will ever be completely eliminated from our capital markets, but we should avoid compounding our mistakes by failing to learn from them. Fortunately, systemic events in the United States have been rare. But the magnitude of their consequences for employment, wages, and economic growth is so large that we can longer afford to ignore them.

---

investigations and serving as a repository for the expertise in conducting forensic examinations of financial incidents.

[13] For example, during the period from 2000 to 2003 when the Fed was cutting interest rates in an attempt to stave off a recession, its research department was no doubt aware of the potential impact on asset prices and aggregate leverage, but the focus of the organization was on stimulating the economy, not on managing systemic risk. In contrast, the SEC—which recently created a new Division of Risk, Strategy, and Innovation, significantly enhancing its ability to analyze and address a broader range of risks—is focused on investor protection, maintaining fair and orderly markets, and facilitating capital formation, not on regulating systemic risk. While both agencies have overlapping responsibilities that involve systemic risk, their different regulatory mandates imply different research agendas and analytical capabilities that the CMSB would complement and reinforce.

References

Acharya, V., Pedersen, L., Philippon, T. and M. Richardson, 2009, "Regulating Systemic Risk", in V. Acharya and M. Richardson, eds., *Restoring Financial Stability: How to Repair a Failed System*, Chapter 13. New York: John Wiley & Sons.

Acharya, V. and M. Richardson, eds., 2009, *Restoring Financial Stability: How to Repair a Failed System*. New York: John Wiley & Sons.

Adrian, T. and M. Brunnermeier, 2008, "CoVaR", Federal Reserve Bank of New York Working Paper No. 348.

Bech, M., Chapman, J., and R. Garratt, 2009, "Which Bank Is the "Central" Bank? An Application of Markov Theory to the Canadian Large Value Transfer System", Federal Reserve Bank of New York Staff Report #356.

Bodie, Z., Gray, D., and R. Merton, 2007, "New Framework for Measuring and Managing Macrofinancial Risk and Financial Stability", NBER Working Paper No. W13607.

Borio, C. and M. Drehmann, 2009, "Towards an Operational Framework for Financial Stability: 'Fuzzy' Measurement and its Consequences", BIS Working Papers No. 284.

Chan, N., Getmansky, M., Haas, S., and A. Lo, 2004, "Systemic Risk and Hedge Funds", Conference Paper, *NBER Conference on the Risks of Financial Institutions*, Woodstock, VT, October 22–23.

Chan, N., Getmansky, M., Haas, S., and A. Lo, 2006, "Do Hedge Funds Increase Systemic Risk?", *Federal Reserve Bank of Atlanta Economic Review* Q4, 49–80.

Chan, N., Getmansky, M., Haas, S., and A. Lo, 2007, "Systemic Risk and Hedge Funds", in M. Carey and R. Stulz, eds., *The Risks of Financial Institutions*. Chicago, IL: University of Chicago Press.

Getmansky, M., Lo, A. and I. Makarov, 2004, "An Econometric Analysis of Serial Correlation and Illiquidity in Hedge-Fund Returns", *Journal of Financial Economics* 74, 529–609.

Getmansky, M., Lo, A., and S. Mei, 2004, "Sifting Through the Wreckage: Lessons from Recent Hedge-Fund Liquidations", *Journal of Investment Management* 2, 6–38.

Gimein, M., 2005, "Is a Hedge Fund Shakeout Coming Soon?", *New York Times*, Sunday, September 4.

Gray, D., 2009, "Modeling Financial Crises and Sovereign Risks", to appear in *Annual Review of Financial Economics* 1.

Gray, D. and S. Malone, 2008, *Macrofinancial Risk Analysis*. New York: John Wiley & Sons.

Huang, X., Zhou, H. and H. Zhu, 2009, "A Framework for Assessing the Systemic Risk of Major Financial institutions", to appear in *Journal of Banking and Finance*.

International Monetary Fund, 2009a, *Systemically Important Institutions, Markets and Instruments* (October 2009). Washington, DC: International Monetary Fund.

International Monetary Fund, 2009b, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks* (April). Washington, DC: International Monetary Fund.

Johnston, B., Psalida, E., de Imus, P., Gobat, J., Goswami, M., Mulder, C., and F. Vazquez, 2009, "Addressing Information Gaps", IMF Staff Position Note SPN/09/06.

Khandani, A. and A. Lo, 2007, "What Happened to the Quants in August 2007?", *Journal of Investment Management* 5, 5–54.

Khandani, A. and A. Lo, 2008, "What Happened to the Quants in August 2007?: Evidence from Factors and Transactions Data", NBER Working Paper No. 14465.

Lerner, J., 2002, "Where Does *State Street* Lead? A First Look at Finance Patents, 1971–2000", *Journal of Finance* 57, 901–930.

Lo, A., 2008a, *Hedge Funds: An Analytic Perspective*. Princeton, NJ: Princeton University Press.

Lo, A., 2008b, "Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008: Written Testimony for the House Oversight Committee Hearing on Hedge Funds (November 13, 2008)", Available at SSRN: http://ssrn.com/abstract=1301217.

Rajan, R. , 2006, "Has Finance Made the World Riskier?", *European Financial Management* 12, 499–533.

Rothman, M., 2007a, "Turbulent Times in Quant Land", U.S. Equity Quantitative Strategies, Lehman Brothers Research.

Rothman, M., 2007b, "View from QuantLand: Where Do We Go Now?", U.S. Equity Quantitative Strategies, Lehman Brothers Research.

Singh, M. and J. Aitken, 2009, "Counterparty Risk, Impact on Collateral Flows and Role for Central Counterparties", IMF Working Paper WP/09/173.

Soramäki, K., Bech, M., Arnold, J., Glass, R. and W. Beyeler, 2007, "The Topology of Interbank Payment Flows", *Physica A* 379, 317–333.

Tarashev, N., Borio, C. and K. Tsatsaronis, 2009, "The Systemic Importance of Financial Institutions", *BIS Quarterly Review* (September), 75–87.

Watts, D., 1999, *Small Worlds: The Dynamics of Networks between Order and Randomness*. Princeton, NJ: Princeton University Press.

Watts, D. and S. Strogatz, 1998, "Collective Dynamics of 'Small-World' Networks", *Nature* 393, 440–442.

Testimony
Property Casualty Insurers Association of America (PCI)

Hearing on
Systemic Regulation, Prudential Matters, Resolution Authority and Securitization

Committee on Financial Services
United States House of Representatives
October 29, 2009

The Property Casualty Insurers Association of America (PCI) is pleased to offer testimony on financial services systemic risk and resolution regulation and the Discussion Draft of the proposed Financial Stability Improvement Act of 2009, which the Treasury Department and the Committee released earlier this week. PCI is the leading property-casualty trade association representing more than 1,000 insurers, the broadest cross-section of insurers of any national trade association.

PCI's overarching concern is that financial services reform legislation reflect the fact that home, auto and business insurers did not cause the financial crisis, are not systemically risky, are subject to strong and effective solvency and consumer protection regulation at the state level, and should not be forced into a Wall Street fix. Property casualty insurers are predominately a Main Street industry, with significantly less concentration and more small business competition than other financial sectors. We have rejected government hand-outs and our industry is stable, healthy and continuing to provide critical services to local economies and their communities. We are committed to working with the Administration and the Congress to develop effective and workable proposals for addressing systemic risk and resolution. However, insurance consumers would not benefit from additional, duplicative federal regulation oversight that will ultimately harm the marketplace and increase costs for consumers.

Systemic Risk Regulation

The financial crisis that began last year has brought into sharp focus a key vulnerability in our current financial services regulatory system -- the absence of a comprehensive understanding of the nature of systemic risk and effective systemic risk oversight. The Federal Reserve Board currently has "umbrella" systemic risk authority only over financial holding companies. To date, this regulation has been bank-centric and has not focused on careful monitoring and understanding of the risks posed by non-bank entities within the financial holding company structure. In fact, former Federal Reserve Chairman Alan Greenspan has said that the Board's regulatory focus failed to effectively monitor and regulate the systemic risk to the larger economy. Furthermore, the Board does not have systemic risk regulatory authority over major thrifts or thrift holding companies (*e.g.*, Indymac, Countrywide, Washington Mutual), investment bank holding companies (*e.g.*, Lehman Brothers, Bear Stearns) or highly leveraged derivatives underwriters. Existing prudential regulators who do have jurisdiction over those entities have not focused on systemic risk. Even within the banking system, the Federal Reserve Board and other depository institution regulators did not regularly collect or coordinate the necessary marketplace information to protect consumers and adequately identify and limit systemic risk.

It is vital that these regulatory gaps be filled now to help restore confidence in our financial system. Irrational exuberance in the marketplace is inevitable and innovative risk-taking should not be restricted. Regulators should be given the tools to monitor systemic risk and a government entity should be tasked with a primary responsibility of trying to identify and limit the impact of the next bubble burst. However, it is equally vital that Congress establish bright line systemic risk measurements based on a solid understanding of what systemic risk is and which activities within our financial system do and do not pose systemic risk. This will help restore marketplace confidence and reduce moral hazards. Excessive grants of authority and regulatory discretion without specific

standards and metrics create the likelihood of abuse and severe uncertainty in the marketplace.

The Administration's Proposal on Financial Regulatory Reform

In significant respects, the Discussion Draft proposes a good starting point for discussing systemic risk. It designates a new Financial Services Oversight Council and the Federal Reserve Board as jointly responsible for monitoring systemic risk, with jurisdiction to fill existing umbrella supervision oversight gaps. The Draft requires the systemic risk regulator to work with existing primary functional regulators in collecting information and making regulatory determinations. It recognizes that there are several factors, including leveraging and interconnectedness, that can contribute to systemic risk. The draft also proposes some useful oversight requirements for companies conducting systemically risky activities.

PCI's testimony today suggests a number of refinements to the Discussion Draft. We believe most members of Congress and Administration officials recognize that the current crisis did not stem from widespread problems in the property casualty insurance industry and that property-casualty insurance is not generally systemically risky. We are concerned, however, that the Discussion Draft does not adequately reflect this understanding and we recommend that careful consideration be given to the impact the draft would have on Main Street, non-systemically risky insurers, including small insurers.

