MODERNIZING BANK SUPERVISION AND REGULATION—PART I

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S. HRG. 111–109

MODERNIZING BANK SUPERVISION AND REGULATION—PART I

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING WAYS TO MODERNIZE AND IMPROVE BANK REGULATION AND SUPERVISION, TO PROTECT CONSUMERS AND INVESTORS, AND HELP GROW OUR ECONOMY IN THE FUTURE

MARCH 19, 2009

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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MODERNIZING BANK SUPERVISION AND REGULATION—PART I

THURSDAY, MARCH 19, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:37 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order.

Senator Shelby is in his office. He will be along shortly but asked us to commence the hearing. So we will begin this morning. Let me welcome my colleagues, welcome our witnesses as well. We have another long table here this morning of witnesses, and we are trying to move through this series of hearings on the modernization of financial regulation. So I am very grateful to all of you for your testimony.

The testimony is lengthy, I might add. Going through last evening the comments—there is Senator Shelby. Very, very helpful, though, and very informative testimony, so we thank you all for your contribution.

I will open up with some comments. I will turn to Senator Shelby, and then we will get right to our witnesses. We have got votes this morning as well, I would notify my colleagues, coming up so we are going to have to stagger this a bit so we do not delay the hearing too long, and we will try to, each one of us, go out and vote and come back so we can continue the hearing uninterrupted, if that would work out. So I will ask my colleagues' indulgence in that regard as well.

We are gathering here again this morning to discuss the modernization of bank supervision and regulation. This hearing marks yet another in a series of hearings to identify causes of the financial crisis and specific responses that will guide this Committee's formulation of a new architecture for the 21st century financial services regulation.

Today, we are going to explore ways to modernize and improve bank regulation and supervision, to protect consumers and investors, and help grow our economy in the decades ahead. A year ago, this Committee heard from witnesses on two separate occasions that the banking system was sound and that the vast majority of banks would be well positioned to weather the storm.

A year later, taxpayers are forced to pump billions of dollars into our major banking institutions to keep them afloat. Meanwhile, every day 20,000 people, we are told, are losing their jobs in our country, 10,000 families' homes are in jeopardy from foreclosure, and credit—the lifeblood of our economy—is frozen solid. People are furious right now, and they should be. But history will judge whether we make the right decisions. And as President Obama told the Congress last month, we cannot afford to govern out of anger or yield to the politics of the moment as we prepare to make choices that will shape the future of our country literally for decades and decades to come.

We must learn from the mistakes and draw upon those lessons to shape the new framework for financial services regulation, an integrated, transparent, and comprehensive architecture that serves the American people well through the 21st century.

Instead of the race to the bottom we saw in the run-up to the crisis, I want to see a race to the top, with clear lines of authority, strong checks and balances that build the confidence in our financial system that is so essential to our economic growth and stability.

Certainly there is a case to be made for a so-called systemic risk regulator within that framework, and whether or not those vast powers will reside in the Fed remains an open question, although the news this morning would indicate that maybe a far more open question in light of the balance sheet responsibilities.

And, Mr. Tarullo, we will be asking you about that question this morning to some degree as well. This news this morning adds yet additional labors and burdens on the Fed itself, and so the question of whether or not, in addition to that job, we can also take on a systemic risk supervisor capacity is an issue that I think a lot of us will want to explore.

As Chairman Bernanke recently said, the role of the systemic risk regulator will entail a great deal of expertise, analytical sophistication, and the capacity to process large amounts of disparate information. I agree with Chairman Bernanke, which is why I wonder whether it would not make more sense to give authority to resolve failing and systemically important institutions to the agency with actual experience in the area—the FDIC.

If the events of this week have taught us anything, it is that the unwinding of these institutions can sap both public dollars and public confidence essential to getting our economy back on track. This underscores the importance of establishing a mechanism to resolve these failing institutions.

From its failure to protect consumers, to regulate mortgage lending, to effectively oversee bank holding companies, the instances in which the Fed has failed to execute its existing authority are numerous. In a crisis that has taught the American people many hard learned lessons, perhaps the most important is that no institution should ever be too big to fail. And going forward, we should consider how that lesson applies not only to our financial institutions, but also to the Government entities charged with regulating them.