Financial Services Oversight Council

The Discussion Draft would grant federal systemic risk regulators authority over insurance companies. Yet the proposed Financial Services Oversight Council includes only one non-voting representative from the insurance regulatory community. Representation on the Council is overwhelmingly

weighted toward banking regulators. The insurance industry has remained strong and stable throughout the economic crisis and is important to the financial services sector and the economy. As such, it should have a vote on the Council and voting power should be distributed more equitably throughout the sector.

Data Demands

Under the new Draft, the Council and the Federal Reserve Board are authorized to require any insurer, regardless of size, to submit any data requested that relates to potential systemic risk. There is no requirement that the burden and cost of complying with the request be weighed against its benefit and these costs ultimately negatively impact consumers. Burdens associated with regulatory data demands can be quite high – even crushing – especially for small, Main Street, insurers. Because insurers are generally not systemically risky and small insurers are particularly non-risky, we recommend that small companies be exempted from this requirement or, at a minimum, that adequate cost-benefit considerations be included to ensure that data demands do not have the perverse effect of threatening the solvency of small companies.

Measuring Systemic Risk – Initial Screening

The most important first step in categorizing companies for systemic risk is to create a relatively simple screen to weed out the vast majority of companies that are unlikely to present significant systemic risk. *We strongly recommend that the Draft be revised to include such a screening mechanism to help ensure that we do not fix what is not broken.* It is critical that systemic risk analysis be based on individual activities, not on a consolidated whole. Some financial activities are simply not systemically risky and should not be subjected to further reporting burdens or oversight creating additional costs for consumers. The initial screening should measure activities that are generally interconnected and correlated with systemic downturns, to determine the amount of off-balance

sheet leveraging of liabilities or uncollateralized liabilities for which regulatory capital is not required (including structured collateralized liabilities for which the collateral cannot practically be identified). This framework builds on the suggested tests in the earlier Administration white paper and in the Discussion Draft to focus on leveraging (including off-balance sheet exposures), interconnectedness, a firm's importance as a source of credit, and the negative economic impact of a firm's failure.

Three-Part Weighted Measurement for Systemic Risk: "Too Risky, Cyclical, and Interconnected for a Disorderly Failure"

For those companies that are conducting significant amounts of potentially systemically risky activities, PCI suggests that Congress consider a weighting of the three elemental systemic risk components for each basket of activities a firm conducts, similar to a combination of the Administration's proposed tests. These are:

- Failure probability (the historic failure rate of the activity modified by the company's leveraging and transparency);
- Cyclicality (the correlation of the activities with systemic downturns), and
- Potential economic impact (interconnectedness/negative economic impact on credit and liquidity).

It is critical that this sophisticated systemic risk analysis be weighted. For example, a company's activities can be highly leveraged and at-risk of failure, but without cyclicality (no correlation with downturns – such as funeral insurance) or with minimal interconnectedness (such as insuring professional athletes) such that any impairment would not significantly affect a critical credit or liquidity market. An activity could be cyclical (correlated with downturns), but with negligible likelihood of failure (liabilities are regulated, well capitalized or capitalized, and with minimal leveraging) or unlikely to negatively impact credit or liquidity markets because the operations are relatively small or unrelated to

critical credit or liquidity markets (such as a recreational boat insurer).

Finally, even some financial operations whose failure could negatively impact critical interconnected markets are not systemically risky if the activities have negligible likelihood of failure (fully regulated, capitalized, and unleveraged), are countercyclical risks (such as hedges that benefit the company during downturns and only create liabilities during periods of economic growth), or have failure costs covered by state guaranty funds (thus eliminating or minimizing 3rd party failure exposure). It is only the combination of these three factors (failure-risk, cyclicality, and interconnectedness) that creates systemic risk, not any of these factors in isolation based on absolute size.

For these reasons, the Draft should be amended to include an initial systemic risk screen and carefully crafted limits on the systemic risk regulator in identifying systemically risky companies or activities. Establishing an initial screen with clear screening criteria will provide valuable guidance to the systemic risk regulator and reduce the likelihood that systemic risk oversight will overreach and involve unhelpful and intrusive data demands and excessive regulation of non-systemically risky firms or activities. For example, the Draft permits the FRB to impose heightened prudential standards on insurance affiliates of banks, even though those affiliates are subject to effective state insurance regulation.

Systemic risk measurements for new financial products will need to be flexible. However, for existing financial products, the market will benefit from objective, bright line tests so that companies can avoid activities that would be considered significantly systemically risky and moral hazards can be minimized. In addition to exclusion (or near- zero weighting) of non-systemically risky activities from aggregate systemic risk measurements, risk measurements should distinguish between liabilities that affect the entire holding company versus exposures limited to particular affiliates or affiliate groups. The transparency (public disclosure) and regulatory oversight of an activity should be

also factored into systemic risk weightings, as should systemic risk history. For example, large thrifts have evidenced an extremely high cyclicality – boom and bust cycle – for many decades that is highly correlated with economic downturns. Similarly, highly leveraged off-balance sheet derivative activities were a major cause of the 1998 global financial crisis and the collapse of Long Term Capital Management (LTCM). We know these activities cause significant systemic risk, and should target oversight accordingly.

Forced BHC Conversions

Forced conversion of small non-bank financing companies that are a negligible part of larger conglomerates into banks and their holding companies into bank holding companies would not lessen systemic risk – the simple fact of affiliation with a relatively very small bank-equivalent does not by itself create additional systemic risk. Numerous insurers have small thrifts that provide important consumer services but do not create systemic risk to the holding company. The Draft proposes that financial firms, including insurers, with non-bank affiliates must convert to bank holding companies and restructure their commercial activities into affiliated holding companies. This provision should include an exemption for firms with only minimal and clearly non-systemically risky commercial activities. Financial stability is not promoted by requiring needless restructuring of non-risky firms.

Resolution Authority

PCI supports the creation of a federal resolution authority to resolve systemically risky financial companies provided it: (1) is focused on systemically risky activities and not on insurance (which is generally not systemically risky); (2) does not duplicate existing and effective state or federal resolution authorities; (3) does not give companies incentives to engage in risky behavior; (4) does not punish those who act responsibly; (5) requires industries to pay their own

resolution costs and does not permit cross-subsidization of resolution costs among industries; (6) does not permit the resolution agency to reach down into and "raid" affiliates that are subject to separate resolution authorities; and (7) is a separate, independent agency that is not a primary regulator

Resolution Scope: Systemically Risky Activities – Not Insurance

As indicated above, there is widespread recognition that home, auto and business insurers did not cause the financial crisis, are not systemically risky, and are subject to strong and effective solvency and consumer protection regulation at the state level. Traditional property casualty products simply do not pose the same types of systemic risk as other financial sectors. Property and casualty companies generate relatively minor counterparty risk, and their failure rates are relative low historically as a percentage of industry premiums.

Chairman Frank and others have correctly observed that one of the most important factors to consider in identifying systemic risk is leverage. A 2008 report by MSCI Barra research bears out these observations, concluding that "exposure to leverage could hurt performance significantly during market crises." The report also demonstrates that the insurance industry is not heavily leveraged, especially in comparison to other sectors of the financial services industry. In a study of cap-weighted financial leverage in 35 industry sectors during the years 1994-2008, the insurance industry was ranked 28th while the banking industry was ranked 7th.

The 2009 *Economic Report to the President* indicated that "[b]efore the financial crisis, the major investment banks were leveraged roughly 25 to 1." Using property casualty insurance metrics similar to those employed in the report noted above, PCI has calculated that the insurance industry was leveraged at roughly 3 to 1 prior to the financial crisis. Property casualty operations are generally low-leveraged businesses with lower asset-to-capital ratios than other

financial institutions, more conservative investment portfolios, and cash outflows that are tied to insurance claims rather than "on demand" access to assets or economic events (limiting any risk of a P&C "run on the bank"). They are therefore less financially fragile than banks and better able to withstand financial stresses. It is clear that different sectors of the financial services industry pose widely varying levels of systemic risk. Any reform legislation the Congress enacts must reflect this fact, not just as a suggestion, but as a bright line standard for who is subjected to systemic risk regulation and assessments.

While some increased federal regulation of systemically risky companies is needed, care must be taken that non-systemically risky entities in the insurance industry are not subjected to federal regulation that duplicates state regulation, or worse, that preempts the effective state regulation that has served the industry well for years as was evident in the recent financial crisis. The Discussion Draft would subject non-systemically risky insurers to a federal resolution process, including subjecting them to potential resolution assessments to pay for the resolution of more risky firms. Any new resolution authority must focus on truly systemically risky entities that are not adequately regulated for systemic risk now and are not already subject to an effective resolution system.

No Resolution Duplication: Insurers Already Have a Resolution Authority

Any federal systemic risk regulation must recognize that the impact of insolvencies in the insurance industry is substantially mitigated by the existing insurance "guaranty fund" system. When a state's insurance commissioner finds that an insurer has financial problems, he or she will initiate increasingly robust levels of oversight and activity to correct those deficiencies. If an insurer does become insolvent, the state guaranty funds, financed by all insurers licensed in a state, are available and well-positioned to help honor policyholder claims.

There is no need to duplicate the existing state insurance resolution system at the federal level. In the last 40 years, the U.S. property/casualty guaranty system has paid out roughly $21 billion in policyholder claims on behalf of insolvent insurers. The existing system of state guaranty funds has served the insurance industry and its consumers well and any new federal regulation of the financial services industry should recognize and preserve that system's strong protections. In part because of the state guaranty fund system, even the failure of one of the largest property-casualty holding companies would be unlikely to create systemic risk or require additional government intervention.

The Treasury Draft gives a nod to the existing, effective state resolution system for insurers by requiring the FDIC to take into account whether insurers have been subject to resolution assessments at the state level. While helpful, this does not *require* the FDIC to refrain from imposing duplicative assessments on insurers. Any legislation adopted must not permit insurers to be subject to assessments at both the state and federal levels. This creates significant inequities and moral hazards.

Resolution Funding: Industries Should Pay Their Own Risk Costs

When an insurance company fails, state guaranty funds are called upon to ensure that the claims of the failed insurer's policyholders will be honored. When a bank fails, the Federal Deposit Insurance Corporation (FDIC) calls on a fund financed by banks to make sure depositors don't lose their life savings. A similar system is in place for securities broker-dealers. The principle is basic and sound. One financial industry does not call on another, or the taxpayers, for bailouts. Each industry finances its own "insurance" fund to protect itself, its customers, and the taxpayers. To require financial companies to shoulder the burden of failures in other industries would result in *all* consumers paying for risky activities of a few entities through higher costs of the financial products we buy. That wouldn't be fair to consumers as they would eventually bear the financial burden,

and equally important, it wouldn't provide incentives for risk-takers to scale back their own risky activities.