Replacing Citibank-size financial institutions with Citibank-size regulators would be a grave mistake. This crisis has illustrated all too well the dangers posed to the consumer and our economy when

we consolidate too much power in too few hands with too little transparency and accountability.

Further, as former Fed Chairman Volcker has suggested, there may well be an inherent conflict of interest between prudential supervision—that is, the day-to-day regulation of our banks—and monetary policy, the Fed's primary mission—and an essential one, I might add.

One idea that has been suggested that could complement and support an entity that oversees systemic risk is a consolidated safety and soundness regulator. The regulatory arbitrage, duplication, and inefficiency that comes with having multiple Federal banking regulators was at least as much of a problem in creating this crisis as the Fed's inability to see the crisis coming and its failure to protect consumers and investors. And so systemic risk is important, but no more so than the risk to consumers and depositors, the engine behind our very banking system.

Creating that race to the top starts with building from the bottom up. That is why I am equally interested in what we do to the prudential supervision level to empower regulators, the first line of defense for consumers and depositors, and increase the transparency that is absolutely essential to checks and balances and to a healthy financial system.

Each of these issues leads us to a simple conclusion: The need for broad, comprehensive reform is clear. We cannot afford to address the future of our financial system piecemeal or *ad hoc* without considering the role that every actor at every level must play in creating a stable banking system that helps our economy grow for decades to come. That must be our collective goal.

With that, let me turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

We are in the midst of an unprecedented financial crisis. I believe the challenge before us involves three tasks: First, we must work to stabilize the system. Second, we must understand the origins of the current crisis. And, third, we must work to restructure our regulatory regime to meet the demands of a 21st century financial system.

Today, the Committee will focus primarily on the third task, rebuilding the regulatory structure. I believe the success of our effort will depend a great deal on our ability to determine what led us to this point. Without that knowledge, we will not know whether we are regulating the right things in the right way.

We need to determine whether the regulators had sufficient authority and whether they used the authority they had to the fullest extent. We need to consider here whether market developments outpace current regulatory capabilities. We also need to better understand the impact regulation has on the private sector's due diligence and risk management practices.

After understanding the nature of the regulatory structure, I believe we need to come to an understanding as to the specific cause or causes of the regulatory failure. We then need to address those failures in such a manner where we create a durable, flexible, and

robust regime that can grow with markets while still protecting consumers and market stability.

This is a very tall order. It will take an intensive and extended effort on our behalf, but in the end, getting this thing done right is more important than getting it done quickly.

Thank you, Mr. Chairman.

Chairman DODD. We have a lot of witnesses, but some of my colleagues may want to make some very brief opening comments on this. Senator Brown, you are next in line. Do you want to make a brief opening comment on this at all?

Senator BROWN. I will pass.

Chairman DODD. You will. Senator Bunning.

Senator BUNNING. Pass.

Chairman DODD. As well. Senator Tester.

Senator TESTER. I will pass.

Chairman DODD. As well. Senator Crapo.

Senator CRAPO. Pass.

Chairman DODD. Let me see. Senator Warner.

Senator WARNER. I will pass.

Chairman DODD. We have a trend going here. Senator Bennett? I was told by my staff that some members wanted to be heard, so I am just responding to the staff request.

Senator BENNETT. I just want to thank you for holding the hearing and recognize that it is going to be the first in a series, because there is probably nothing more important that we will do in this Committee this year than deal with this problem. The future is a very—there are many demands that we have to deal with, with respect to the future here.

Chairman DODD. Thank you.

Senator Schumer.

Senator SCHUMER. Pass.

Chairman DODD. All right. Senator Merkley.

Senator MERKLEY. I will pass.

Chairman DODD. Senator Bennet.

Senator BENNET. I appreciate the opportunity to make a lengthy opening statement.

[Laughter.]

Chairman DODD. Statements will be included in the record. We will make sure that happens.

We will begin with our witnesses here. We are very fortunate to have a good, strong group of folks who know these issues well and have been involved before with this Committee on numerous occasions. Let me briefly introduce them each.

I will begin with John Dugan. He is currently the Comptroller of the Currency. We thank you for coming back before the Committee once again.

Sheila Bair, Chairperson of the Federal Deposit Insurance Corporation, has been before the Committee on numerous occasions.