The Discussion Draft rejects the principle that industries should be responsible for their own resolution costs and instead spreads those costs among large companies across the entirety of the financial services sector. Consumers of insurance holding companies with consolidated assets exceeding $10 billion will have to pay the risk costs for highly leveraged investment banks, even if the insurer does not present any systemic risk. The Draft should be amended to provide that resolution funding is assessed separately for each financial industry as it is now in the insurance industry and portions of the banking and broker-dealer industries. To the extent that new systemic risks are being created by activities without government guarantees, such as investment banking, and derivatives, those industries should bear their own risk costs and have it factored into their pricing. Industries should not subsidize each others' activities. This minimizes moral hazards, cross-subsidies, and regulatory arbitrage; reduces market distortion and ensures accurate risk pricing; limits failures from contaminating other industries; increases the risk pool; and maximizes the incentives for each industry to work with its regulator to create the optimal balance between solvency protection and risk.

To the extent any additional funding is necessary for holding company resolutions unrelated to a particular financial activity it should be systemic risk weighted/scalable and assessed post-event. Any assessments should be risk-based and only imposed on systemically risky entities not otherwise subject to risk assessments. Activities that are not systemically risky should be excluded from calculations for covered financial companies and assessments.

Resolution Impact: Do Not Reward Risky Behavior (No Moral Hazards)

Providing federal subsidies selectively to companies within an industry can have the effect of rewarding risky behavior, and harms Main Street. This creates a "moral hazard," *i.e.*, an incentive for firms to engage in and continue their risky activities firm in the knowledge that the taxpayers will bail them out if the risks go bad. This is both unfair to consumers and businesses and unwise.

Any federal resolution agency must have as a high required priority the avoidance of moral hazard and destabilizing markets. It must act cautiously and sparingly and, to the greatest extent possible, use predetermined formulae and priority of claims rules to help level the playing field and ensure that all market participants know what to expect. This includes a well-defined and well-understood trigger for putting a systemically entity into resolution. That trigger must accommodate the reality that an entity might be failing in a manner that does not pose a systemic risk in the particular circumstance. The trigger should be tied to a true systemic threat: (a) the company is in default or has significant risk of imminent default if no government action is taken; (b) the company presents significant systemic risk such that its failure is likely to significantly negatively affect the larger economy; and (3) such negative effects would require unusual federal intervention to ameliorate and could be significantly mitigated through federal resolution.

The Discussion Draft leaves too much discretion to the FRB and the FDIC, and fails to ensure that the resolution authority is designed to avoid moral hazards. Thus, the proposal could actually have the effect of increasing risky activities and thus systemic risk – the opposite of what the legislation is intended to achieve.

Reach Down: Don't Punish the Innocent

Any federal resolution agency should certainly be able to manage a parent holding company's equity interest, but it should not be able to reach down into affiliates that are subject to separate resolution authority. Denuding the assets of an insurer, bank, or broker-dealer affiliate would unfairly subject the less risky competitors whom have acted responsibly of that entity to potential assessments to pay the failed company's liabilities – potentially twice --once at the systemic risk level and a second time through the guaranty funds. This is a particular concern in protecting insurance surplus, which is necessary to cover long-term uncertain liabilities of policyholders, in comparison to banking liabilities that the resolution agency might be more familiar with that could be more immediate and quantifiable.

Reach down authority should be limited only to: (1) preventing fraudulent conveyances such as last minute transactions to shield assets; or (2) coordinating with primary regulators to unwind contractual agreements between heavily regulated entities (insurers, banks, broker-dealers) and the parent company or other affiliates. We will work with the Committee and the Administration on legislative language that ensures appropriate limits on the FDIC's reach-down authority.

Retain Existing Contracts and Priorities

Any federal resolution agency's authority should be permitted to repudiate contracts with regulated insurers <u>only</u> to the extent necessary to allow the resolution. Preemption related to insurance affiliates should be limited to the extent necessary to unwind from non-insurance affiliates, such as requiring divestitures or cease-and-desist orders for activities posing significant risk to non-insurance affiliates (*e.g.*, preempting state laws preventing related

cancellation/non-renewal, agent termination, and withdrawals). Preemption should not include voiding insurance contracts.

* * *

We appreciate the opportunity to offer our thoughts and concerns about federal resolution authority proposals and to underscore the strengths of the property casualty industry. Attached to this testimony are more complete versions of our systemic risk and resolution authority proposals with respect to:

- Systemic risk principles
- Systemic risk measurement
- Systemic risk oversight
- Resolution of risky companies

Also attached is a table and graphic showing the impairment rates for four major financial sectors over the last 30 years, including during the past four systemic downturns.

PCI looks forward to continuing to work constructively with the Committee and the Administration on this important legislation would be pleased to provide any further information the Committee may require.

Analyzing, Measuring, Overseeing and Resolving Systemic Risk

"Systemic risk" is the likelihood and the degree that the institution's activities will negatively affect the larger economy as part of a systemic downturn such that unusual and extreme federal intervention would be required to ameliorate the effects.

Principles of Systemic Risk Measurement

- Initial systemic risk screening should focus on unregulated activities and factors such as the degree of leverage and uncollateralized liabilities (for which regulatory capital is not required), off-balance sheet exposures (which include those liabilities which have been accounted for as a sale -- and thus removed from the financial statements -- but where the company has not surrendered control over those liabilities), and degree of reliance on short term funding.
- Subsequent systemic risk measurements should not be binary (fail/pass) tests, but should be weighted to take account of varying degrees of risk. Key elements of an effective system risk system should include:
    - Weighted risk tests based on failure probability and correlation with and contribution to overall systemic risk;
    - Scalable systemic risk oversight;
    - Systemic risk measurements that provide a break-down by industry group, identifying and allowing for exclusion of non-risky activities and corporate structure that segregates liability (e.g., if an insurer is engaging in a derivatives business through a subsidiary, only the derivatives subsidiary should be designated as systemically risky); and,
    - Focus on monitoring and regulation of systemically risky activities to minimize systemic economic downturns rather than on punitive measures.
- Different activities engaged in within a group or company should be analyzed separately so that activities that are not systemically risky (e.g., property-casualty insurance) will be excluded from aggregations. Activities should also be excluded to the extent that any liabilities arising from those activities are already covered under risk-based assessment or guaranty fund systems. Systemic risk measurements should be objective bright line tests, with well defined terms.
- Companies in regulated industries with guaranty funds should not be subject to the same strict capital requirements or required to subsidize resolution costs of less regulated activities without guaranty funds – this would create an enormous moral hazard.
- Very small affiliated thrifts or similar entities that are forced to convert into banks that do not themselves pose systemic risk should not subject their holding companies to stricter bank holding company regulation and required divestiture of non-financial (commercial) activities within 5 years. This is overly prescriptive and not appropriate in all circumstances, especially where the affiliated thrift is small and poses negligible systemic risk.

Measuring Systemic Risk

Step 1 – Screen to Eliminate Systemically Non-Risky Entities

For prudentially regulated entities, initial systemic risk screening should be performed by the functional regulator, focusing on unregulated activities and factors such as the degree of leverage and liabilities without specific collateralization (for which regulatory capital is not required), off-balance sheet exposures, and degree of reliance on short term funding.

Step 2 – Measuring Degree of Systemic Risk to Determine Appropriate Regulatory Response

Systemic risk is a company's probable contribution to a systemic downturn. It is a weighted multiple of three factors calculated separately for each group of activities:

- Failure probability;
- Cyclicality; and
- Economic impact.

Failure Probability. The likelihood of failure is the probability of insolvency of the relevant financial activity of a company, which for existing product lines can be measured historically. For example historical impairment rates for insurance and banking are: 0.29% for property casualty insurance; 0.32% for life insurance; 0.65% for banking; 3.19% for thrifts.[1] This historical failure measurement by activity would then be adjusted up or down for each company based on bright-line predetermined formulas depending on whether the following factors are above or below average for the activity:

- Capital reserves;
- Leveraging;
- Liquidity;
- Reliance on short-term funding
- Enterprise risk management; and
- Transparency (regulatory and public disclosure).

Cyclicality. The "cyclicality of risk" is the degree to which impairments correlate with economic downturns. For example, the correlation coefficient for p/c over the past 30 years is extremely low, as economic downturns do not correlate with increased auto or homeowners accidents, p/c markets are somewhat inelastic (mandatory), and p/c insurers are not subject to a "run on the bank". In contrast, activities that have exhibited higher cyclicality of risk include mortgage lending, credit lending, and derivatives.

Economic Impact. Economic impact is the expected contraction a firm's failure would cause to critical financial markets (such as the credit and capital liquidity markets) and the resulting reduction in U.S. gross domestic product (GDP). A very blunt cursory measure of potential economic impact is the amount of highly leveraged liabilities that are not already addressed by a government or statutory-enacted guaranty fund mechanism. A more sophisticated analysis would examine the potential reduction of supply in critical financial markets (credit and capital) that the failure of a firm's activities would cause, potentially measured by the price increases in those critical

[1] See attached chart, "Impairment Experience of the Financial Services Industry", PCI, 2009.

markets during a systemic crisis (such as the increase in LIBOR rates, nonconforming mortgages, equity and debt issuances, and auction rate securities failures and prices). A very high level analysis might also consider the effect of a firm's failure on counterparty industries, measuring off-balance sheet liabilities owed to other major systemically risky firms.

New Financial Products. More subjectivity would have to be allowed to assess the systemic risk of new financial products that do not have historical failure or cyclicality data, considering factors such as: the extent to which the product is regulated, the extent to which the providers underwrite their own risk, whether the risk accrues to the provider or investors, the ability and likelihood of a consumer run, the level of allowed leveraging and required collateral, elasticity of demand, and the extent to which the individuals making risk decisions are compensated based on short term returns.

Systemic Risk Oversight Framework

Issue	Proposal
COVERED COMPANIES	Only systemically risky US financial companies. The focus should be on those activities of holding companies and financial subsidiaries that are not subject to prudential regulation by a functional regulator, targeting financial entities with large off-balance sheet exposures and other obligations that are indicative of systemic risk.
SYSTEMIC RISK DEFINITION	Systemic risk is the likelihood and the degree that a financial institution's activities will negatively affect the larger economy as part of a systemic downturn. It can be measured by a risk weighting of the likelihood of failure, cyclicality of risk, and economic impact of firm's activities. Respectively, these factors would be based in part on historical failure rate of a product line (adjusted by available capital, leveraging, liquidity, reliance on short-term funding, etc.), the historical proclivity of a product line to fail in unison with economic downturns, and the estimated supply contractions caused by such product lines to various critical financial markets during systemic failures (measured by price spikes after failures). Heavily regulated activities with low leveraging, low interconnectedness, and high transparency are generally not systemically risky, and systemic risk is further reduced to the extent that obligations are already covered by existing industry guaranty funds.
TRIGGER	Systemic risk (SR) regulation should be scalable and based on a series of qualitative and quantitative triggers which, when activated, result in more strenuous, but not duplicative, oversight or regulation. SR regulation should consider existing mechanisms within particular financial industry sectors that internalize and absorb counterparty risks of individual firms (e.g., guaranty funds) and should not obstruct existing functional regulation that manages those risks. As each trigger is activated the analysis performed and regulatory involvement will become more detailed and for highly systemically risky entities could include capital requirements based on risk levels and uncertainty. Activation of the final trigger would result in resolution. **Step 1 – Screening to eliminate non-risky entities** Functional regulators of financial companies would be directed to: • Identify entities that have excessive leverage, liabilities without specific collateralization (for which regulatory capital is not required), off-balance sheet exposures (relating to interests in entities that are not shown on their GAAP or regulatory financial statement balance sheets) or degree of reliance on short term funding. • Report information on <u>only</u> those entities identified above to the SR regulator (SRR) for Tier #1 review as described below. • Strengthen their own oversight of potentially systemically risky companies with respect to enterprise risk management, measuring risk exposure, performing stress and/or scenario tests, control identification, etc.

	Step 2 – Measuring degree of systemic risk and applying appropriate oversight Financial companies that are not eliminated via the Step 1 screen would be subject to systemic risk regulatory review and classification by tiers. Tier #1: The SR regulator (SRR) would annually provide various numerical tests based on the systemic risk quantification by product line. These tests would include review of the relative size of off-balance sheet risk and unfunded commitments. Companies whose activities exceed a certain dollar threshold would self-determine if they exceed the numerical test, in which case they would be required to report certain consolidated holding company information to the SRR. Tier #2: If a company's SR exceeds a certain level based on the consolidated tests, and the SRR determines that existing regulatory scrutiny of the company's SR is not adequate to manage those risks, that company would become subject to additional monitoring (including monitoring of the number and amount of obligations to different counterparties), a basic level of reporting on its enterprise risk management, and potential risk auditing by the SRR. Periodic risk auditing would identify deficiencies and require affected companies to develop, within a given timeframe, a corrective action plan and to achieve compliance. The SRR may also perform criminal background checks on key holding company management. Tier #3: Companies that reach high levels of systemic risk would be subject to scalable capital charges depending on the level of systemic risk presented. Tier #4: Companies that reach very high levels of systemic risk (or that fail to achieve timely compliance to correct systemic risk deficiencies) would be subject to corrective action agreements to implement more robust enterprise risk management and capital standards at the holding company level. SR reporting could become quarterly. Tier #5: Companies that fail to implement corrective action agreements for enterprise risk management and capital standards would be subject to cease and desist orders. Companies that fail to try to fulfill corrective action agreements willfully or consistently in bad faith would be subject to civil penalties. Tier #6: Insolvent companies that are systemically risky, that are not otherwise subject to a resolution procedure, whose failure would create an unacceptable systemic risk to the economy, would be put into conservatorship or otherwise resolved by the systemic resolution agency. Companies would have the option to request a higher tier of oversight (for equivalency purposes). Companies should be able to petition to immediately lower their tiering upon taking action to reduce systemic risk, such as by reducing leveraging or raising more capital. Companies should also have an appeals process to review systemic risk determinations.
SYSTEMIC RISK AGENCY	Federal Reserve Board (in consultation with applicable primary regulators)

FUNDING	Congressional appropriations. If funding is necessary over and above general appropriations from Congress, funding for direct costs of systemic regulation, other than those related to resolutions, should be through scalable assessments on covered financial companies. Scalability should be based on the aggregate systemic risk of companies' systemically risky activities (*i.e.*, the measure should be the systemic risk of each of a company's activities, not the overall size of the holding company that could include many less systemically risky activities).
INSURANCE LEAD REGULATOR	For purposes of coordinating systemic risk oversight and insurance holding company resolutions, a lead insurance regulator for each insurance holding company should be identified by the states, based on consideration of the following criteria: • State with the largest number of domestic insurance companies; • State of largest premium volume (by domestic companies or by coverage written in the state); • State of domicile of top-tiered insurer in holding company system; • Physical location of the main corporate offices; • Insurance department expertise in the area of concern and experience of staff in similar situations; and • State whose regulatory requirements have driven the design of the group's infrastructure. The lead state regulator for an insurance group shall collect information on potential systemic risk, focusing on significant off-balance sheet, unfunded contingent liabilities over a certain threshold; and, report such information to the office of the federal systemic risk regulator.
INFORMATION FLOW BETWEEN REGULATORS	The Antifraud Network Act should be enacted to create appropriate privileges for information sharing among regulators. Expanded President's Working Group on Financial Markets (PWG) information sharing should also be enacted. With respect to information oversight for specific holding companies with a tier 3-6 systemic risk, the FRB should hold regular "Supervisory Colleges" with regulators of all regulated entities within group, to coordinate oversight and establish additional protocols for information flow among the members.
AVOIDANCE OF COMPOUNDING OF RISK BY AFFILIATES	The PWG and Supervisory Colleges should assist the FRB in developing standards to ensure that systemically risky holding companies' enterprise risk management standards include provisions for ensuring that affiliate risk taking diversifies holding company risk rather than compounds it.
SYSTEMIC RISK REGULATION FOR SUBSIDIARY COMPANIES	The overall goal of systemic risk regulation is to allow holding company subsidiaries to fail separately, not to eliminate or even reduce the possibility of a subsidiary failing.

Resolution of Failing Systemically Risky Companies

PCI supports creation of a federal resolution authority to address the potential failure of financial firms by allowing the government to resolve systemically risky financial companies *that are not otherwise subject to federal or state regulatory resolution.* We suggest that, in establishing a resolution authority, the Congress should establish in advance clear goals, process, and criteria for resolution, including:

- Provide an orderly unwinding of systemically risky failing firms to maximize resolution value;
- Activities should bear their own risk costs (no cross-industry subsidizations);
- Depoliticize resolutions – predetermine formulas and prioritization of claims (recognizing some claims take longer to mature);
- Avoid destabilizing markets
- Minimize moral hazards

Industries Should Pay Their Own Risk Costs: Resolution funding should be assessed separately for each financial industry. Industries should not subsidize each others' activities. Insurers, banks, and broker-dealers already have assessment systems to pay for the failure risks generated by their industries. To the extent that new systemic risks are being created by activities without government guarantees (investment banking, derivatives, etc.) then those industries should bear their own risk costs and have it factored into their pricing. In effect these industries should be compelled to internalize the costs they could impose on society in the event of failure. This minimizes moral hazards, cross-subsidies, and regulatory arbitrage; reduces market distortion and ensures accurate risk pricing; limits failures from contaminating other industries; increases the risk pool; and maximizes the incentives for each industry to work with its regulator to create the optimal balance between solvency protection and risk. Any assessments should be risk-based and only imposed on systemically risky entities not otherwise subject to risk assessments. Activities that are not systemically risky should be excluded from calculations for covered financial companies and assessments. To the extent any additional funding is necessary for holding company resolutions unrelated to a particular financial activity (this should be minimal), it should be systemic risk weighted/scalable and post-event.

Don't Punish the Innocent: The resolution agency should be able to manage a parent holding company's equity interests, but should not be able to reach down into affiliates subject to separate resolution authority. Diluting the assets of an insurer, bank, or broker-dealer affiliate would then unfairly subject the less risky competitors of that entity to potential assessments to pay the failed company's liabilities – potentially twice (once at the systemic risk level and a second time through the guaranty funds). This is a particular concern in protecting insurance surplus, which is necessary to cover long-term uncertain liabilities of policyholders, in comparison to banking liabilities that the resolution agency might be more familiar with that could be more immediate and quantifiable.

Retain Existing Contracts and Priorities: Insurance law prioritizing policyholder (and reinsurance) claims should be retained to ensure they are made whole before other creditors. Insurance contracts should not be repudiated except as absolutely

necessary to disentangle entities. Bridge insurers with separate charters should not be created and not given competitive advantages.

Avoid Perception of Conflicts: Resolutions should be determined by Treasury after consulting with the FRB and the primary regulators of any involved affiliates (such as an insurer's lead state regulator). Treasury should report to Congress and the President on any disagreements among involved regulators. In addition, the following elements should be included to avoid conflicts:

- Resolution funds should be managed by Treasury's designee (that is not a primary regulator).
- Resolutions should be performed by a separate resolution agency overseen by Treasury.
- Avoid regulatory moral hazard that requires an agency with primary responsibility for a particular market segment to resolve competing claims from other financial markets.

Thank you for the opportunity to provide the Committee with information on the question of whether some financial services companies are "too big to fail" and potential actions to improve economic oversight. PCI looks forward to continuing to be a resource on financial services regulatory reform issues.

PCI Property Casualty Insurers Association of America
Shaping the Future of American Insurance

Impairment Experience of the Financial Services Industry

In brief

The property casualty insurance industry has historically experienced a consistent and low impairment rate that is uncorrelated with larger economic downturns.