We have next Michael Fryzel, Chairman of the National Credit Union Administration, and we appreciate your participation.

Dan Tarullo is with the Federal Reserve. We thank you, Dan. Congratulations on your recent confirmation as well.

Scott Polakoff currently serves as the Acting Director of the Office of Thrift Supervision.

Joseph Smith is currently North Carolina Commissioner on Banks and is appearing on behalf of the State Bank Supervisors, and we thank you for being here.

And George Reynolds is the Chairman of the National Association of State Credit Union Supervisors and Senior Deputy Commissioner of the Georgia Department of Banking and Finance. And we thank you as well for joining us.

I am going to ask, given the magnitude, the size of our Committee here this morning—I noticed, for instance, John, your testimony is about 18 or 20 pages long last night as I went through it, and I am hopeful you are not going to try and do all 20 pages here this morning. Dan, yours is about 16 or 17 pages as well. If you could abbreviate this down to about 5 or 6 minutes or so—and it is important we hear what you have to say, so I do not want to constrain you too much. But I would like to be able to get through everyone so we can go through the question period.

We will begin with you.

STATEMENT OF JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. DUGAN. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee.

The financial crisis has raised legitimate questions about whether we need to restructure and reform our financial regulatory system, and I welcome the opportunity to testify on this important subject on behalf of the OCC.

Let me summarize the five key recommendations from my written statement which address issues raised in the Committee's letter of invitation.

First, we support the establishment of a systemic risk regulator, which probably should be the Federal Reserve Board. In many ways, the Board already serves this role with respect to systemically important banks, but no agency has had similar authority with respect to systemically important financial institutions that are not banks, which created real problems in the last several years as risk increased in many such institutions. It makes sense to provide one agency with authority and accountability for identifying and addressing such risks across the financial system.

This authority should be crafted carefully, however, to address the very real concerns of the Board taking on too many functions to do all of them well, while at the same time concentrating too much authority in a single Government agency.

Second, we support the establishment of a regime to stabilize resolve and wind down systemically significant firms that are not banks. The lack of such a regime this past year proved to be an enormous problem in dealing with distressed and failing institutions such as Bear Stearns, Lehman Brothers, and AIG. The new regime should provide tools that are similar to those the FDIC currently has for resolving banks, as well as provide a significant funding source, if needed, to facilitate orderly dispositions, such as a significant line of credit from the Treasury. In view of the systemic nature of such resolutions and the likely need for Government funding, the systemic risk regulator and the Treasury Department should be responsible for this new authority.

Third, if the Committee decides to move forward with reducing the number of bank regulators—and that would, of course, shorten this hearing—we have two general recommendations. The first may not surprise you. We believe strongly that you should preserve the role of a dedicated prudential banking supervisor that has no job other than bank supervision. Dedicated supervision produces no confusion about the supervisor's goals or mission, no potential conflict with competing objectives; responsibility and accountability are well defined; and the result is a strong culture that fosters the development of the type of seasoned supervisors that we need. But my second recommendation here may sound a little strange coming from the OCC given our normal turf wars. Congress, I believe, should preserve a supervisory role for the Federal Reserve Board, given its substantial experience with respect to capital markets, payment systems, and the discount window.

Fourth, Congress should establish a system of national standards that are uniformly implemented for mortgage regulation. While there were problems with mortgage underwriting standards at all mortgage providers, including national banks, they were least pronounced at regulated banks, whether State or nationally chartered. But they were extremely severe at the nonbank mortgage companies and mortgage brokers regulated exclusively by the States, accounting for a disproportionate share of foreclosures. Let me emphasize that this was not the result of national bank preemption, which in no way impeded States from regulating these providers. National mortgage standards with comparable implementation by Federal and State regulators would address this regulatory gap and ensure better mortgages for all consumers.

Finally, the OCC believes the best way to implement consumer protection regulation of banks, the best way to protect consumers is to do so through prudential supervision. Supervisors' continual presence in banks through the examination process creates especially effective incentives for consumer protection compliance, as well as allowing examiners to detect compliance failures much earlier than would otherwise be the case. They also have strong enforcement powers and exceptional leverage over bank management to achieve corrective action. That is, when examiners detect consumer compliance weaknesses or failures, they have a broad range of corrective tools from informal comments to formal enforcement action, and banks have strong incentives to move back into compliance as expeditiously as possible.