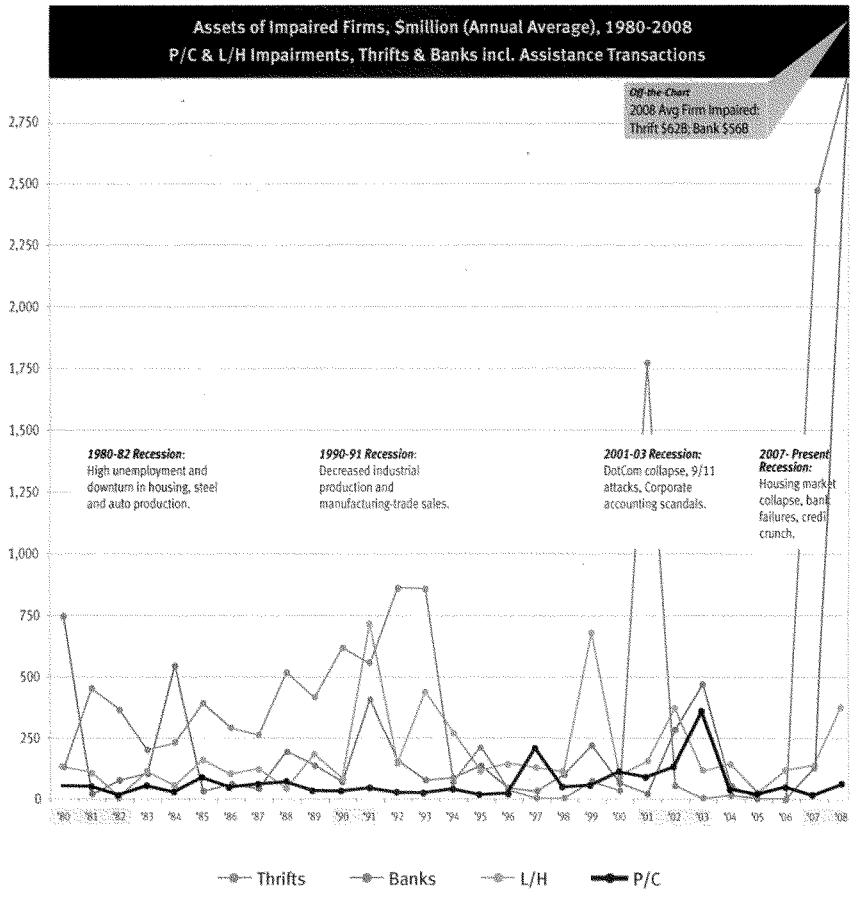
The property casualty insurance industry has historically experienced a consistent and low impairment rate that is uncorrelated with larger economic downturns. The tables and charts below indicate the recent and historical impairment activity over the last 30 years within four major sectors of the financial services industry: Thrifts, Banks, Life/Health, and Property/Casualty. Impaired firms are those requiring regulatory intervention.

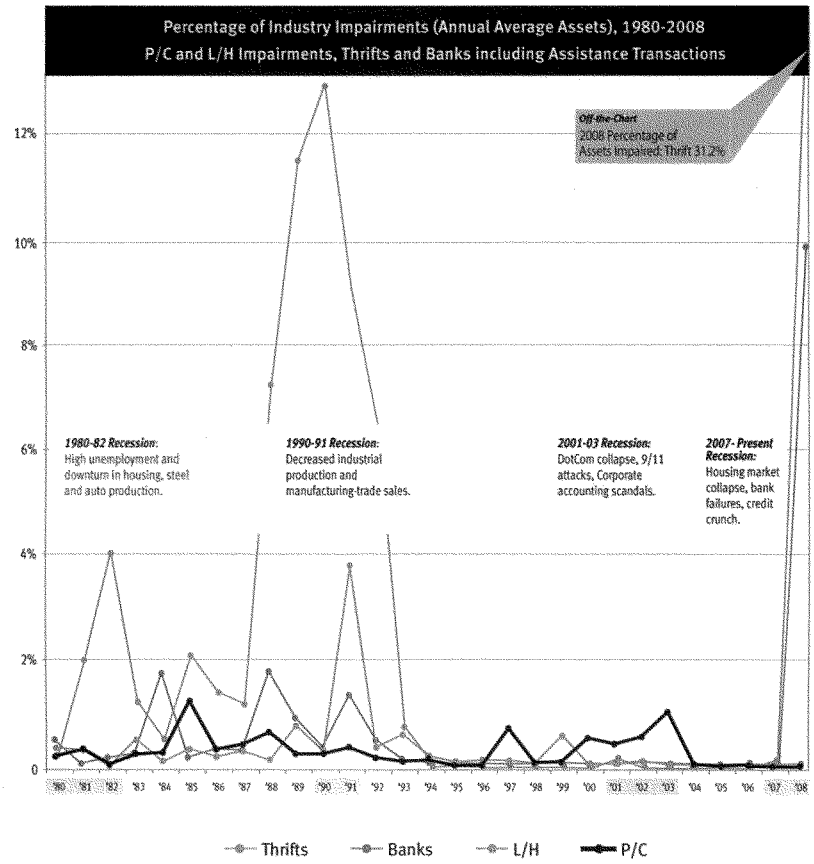
The data clearly demonstrate that the insurance industry, particularly the property casualty insurance industry, experiences far lower average impairments than their industry counterparts. The Assets of Impaired Firms table indicates the average annual dollar amount of impairments in each of the four sectors. The Percentage of Industry Impairments table compares the impairments as a percentage of each industry's assets. The corresponding charts illustrate the level of impairment (in dollars and percentage) during four key periods of financial crisis over the last thirty years.

	Depository Institutions		Insurance	
	Thrifts	Banks	Life / Health	Property / Casualty
Assets of Impaired Firms, $million* *(Annual Average)*				
2008	$62,320	$56,477	$382	$51
2007	2,474	125	137	7
2006	0	0	118	42
2005	0	0	22	12
2000-2008	7,406	6,388	170	89
1990-1999	327	130	282	44
1980-1989	324	193	100	41
1980-2008	2,523	2,094	185	57
Percentage of Industry Impairments *(Annual Average Assets)*				
2008	31.18%	10.55%	0.06%	0.02%
2007	0.16%	0.00%	0.02%	0.00%
2006	0.00%	0.00%	0.01%	0.04%
2005	0.00%	0.00%	0.00%	0.01%
2000-2008	3.50%	1.18%	0.03%	0.30%
1990-1999	2.91%	0.22%	0.60%	0.19%
1980-1989	3.13%	0.57%	0.29%	0.39%
1980-2008	3.19%	0.65%	0.32%	0.29%

PCI is comprised of more than 1,000 member companies, representing the broadest cross-section of insurers of any national trade association. PCI members write over $176 billion in annual premium, 35.9 percent of the nation's property casualty insurance. Member companies write 43.8 percent of the U.S. automobile insurance market, 29.6 percent of the homeowners market, 32.8 percent of the commercial property and liability market, and 38.4 percent of the private workers compensation market.

2600 South River Road, Des Plaines, IL 60018 Telephone 847-297-7800 Facsimile 847-297-7800 www.pciaa.net


Assets of Impaired Firms, $million (Annual Average), 1980-2008
P/C & L/H Impairments, Thrifts & Banks incl. Assistance Transactions
Off-the-Chart
2008 Avg Firm Impaired:
Thrift $62B; Bank $56B
2,750
2,500
2,250
2,000
1,750
1,500
1,250
1,000
750
500
250
0
1980-82 Recession:
High unemployment and downturn in housing, steel and auto production.
1990-91 Recession:
Decreased industrial production and manufacturing-trade sales.
2001-03 Recession:
DotCom collapse, 9/11 attacks, Corporate accounting scandals.
2007- Present Recession:
Housing market collapse, bank failures, credit crunch.
'80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08
Thrifts
Banks
L/H
P/C



Source: A.M. Best Company, Office of Thrift Supervision (OTS), and Federal Deposit Insurance Corporation (FDIC)

Notes:

* Asset dollars are not inflation-adjusted

Property Casualty Insurance Industry

In 2003, a spike in impaired assets was driven by Kemper Insurance Companies - caused primarily by deficient loss reserves and inadequate pricing, according to A.M. Best, accounting for over 70% of the year's aggregate impaired insurer assets.

In 2008, the only property casualty insurers declared financially impaired were seven very small companies that did not maintain an A.M. Best financial strength rating. Four were mortgage title insurance companies. It is also notable that A.M. Best U.S. Property Casualty Report indicates that over the last 40 years the majority of property casualty financial impairments were caused by either deficient loss reserves, inadequate pricing or rapid growth (as opposed to over-leveraged assets)

Thrifts -
Through May 22, 2009, there have been four thrift impairments with assets of $14.8 Billion

Banks -
Through May 22, 2009, there have been 32 commercial bank impairments with assets of $19.5 billion.

As of 5-22-09

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 -- (House of Representatives - October 03, 2008)

[Page: H10712]

Mr. FRANK of Massachusetts. Madam Speaker, pursuant to House Resolution 1525, I call up from the Speaker's table the bill (H.R. 1424) to amend section 712 of the Employee Retirement Income Security Act of 1974, section 2705 of the Public Health Service Act, and section 9812 of the Internal Revenue Code of 1986 to require equity in the provision of mental health and substance-related disorder benefits under group health plans, and offer the motion at the desk.

The SPEAKER pro tempore. The Clerk will report the title of the bill, designate the Senate amendments, and designate the motion.

The Clerk read the title of the bill.

The text of the Senate amendments is as follows:

Strike all after the enacting clause and insert the following:

DIVISION A--EMERGENCY ECONOMIC STABILIZATION

SECTION 1. SHORT TITLE AND TABLE OF CONTENTS.

(a) *Short Title*.--This division may be cited as the ``Emergency Economic Stabilization Act of 2008".

(b) *Table of Contents*.--The table of contents for this division is as follows:

Sec..1..Short title and table of contents.

Sec..2..Purposes.

Sec..3..Definitions.

TITLE I--TROUBLED ASSETS RELIEF PROGRAM

Sec..101..Purchases of troubled assets.

Sec..102..Insurance of troubled assets.

Sec..103..Considerations.

Sec..104..Financial Stability Oversight Board.

Sec..105..Reports.

Sec..106..Rights; management; sale of troubled assets; revenues and sale proceeds.

Sec..107..Contracting procedures.

Sec..108..Conflicts of interest.

Sec..109..Foreclosure mitigation efforts.

Sec..110..Assistance to homeowners.

Sec..111..Executive compensation and corporate governance.

Sec..112..Coordination with foreign authorities and central banks.

Sec..113..Minimization of long-term costs and maximization of benefits for taxpayers.

Sec..114..Market transparency.

Sec..115..Graduated authorization to purchase.

Sec..116..Oversight and audits.

Sec..117..Study and report on margin authority.

Sec..118..Funding.

Sec..119..Judicial review and related matters.

Sec..120..Termination of authority.

Sec..121..Special Inspector General for the Troubled Asset Relief Program.

Sec..122..Increase in statutory limit on the public debt.

Sec..123..Credit reform.

Sec..124..HOPE for Homeowners amendments.

Sec..125..Congressional Oversight Panel.

Sec..126..FDIC authority.

Sec..127..Cooperation with the FBI.

Sec..128..Acceleration of effective date.

Sec..129..Disclosures on exercise of loan authority.

Sec..130..Technical corrections.

Sec..131..Exchange Stabilization Fund reimbursement.

Sec..132..Authority to suspend mark-to-market accounting.

Sec..133..Study on mark-to-market accounting.

Sec..134..Recoupment.

Sec..135..Preservation of authority.

Sec..136..Temporary increase in deposit and share insurance coverage.

TITLE II--BUDGET-RELATED PROVISIONS

Sec..201..Information for congressional support agencies.

Sec..202..Reports by the Office of Management and Budget and the Congressional Budget Office.

Sec..203..Analysis in President's Budget.

Sec..204..Emergency treatment.

TITLE III--TAX PROVISIONS

Sec..301..Gain or loss from sale or exchange of certain preferred stock.

Sec..302..Special rules for tax treatment of executive compensation of employers participating in the troubled assets relief program.

Sec..303..Extension of exclusion of income from discharge of qualified principal residence indebtedness.

SEC. 2. PURPOSES.

The purposes of this Act are--

(1) to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States; and

(2) to ensure that such authority and such facilities are used in a manner that--

(A) protects home values, college funds, retirement accounts, and life savings;

(B) preserves homeownership and promotes jobs and economic growth;

(C) maximizes overall returns to the taxpayers of the United States; and

(D) provides public accountability for the exercise of such authority.

SEC. 3. DEFINITIONS.

For purposes of this Act, the following definitions shall apply:

(1) **APPROPRIATE COMMITTEES OF CONGRESS.**--The term ``appropriate committees of Congress" means--

(A) the Committee on Banking, Housing, and Urban Affairs, the Committee on Finance, the Committee on the Budget, and the Committee on Appropriations of the Senate; and

(B) the Committee on Financial Services, the Committee on Ways and Means, the Committee on the Budget, and the Committee on Appropriations of the House of Representatives.

October 29, 2009

BRAD SHERMAN
UNITED STATES CONGRESS

PH: (202) 225-5911
FAX: (202) 225-5879

Re: Let's not Adopt "TARP on Steroids"

Dear Colleague:

The new Resolution Authority, set forth in Treasury's 253-page legislative draft of October 27, 2009 provides permanent, unlimited bailout authority. This means:

(1) Unprecedented powers for the Executive to decide spending and taxes, without Congressional approval; and

(2) Depending on the desires of the Executive Branch from time to time, the greatest transfer of money from the Treasury to Wall Street in U.S. history.

The bill allows for the bailout of both solvent and troubled financial institutions. **The Secretary of the Treasury has rejected a $1 Trillion limit on this bailout power** in testimony before the House Financial Services Committee on September 23, 2009.

The Executive Branch may loan an unlimited amount to any *solvent* financial institution "if necessary to prevent financial instability" (§1109(a)), or to a *troubled* financial institution, the default of which would "have serious effects on economic condition in the United States (§1603(b)(2) and §1604(c)(1)). As to troubled firms, the bailout can also take the form of purchasing assets from the institution (§1604(c)(2)) or investing in the institution (§1604(b)(4)).

When bailout funds are lent to a *solvent* financial institution under §1109, the executives and shareholders lose nothing. Executives keep their jobs and their compensation packages; shareholders retain all their rights. In contrast, when a *troubled* institution receives a bailout under §1604, some executives lose their jobs, and shareholders have to stand behind taxpayers.

The chief beneficiary of bailouts of *troubled* institutions is the creditors. The chief economic effect of Treasury's proposed unlimited bailout legislation is **to cause creditors to lend money on favorable terms to "systemically important institutions" (the top 10 to 25). If the institution cannot repay those creditors, the Government probably will.**

This paper analyzes the legislative proposal put forward by Treasury on October 27, 2009. Since then, I have had some preliminary discussions with Chairman Frank. The Chairman may consider accepting amendments which will address some of my concerns. Such amendments might provide for a sunset (with expedited consideration of legislation providing for an extension) and/or dollar limits on the amount of taxpayer funds advanced.

RECYCLED PAPER

(OVER)

However, the shareholders of bailed-out troubled institutions also stand to benefit handsomely. The taxpayers take an enormous risk by investing in the insolvent entity. If things go well, the taxpayers merely get their money back, and the shareholders own a revived profitable corporation.

The taxpayer losses are supposed to be recovered from a new tax imposed on large and medium-large financial institutions. **The statute requires the Executive Branch to recoup taxpayer funds within 60 months but then allows them to extend this period for as long as they want** (§1609(o)(1)). Further, it is difficult to see how any tax on financial institutions would provide the hundreds of billions of revenue which might be needed to repay a large bailout.

The Executive Branch is empowered to write this new tax law. (Under our Constitutional system, the House of Representatives is *supposed* to write tax laws.) Congress will have no say in whether the tax is designed to produce $10 million in revenue per year, or $10 billion. How much will be paid each year by a medium-sized financial institution — whether it will pay $100,000 or $100 million — will be decided by the Executive Branch, and the amount could be $100,000 in one year, and $100 million the next.

This law will allow those institutions which are clearly systematically important (the top 10 to 25) to borrow at a lower cost. This will help the largest institutions get larger, so they can pose a greater systemic risk.

Those financial institutions which are medium-large ($10 billion to $90 billion in assets) will have to pay whatever tax the Executive Branch imposes. However, they will not be able to borrow at lower rates, because investors will not believe they will be bailed out. (Under the plan, bailouts are supposed to go only to the "systemically important" institutions.) So those medium-large institutions will fund a program which benefits only their truly large competitors.

While the tax imposed on large and medium-large financial institutions is called an "assessment" or an "insurance premium," it is clearly a tax. No one has a right to collect any insurance amount — whether anyone gets a bailout is at the whim of the Executive Branch. It's like being forced to pay insurance on your competitor's business, while yours goes uninsured.

The tax is also called "polluter pays." But the "polluter" — the financial institution that took big risks, and became insolvent — pays nothing. Instead, prudent financial institutions must compete against the high-flyers in the good times, and then pay to bail out their high-flying competitors in the bad times.

Please join with me to insist that any future bailout will occur only with the approval of future Congresses. This will signal to Wall Street that future bailouts are unlikely. Accordingly, those lending money to huge Wall Street firms will do so only if those firms have strong balance sheets and prudent policies. The era of taxpayer-supported gambling is over.

---- Brad Sherman

STATEMENT OF THE COMMERCIAL MORTGAGE SECURITIES ASSOCIATION

In Connection With

THE UNITED STATES HOUSE FINANCIAL SERVICES COMMITTEE

Hearing on "Systemic Regulation, Prudential Matters, Resolution Authority and Securitization"

October 29, 2009

The Commercial Mortgage Securities Association ("CMSA") is grateful to Chairman Frank, Ranking Member Bachus, and the Members of the Committee for the opportunity to share our perspective concerning the securitized credit markets for commercial real estate in connection with your hearing on Systemic Regulation, Prudential Matters, Resolution Authority and Securitization.

We would like to take this opportunity to discuss securitization in the commercial real estate ("CRE") mortgage context and address the following issues in our statement: 1) the challenges facing the $3.5 trillion market for commercial real estate finance; 2) the unique structure of the commercial market and the need to customize regulatory reforms accordingly to support, and not undermine, our nation's economic recovery; and 3) efforts to restore the availability of credit by promoting and enhancing the viability of commercial mortgage-backed securities ("CMBS").

CMSA & The Current State of the Market

CMSA represents the full range of CMBS market participants, including investment and commercial banks; rating agencies; accounting firms; servicers; other service providers; and investors such as insurance companies, pension funds, and money managers. CMSA is a leader in the development of standardized practices and in ensuring transparency in the commercial real estate capital market finance industry.

Because our membership consists of all constituencies across the entire market, CMSA has been able to develop comprehensive responses to policy questions to promote increased market efficiency and investor confidence. For example, our members continue to work closely with policymakers in Congress, the Administration, and financial regulators, providing practical advice on measures designed to restore liquidity and facilitate lending in the commercial mortgage market (such as the Term Asset-Backed Securities Loan Facility ("TALF") and the Public-Private Investment Program ("PPIP")). CMSA also actively participates in the public policy debates that impact the commercial real estate capital markets.

The CMBS market is a responsible and key contributor to the overall economy that historically has provided a tremendous source of capital and liquidity to meet the needs of commercial real estate borrowers. CMBS helps support the commercial real estate markets that fuel our country's economic growth. The loans financed through those markets help provide jobs and services to local communities, as well as housing for millions of Americans in multi-family dwellings.

Unfortunately, the recent turmoil in the financial markets coupled with the overall downturn in the U.S. economy have brought the CMBS market to a standstill and created many pressing challenges, specifically:

- No liquidity or lending – While the CMBS market provided approximately $240 billion in commercial real estate financing in 2007 (nearly 50% of all commercial lending), CMBS issuance fell to $12 billion in 2008, despite strong credit performance and high borrower demand. There has been no new private label CMBS issuance year-to-date in 2009, as the lending markets remain frozen;

- Significant loan maturities through 2010 – At the same time, there are significant commercial real estate loan maturities this year and next – amounting to hundreds of billions of dollars – but the capital necessary to re-finance these loans remains largely unavailable and loan extensions are difficult to achieve; and

- The U.S. economic downturn persists – The U.S. recession continues to negatively affect both consumer and business confidence, which impacts commercial and multifamily occupancy rates and rental income, as well as business performance and property values.

Significantly, it is important to note that the difficulties faced by the overall CRE market are not attributable solely to the current trouble in the CMBS market, but also stem from problems with unsecured CRE debt, such as construction loans. As described by Richard Parkus, an independent research analyst with Deutsche Bank who has testified before both the Joint Economic Committee and the TARP Oversight Panel, while the overall CRE market will experience serious strain (driven by poor consumer confidence and business performance, high unemployment, and property depreciation), it is the non-securitized debt on the books of small and regional banks that will be most problematic, as the projected default rates for such unsecuritized commercial debt have been, and are expected to continue to be, significantly higher than CMBS loan default rates.