Finally, because examiners are continually exposed to the practical effects of implementing consumer protection rules for bank customers, the prudential supervisory agency is in the best position to formulate and refine consumer protection regulation for banks.

Proposals to remove consumer protection regulation and supervision from prudential supervisors, instead consolidating such authority in a new Federal agency, would lose these very real benefits, we believe. If Congress believes that the consumer protection regime needs to be strengthened, the best answer is not to create a new agency that would have none of the benefits of the prudential supervisor. Instead, we believe the better approach is for Congress to reinforce the agency's consumer protection mission and direct them to toughen the applicable standards and close any gaps

in regulatory coverage. The OCC and the other prudential bank supervisors will rigorously apply any new standards, and consumers will be better protected.

Thank you very much. I would be happy to answer questions.

Chairman DODD. Thank you very much.

Ms. Bair, thank you for joining us.

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

Ms. BAIR. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today.

Our current regulatory system has clearly failed in many ways to manage risk properly and to provide market stability. While it is true that there are regulatory gaps which need to be plugged, U.S. regulators already have broad powers to supervise financial institutions. We also have the authority to limit many of the activities that undermined our financial system. The plain truth is that many of the systemically significant companies that have needed unprecedented Federal help were already subject to extensive Federal oversight. Thus, the failure to use existing authorities by regulators casts doubt on whether simply entrusting power in a new systemic risk regulator would be enough.

I believe the way to reduce systemic risk is by addressing the size, complexity, and concentration of our financial institutions. In short, we need to end "too big to fail." We need to create regulatory and economic disincentives for systemically important financial firms. For example, we need to impose higher capital requirements on them in recognition of their systemic importance to make sure they have adequate capital buffers in times of stress. We need greater market discipline by creating a clear, legal mechanism for resolving large institutions in an orderly manner that is similar to the one for FDIC-insured banks.

The *ad hoc* response to the current crisis is due in large part to the lack of a legal framework for taking over an entire complex financial organization. As we saw with Lehman Brothers, bankruptcy is a very poor way to resolve large, complex financial organizations. We need a special process that is outside bankruptcy, just as we have for commercial banks and thrifts.

To protect taxpayers, a new resolution regime should be funded by fees charged to systemically important firms and would apply to any institution that puts the system at risk. These fees could be imposed on a sliding scale, so the greater the risk the higher the fee. In a new regime, rules and responsibility must be clearly spelled out to prevent conflicts of interest. For example, Congress gave the FDIC back-up supervisory authority and the power to self-appoint as receiver when banks get into trouble. Congress did this to ensure that the entity resolving a bank has the power to effectively exercise its authority even if there is disagreement with the primary supervisor. As Congress has determined for the FDIC, any new resolution authority should also be independent of any new systemic risk regulator.

The FDIC's current authority to act as receiver and to set up a bridge bank to maintain key functions and sell assets is a good

starting point for designing a new resolution regime. There should be a clearly defined priority structure for settling claims depending on the type of firm. Any resolution should be required to minimize losses to the public. And the claims process should follow an established priority list. Also, no single Government entity should have the power to deviate from the new regime. It should include checks and balances that are similar to the systemic risk exception for the least cost test that now applies to FDIC-insured institutions.

Finally, the resolution entity should have the kinds of powers the FDIC has to deal with such things as executive compensation. When we take over a bank, we have the power to hire and fire. We typically get rid of the top executives and the managers who caused the problem. We can terminate compensation agreements, including bonuses. We do whatever it takes to hold down costs. These types of authorities should apply to any institution that gets taken over by the Government.

Finally, there can no longer be any doubt about the link between protecting consumers from abusive products and practices and the safety and soundness of America's financial system. It is absolutely essential that we set uniform standards for financial products. It should not matter who the seller is, be it a bank or nonbank. We also need to make sure that whichever Federal agency is overseeing consumer protection, it has the ability to fully leverage the expertise and resources accumulated by the Federal banking agencies. To be effective, consumer policy must be closely coordinated and reflect a deep understanding of financial institutions and the dynamic nature of the industry as a whole.

The benefits of capitalism can only be recognized if markets reward the well managed and punish the lax. However, this fundamental principle is now observed only with regard to smaller financial institutions. Because of the lack of a legal mechanism to resolve the so-called systemically important, regardless of past inefficiency or recklessness, nonviable institutions survive with the support of taxpayer funds. History has shown that Government policies should promote, not hamper, the closing and/or restructuring of weak institutions into stronger, more efficient ones. The creation of a systemic risk regulator could be counterproductive if it reinforced the notion that financial behemoths designated as systemic are, in fact, too big to fail.

Congress' first priority should be the development of a framework which creates disincentives to size and complexity and establishes a resolution mechanism which makes clear that managers, shareholders, and creditors will bear the consequences of their actions.

Thank you.

Chairman DODD. Thank you very much.

Mr. Fryzel.

STATEMENT OF MICHAEL E. FRYZEL, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Mr. FRYZEL. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. As Chairman of the National Credit Union Administration, I appreciate this opportunity to provide the agency's position on regulatory modernization.

Federally insured credit unions comprise a small but important part of the financial institution community, and I hope NCUA's perspective on this matter will add to the understanding of the unique characteristics of the credit union industry and the 90 million members they serve.

The market dislocations underscore the importance of your review of this subject. I see a need for revisions to the current regulatory structure in ways that would improve Federal oversight of not just financial institutions, but the entire financial services market. My belief is that there is a better way forward, a way that would enable Federal regulators to more quickly and effectively identify and deal with developing problems.

Before I express my views on possible reforms, I want to briefly update you on the condition of the credit union industry.

Overall, credit unions maintained reasonable performance in 2008. Aggregate capital level finished the year at 10.92 percent, and while earnings decreased due to the economic downturn, credit unions still posted a 0.30 percent return on assets in 2008. I am pleased to report that even in the face of market difficulties, credit unions were able to increase lending by just over 7 percent. Loan delinquencies were 1.3 percent, and charge-offs were 0.8 percent, indicating that credit unions are lending prudently.

Credit unions are fundamentally different in structure and operation than other types of financial institutions. They are not-for-profit cooperatives owned and governed by their members. Our strong belief is that these unique and distinct institutions require unique and distinct regulation, accompanied by supervision tailored to their special way of operating.

Independent NCUA regulation has enabled credit unions to perform in a safe and sound manner while fulfilling the cooperative mandate set forth by Congress. One benefit of our distinct regulatory approach is the 18-percent usury ceiling for Federal credit unions that enhances their ability to act a low-cost alternative to predatory lenders. Another is the existence of a supervisory committee for Federal charters, unique among all financial institutions. These committees, comprised of credit union members, have enhanced consumer protection by giving members peer review of complaints and have supplemented the ability of NCUA to resolve possible violations of consumer protection laws.

NCUA administers the National Credit Union Share Insurance Fund, the Federal insurance fund for both Federal and State-chartered credit unions. The fund currently has an equity ratio of 1.28 percent. The unique structure of the fund where credit unions make a deposit equal to 1 percent of their insured shares, augmented by premiums as needed, to keep the fund above a statutory level of 1.20 percent has resulted in a very stable and well-functioning insurance fund. Even in the face of significant stress in the corporate credit union part of the industry, stress that necessitated extraordinary actions by the NCUA board to stabilize the corporates, the fund has proven durable.

I want to underscore the benefits of having the fund administered by NCUA. Working in concert with our partners in the State regulatory system, NCUA uses close supervision to control risks. This concept was noted prudently by GAO studies over the years,

as were the benefits of a streamlined oversight and insurance function under one roof. This consolidated approach has enabled NCUA to manage risk in an efficient manner and identify problems in a way that minimizes losses to the fund.

NCUA considers the totality of our approach for mixed deposit and premium funding mechanism to unify supervisory and insurance activities, to be the one that has had significant public policy benefits, and one worth preserving. Whatever reorganization Congress contemplates, the National Credit Union Share Insurance Fund should remain integrated into the Federal credit union regulator and separate from any other Federal insurance funds.

Regarding restructuring of the financial regulatory framework, I suggest creating a single oversight entity whose responsibilities would include monitoring financial institution regulators and issuing principles-based regulations and guidance. The entity would be responsible for establishing general safety and soundness standards, while the individual regulators would enforce them in the institutions they regulated. It would also monitor systemic risks across institution types.