As recently as early this year, default rates in the CMBS market, which have historically been low (less than .50% for several years) still hovered around a mere 1.25%. Unfortunately, the economic recession that began as a crisis of liquidity in some sectors transformed into a crisis in confidence that affected all sectors, and it was only a matter of time before CMBS was affected. No matter the strength of our fundamentals and loan performance, once investors lost confidence and began to shy away from mortgaged-backed securities, CMBS could not avoid the contagion.

This unfortunate combination of circumstances leaves the broader CRE sector and the CMBS market with several overarching problems: 1) a liquidity gap (the difference between borrowers' demand for credit and the nearly non-existent supply of credit); 2) an equity gap (the difference between the current market value of commercial properties and what is owed on them, which will be extremely difficult to refinance as current loans mature); and 3) the fact that potential CMBS sponsors are very reluctant to take the risk of trying to aggregate loans for securitization, since there is no assurance that private sector investors will buy the securities, all of which serves to simply perpetuate the cycle of frozen credit markets.

Unique Characteristics of the CMBS Market

There are a number of important distinctions between CMBS and other asset-backed securities ("ABS") markets, and those distinctions should be considered in fashioning any broad securitization-related regulatory reforms. These differences relate not only to the structure of securities, but also to the underlying collateral, the type and sophistication of the borrowers, as well as to the level of transparency in CMBS deals.

Commercial Borrowers

Commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases. This characteristic stands in stark contrast to the residential market where, for example, loans were underwritten in the subprime category for borrowers who may not have been able to document their income, or who may not have understood the effects of factors like floating interest rates and balloon payments on their mortgage's affordability.

Additionally, securitized commercial mortgages have different terms (generally 5-10 year "balloon" loans), and they are, in the vast majority of cases, non-recourse loans. This means that if the borrower defaults, the lender can seize the collateral, although it may not pursue a claim against the borrower for any deficiency in recovery. This dramatically decreases the cost of default because the loan work-out recoveries in the CMBS context tend to be significantly more efficient than, for example, the residential loan foreclosure process.

Structure of CMBS

There are multiple levels of review and diligence concerning the collateral underlying CMBS, which help ensure that investors have a well informed, thorough understanding of the risks involved. Specifically, in-depth property-level disclosure and review are done by credit rating agencies as part of the process of rating CMBS bonds.

Moreover, non-statistical analysis is performed on CMBS pools. This review is possible given that there are only 100-300 commercial loans in a pool that support a bond, as opposed, for example, to tens of thousands of loans in residential mortgage-backed securities pools. This limited number of loans allows market participants (investors, rating agencies, etc.) to gather detailed information about income producing properties and the integrity of their cash flows, the credit quality of tenants, and the experience and integrity of the borrower and its sponsors, and thus conduct independent and extensive due diligence on the underlying collateral supporting their CMBS investments.

First-loss Investor ("B-Piece Buyer") Re-Underwrites Risk

CMBS bond issuances include a first-loss, non-investment grade bond component. The third-party investors that purchase these lowest-rated securities (referred to as "B-piece" or "first-loss" investors) conduct their own extensive due diligence (usually including, for example, site visits to every property that collateralizes a loan in the loan pool) and essentially re-underwrite all the loans in the proposed pool. Because of this, the B-piece buyers often negotiate the removal of any loans they consider to be unsatisfactory from a credit perspective, and specifically negotiate with bond sponsors or originators to purchase this non-investment-grade risk component of the

bond offering. This third-party investor due diligence and negotiation occurs on every deal before the investment-grade bonds are issued.

Greater Transparency

A wealth of transparency currently is provided to CMBS market participants via the CMSA Investor Reporting Package® (CMSA IRP®). The CMSA IRP provides access to loan, property and bond-level information at issuance and while securities are outstanding, including updated bond balances, amount of interest and principal received, and bond ratings, as well as loan-level and property-level information on an ongoing basis. The "CMSA IRP" has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market.

Current Efforts to Restore Liquidity

Private investors are absolutely critical to restoring credit availability in the capital finance markets. Accordingly, government initiatives and reforms must work to encourage private investors – who bring their own capital to the table – to come back to the capital markets.

Treasury Secretary Geithner emphasized this need when he stressed during the introduction of the Administration's Financial Stability Plan that "[b]ecause this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small." The importance of restoring the securitization markets is recognized globally as well, with the International Monetary Fund noting in its most recent Global Financial Stability Report that "restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions."[1]

As a centerpiece of the Financial Stability Plan, policymakers hope to restart the CMBS and other securitization markets through innovative initiatives (such TALF and the PPIP), and CMSA welcomes efforts to utilize private investors to help fuel private lending. In this regard, the TALF program for new CMBS issuance has been particularly helpful in our space, as evidenced in triple-A CMBS cash spreads tightening almost immediately after the program was announced, as one example.

To this end, CMSA continues to engage in an ongoing dialogue with many members of the relevant Congressional committees, as well as with key policymakers at the Treasury Department, Federal Reserve and other agencies, and with participants in various sectors of the commercial real estate market. The focus of our efforts has been on creative solutions to help bring liquidity back to the commercial real estate finance markets. We appreciate policymakers' recognition, as evidenced by programs like TALF and PPIP, that a major part of the solution will be to bring private investors back to the market through securitization. We also appreciate the willingness of Congress and other policymakers to listen to our recommendations on how to make these programs as effective as possible.

---

[1] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (October 2009), at 33 ("Conclusions and Policy Recommendations" section) available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

There is still a long way to go toward recovery in the CRE market, however, despite the early success of the TALF program. The market faces the overarching problems of the liquidity and equity gaps. This is driven in part by the absence of any aggregation mechanism – securitizers are unwilling to bear all of the non-credit risks (like interest rate changes) they must currently take on between the time a loan is made and when it can be securitized (a process that takes months across a pool of loans). This is especially true now when there still is uncertainty as to whether there will be willing investors at the end of the process.

CMSA also is committed to working on additional long-term solutions to ensure the market is able to meet ongoing commercial borrowing demands. For example, CMSA supports efforts to facilitate a U.S. commercial covered bond market in order to provide an additional source of liquidity through new and diverse funding sources. We will continue to work with Congress on the introduction of comprehensive legislation that would include high quality commercial mortgage loans and CMBS as eligible collateral in the emerging covered bond marketplace.

Financial Regulatory Reform and Commercial Real Estate

The Administration has proposed new and unprecedented financial regulatory reform proposals that will change the nature of the securitized credit markets which are at the heart of recovery efforts. A discussion draft of proposed legislation for consideration by this Committee that incorporates many of the Administration's suggestions also has been distributed. These securitization reform proposals appear to be prompted by some of the practices that were typical in the subprime and residential securitization markets. At the outset, we must note that CMSA does not oppose efforts to address such issues, as we have long been an advocate within the industry for enhanced transparency and sound practices.

As a general matter, however, policymakers must ensure that any regulatory reforms are tailored to address the specific needs of each securitization asset class. As discussed above, the structure of the CMBS market has incorporated safeguards that minimize the risky securitization practices that policymakers hope to address. Thus, the securitization reform initiatives should be tailored to take these differences into account. In doing so, policymakers can protect the viability of the markets that already are functioning in a way that does not pose a threat to overall economic stability, and ensure that such markets can continue to be a vital component of the economic recovery solution.

CMSA and its members are concerned that the Administration's securitization reform proposals could undermine rather than support the Administration's many innovative efforts to re-start the securitization markets, effectively stalling recovery efforts by making lenders less willing or able to extend loans and investors less willing or able to buy CMBS bonds – two critical components to the flow of credit in the commercial market.

The two aspects of the securitization reform proposal that are of utmost concern to CMSA is the requirement that originators retain at least 10 percent of the credit risk in any securitized asset they sell, and an associated restriction on the ability of originators to hedge the retained risk. Again, CMSA does not oppose these measures *per se*, but emphasizes that they should be tailored to reflect key differences between the different asset-backed securities markets.

Significantly, we are not alone in advocating a tailored approach. The IMF, which recently expressed concern that U.S. and European retained risk proposals may be too simplistic, warned that "[p]roposals for retention requirements should not be imposed uniformly across the board, but tailored to the type of securitization and underlying assets to ensure that those forms of securitization that already benefit from skin in the game and operate well are not weakened. The effects induced by interaction with other regulations will require careful consideration."

Risk Retention for Securitizers

The retention of risk is an important component regardless of who ultimately retains it: the originator, the issuer, or the first-loss buyer. As explained above, the CMBS structure has always had a third-party in the first-loss position that specifically negotiates to purchase this risk. Most significantly, these third-party investors are able to, and do, protect their own interests in the long-term performance of the bonds rather than relying merely on the underwriting and representations of securitizers or originators. First-loss buyers conduct their own extensive credit analysis on the loans, examining detailed information concerning every property – before buying the highest risk bonds in a CMBS securitization. In many cases, the holder of the first-loss bonds is also related to the special servicer who is responsible on behalf of all bondholders as a collective group for managing and resolving defaulted loans through workouts or foreclosure.

Thus, the policy rationale for imposing a risk retention requirement on issuers or underwriters as "securitizers" that could preclude them from transferring the first-loss position to third parties is unnecessary in this context, because, although the risk is transferred, it is transferred to a party that is acting as a "securitizer" and that is fully cognizant, through its own diligence, of the scope and magnitude of the risk it is taking on. In effect, when it comes to risk, the first-loss buyer is aware of everything the issuer or underwriter is aware of.

Because the CMBS market is structured differently than other securitization markets, policymakers' focus in this market should be on the proper transfer of risk (e.g., sufficient collateral disclosure, adequate due diligence and/or risk assessment procedures on the part of the risk purchaser), analogous to what takes place in CMBS transactions. Therefore, CMBS originators and issuers should be permitted to transfer risk to B-piece buyers who – in the CMBS context at least – act as "securitizers." To require otherwise would hamper the ability of CMBS lenders to originate new bond issuances by needlessly tying up their capital and resources in the retained risk, which, in turn, would squelch the flow of credit at a time when our economy desperately needs it.

CMSA therefore suggests that securitization legislation specifically clarify that the definition of "securitizer" include third parties akin to the CMBS first-loss investors. Such an approach will provide explicit recognition of the ability to transfer retained risk to third parties under circumstances in which the third party agrees to retain the risk and is capable of adequately protecting its own interests.

Prohibition on Hedging of Retained Risk

In conjunction with the retained risk requirement, there also is a proposal to prohibit "securitizers" from hedging that risk. Rather than adopting an outright ban on hedging the retained risk, however, the measure needs to be designed to strike a balance between fulfilling the legislation's objective of ensuring that securitizers maintain an appropriate stake in the risks they

underwrite. Such tailoring is necessary to avoid imposing undue constraints on "protective" mechanisms that are legitimately used by securitizers to maintain their financial stability.

Several risks inherent in any mortgage or security exposure arise not from imprudent loan origination and underwriting practices, but from outside factors such as changes in interest rates, a sharp downturn in economic activity, or regional/geographic events such as a terrorist attack or weather-related disaster. Securitizers attempt to hedge against these market-oriented factors in keeping with current safety and soundness practices, and some examples in this category of hedges are interest rate hedges using Treasury securities, relative spread hedges (using generic interest-rate swaps), and macro-economic hedges (that, for example, are correlated with changes in GDP or other macro-economic factors). The hallmark of this category is that these hedges seek protection from factors the securitizer does not control, and the hedging has neither the purpose nor the effect of shielding the originators or sponsors from credit exposures on individual loans.

As such, hedges relate to generally uncontrollable market forces that cannot be controlled independently. There is no way to ensure that any such hedge protects 100% of an investment from loss – particularly as it pertains to a CMBS transaction that, for example, is secured by a diverse pool of loans with exposure to different geographic locations, industries and property types. Therefore, loan securitizers that must satisfy a retention requirement continue to carry significant credit risk exposure that reinforces the economic tie between the securitizer and the issued CMBS even in the absence of any hedging constraints.

For these reasons, securitization reform legislation should not seek to prohibit securitizers from using market-oriented hedging vehicles. Instead, if a limitation is to be placed on the ability to hedge, it should be targeted to prohibit hedging any *individual* credit risks within the pool of risks underlying the securitization. Because these types of vehicles effectively allow the originator or issuer to completely shift the risk of default with respect to a particular loan or security, their use could provide a disincentive to engage in prudent underwriting practices – the specific type of disincentive policymakers want to address.

Conclusion

There are enormous challenges facing the commercial real estate sector. While regulatory reforms are important and warranted, these proposals should not detract from or undermine efforts to get credit flowing, which is critical to economic recovery. Moreover, any policies that make debt or equity interests in commercial real estate less liquid will have a further negative effect on property values and the cost of capital. Accordingly, we urge Congress to ensure that regulatory reform measures are tailored to account for key differences in the various securitization markets.

October 28, 2009

The Honorable Barney Frank
Chairman
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
2128 Rayburn House Office Building
Washington, DC 20515

Re: Financial Regulatory Reform and Commercial Real Estate Finance

Dear Chairman Frank and Ranking Member Bachus:

As a broad and diverse group representing all market participants in the commercial real estate sector, we applaud you for recognizing the need to restore confidence and to provide greater transparency in our financial markets through regulatory reform. In the coming weeks, as the Committee explores financial regulatory reform proposals, we urge you to consider the enormous challenges facing commercial real estate and the uniqueness of the markets that finance this $6 trillion sector by customizing reforms accordingly in order to support, rather than impede, our market's recovery.

Over the last two decades, commercial real estate has helped fuel our nation's economic growth while providing jobs and services to local communities, as well as housing for millions of Americans in multi-family dwellings. Unfortunately, the recent turmoil in our economy and financial markets has created a serious lack of liquidity and virtually no credit availability in the commercial mortgage market. For instance, the commercial mortgage-backed securities (CMBS) market – which represented more than $230 billion of financing in 2007 (or nearly half of all commercial lending) – provided less than $13 billion in loan issuance in 2008, despite strong credit performance and tremendous demand from borrowers. Most alarming, there has been no private label CMBS issuance to date this year.

This lack of capacity – coupled with the downturn in the overall economy, including high unemployment, low consumer confidence and falling property values – threatens our economic recovery and is severely compounded by the fact that more than $1 trillion in commercial mortgage loan maturities are coming due in the next several years. In fact, the inability to secure financing could easily result in increased loan defaults, or the forced sale of properties at greatly depressed prices, creating a ripple effect of financial losses and more job layoffs.

We have welcomed efforts to promote liquidity and facilitate private lending, such as the Term Asset-Backed Securities Lending Facility (TALF) and Public Private Investment Program (PPIP). We also recognize and appreciate that policymakers have approached regulatory reforms with a sense of urgency to address the lack of certainty and confidence in our financial markets that threatens our entire financial system and recovery in the commercial real estate market. In this regard, it is crucial that reforms are sufficiently tailored to account for the essential differences of inherently different markets, such as commercial real estate, so that reforms do not undermine these recovery efforts.

Specifically, we urge policymakers to ensure that reforms aimed at the securitized credit markets are customized and applied appropriately in order to support the existing financing mechanisms in commercial real estate finance that work well, create liquidity, and promote sound practices and transparency. It is most critical, for example, that any risk retention requirement be structured carefully to maintain and strengthen the safeguards that exist in the CMBS market by explicitly recognizing the important role of third party investors who retain a first-loss position and – during the pre-issuance phase – conduct extensive due diligence and re-underwrite the loans in the pool (in addition to the originators and issuers that would be encompassed by the retention requirements under the Administration's initial proposal). In this regard, we highlight a recent recommendation by the International Monetary Fund (IMF) that "[p]roposals for retention requirements should not be imposed uniformly across the board, but tailored to the type of securitization and underlying assets to ensure that those forms of securitization that already benefit from skin in the game and operate well are not weakened."

Ultimately, there is no question that our nation's regulatory reform structure needs to be updated to meet current and future challenges and to provide investors and consumers with regulatory certainty and transparency. At the same time, tailoring the final regulatory reform proposals to avoid a "one size fits all" approach to the securitized credit markets for commercial real estate will support efforts to restore lending – and the capital markets investing that fuels such lending – which is critical to our overall recovery.

We appreciate your consideration and stand ready to work with you on these issues.

Sincerely,

American Land Title Association
American Resort Development Association
Associated General Contractors of America
Building Owners and Managers Association International
CCIM Institute
Commercial Mortgage Securities Association
Institute of Real Estate Management
International Council of Shopping Centers
NAIOP, Commercial Real Estate Development Association
National Association of REALTORS®
National Association of Real Estate Investment Managers

cc: Subcommittee Chairman Paul E. Kanjorski
Subcommittee Ranking Member Scott Garrett

Addendum to the Testimony of Jane D'Arista, October 29, 2009:
Proposals to Regulate Proprietary Trading

The explosion in proprietary trading that inflated the balance sheets of large financial institutions was encouraged by the relaxation of restrictions on borrowing by banks under the Financial Services Modernization Act (Gramm-Leach-Bliley) of 1999 that facilitated the increase in lending by financial institutions to other financial institutions, and the SEC's relaxation of leverage ratios for investment banks in 2004. Regulatory proposals to rein in proprietary trading include those that would impose an out-right ban on the activity by banks, as suggested by former Federal Reserve Board Chairman, Paul Volcker, and others that would do so by restricting leverage and/or limiting financial institutions' short-term borrowing. These include:

- **higher capital requirements on assets banks acquire through proprietary trading.**
- **liquidity requirements to limit short-term borrowing by banks.**
- **re-imposing pre-2004 leverage ratios on investment banks.**
- **leveling the playing field by imposing leverage limits on all financial institutions, including the finance arms of conglomerates and hedge and private equity funds. These limits could be raised or lowered by the systemic regulator to counter either a boom or downturn.**
- **margin requirements on all tradable instruments, not just equities. These requirements would constrain excessive use of leverage by nonfinancial as well as financial speculators and give the systemic regulator another countercyclical tool to dampen or encourage trading in particular assets such as mortgage-backed and other asset-backed securities as well as commodities and derivatives.**
- **extending the provisions of the National Bank Act to limit individual and aggregate bank lending to financial counterparties in relation to capital.**
- **imposing a tax on securities transactions to provide a disincentive for trading.**

November 25, 2009

Phillip Swagel
Georgetown University
ps396@georgetown.edu
(202) 687-4869 office

Supplemental answer for Page 230, line 5063 of transcript for the October 29, 2009 Committee on Financial Services hearing on "Systemic Regulation, Prudential Matters, Resolution Authority, and Securitization."

This note responds to the request of Representative Watt that I should provide a written explanation for why the director of a consumer financial protection agency should not be part of a systemic risk oversight council.

I believe that it would be a bad idea for the director of a consumer financial protection agency to have a seat on a systemic risk oversight council. The roles for these two organizations are very different and potentially in conflict. At times of crisis, it is possible that steps must be taken that appear to be "unfair" to consumers in a narrow perspective, but necessary for a broader purpose of financial and economic stability. I worry that a director of a consumer financial protection agency would not have the expertise to recognize and evaluate the tradeoffs involved, and that the mission of this person's agency would lead him or her to naturally oppose steps to stabilize the financial system because they might be seen as unfair to consumers. Indeed, I worry that a director of the consumer financial protection agency would see such a situation as an opportunity for "bureaucratic leverage," under which the director would assent to recommending or undertaking the steps necessary to address a systemic financial issue only in return for other members of the systemic oversight council agreeing to certain consumer-related provisions. The role of the director of a consumer financial protection agency would be to focus on consumers; this should not be diluted by asking the director to focus on the broad systemic stability of the financial system or the economy.

A better approach to the issues of systemic risk oversight and consumer protection was developed in the Department of the Treasury's March 2008 Blueprint for Financial Regulatory Reform. That document describes an optimal regulatory structure with three regulators: a regulator focused on market stability across the entire financial sector, a regulator focused on safety and soundness of those institutions supported by a federal guarantee, and a regulator focused on protecting consumers and investors.

The market stability regulator would be given broad powers to protect the stability of the overall financial system. To do this effectively, the market stability regulator should collect information from all market participants including commercial banks, investment banks, insurance companies, hedge funds and commodity pool operators. But rather than focus on the health of a particular individual organization, it will focus on whether a firm's or industry's practices threaten overall financial stability. This function should be kept distinct from that of the protection of consumers and investors.