Again, for this structure to be effective for federally insured credit unions and the consumers they serve, the National Credit Union Share Insurance Fund should remain independent in order to maintain the dual NCUA regulatory and insurance roles that have been tested and proven to work for almost 40 years.

I appreciate the opportunity to provide testimony today and would be pleased to answer any questions.

Chairman DODD. Thank you very, very much.

Dan Tarullo, thank you very much for being here on behalf of the Fed.

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

Mr. TARULLO. Thank you, Mr. Chairman, Senator Shelby, and Members of the Committee. We are here this morning because of systemic risk. We have had a systemic crisis. We are still in the middle of it, and I would endorse wholeheartedly Senator Shelby's three-part approach to responding to that crisis.

In the weeks that I have been at the Federal Reserve, the discussions that have taken place internally, both among staff and among the members, have focused on the issue of systemic risk and how to prevent it going forward. The important point I would make as a prelude to our recommendations is that the source of systemic risk in our financial system has to some considerable extent migrated from traditional banking activities to markets over the last 20 or 25 years. If you think about the problems that led to the Depression, that were apparent even in the 1970s among some banks, the concern was that there would be a run on a bank, that depositors would be worried about the safety and soundness of that bank and that there would be contagion spreading to other institutions as depositors were uncertain as to the status of those institutions.

What has been seen more recently is a systemic problem starting in the interactions among institutions in markets. Now, banks are participants in markets, so this can still be something that affects

banks. But we have also seen other kinds of institutions at the source of the systemic problems we are undergoing right now.

I think you cannot focus on a single institution or even just look at institutions as a series of silos, as it were, and concentrate solely on trying to assure their safety and soundness. We need to look at the interaction among institutions. Sometimes that means their actual counterparty relationships with one another. Sometimes it means the fora in which they interact with one another, in payment systems and the like. Sometimes it even means the parallel strategies which they may be pursuing—when, for example, they are all relying on the same sources of liquidity if they have to change their investing strategies. So they may not even know that they are co-dependent with other actors in the financial markets.

For all of these reasons, our view is that the focus needs to be on an agenda for financial stability, an agenda for systemic risk management. I emphasize that because, although there is rightly talk about a systemic risk regulator, it is important that we understand each component of an agenda which is going to be fulfilled by all the financial regulators over which you have jurisdiction.

So what do we mean by this agenda? Well, I tried in my testimony to lay out five areas in which we should pay attention. First, we do need effective consolidated supervision of any systemically important institution. We need consolidated supervision and it needs to be effective. There are institutions that are systemically important, and certainly were systemically important over the last few years, which were not subject to consolidated prudential supervision by any regulator.

But that supervision needs to be effective. I think everybody is aware, and ought to be aware, of the ways in which the regulation and supervision of our financial institutions in recent years has fallen short. And unless, as Senator Shelby suggests, we all concentrate on it and reflect on it without defensiveness, we are not going to learn the lessons that need to be learned.

Second, there is need for a resolution mechanism. I am happy to talk about that in the back and forth with you, but Comptroller Dugan and Chairman Bair have laid that out very well.

Third, there does need to be more oversight of key areas in which market participants interact in important ways. We have focused in particular on payments and settlement systems, because there the Fed's oversight authority derives largely from the coincidence that some of the key actors happen to be member banks. But if they weren't, if they had another corporate form, there is no statutory authority right now for us to exercise prudential supervision over those markets in which problems can arise.

Fourth, consumer protection. Now, consumer protection is not and should not be limited to its relationship with potential systemic risk. But, as the current crisis demonstrated, there are times in which good consumer protection is not just good consumer protection, but it is an important component of an agenda for containment of systemic risk.

Fifth and finally is the issue of a systemic risk regulator. This is something that does seem to fit into an overall agenda. There are gaps in covering systemically important institutions. There are also gaps in attempting to monitor what is going on across the system.

I think in the past there have been times at which there was important information being developed by various regulators and supervisors which, if aggregated, would have suggested developing issues and problems. But without a charge to one or more entities to try to put all that together, one risks looking at things, as I said, in a more siloed fashion. The extent of those authorities for a systemic risk regulator is something that needs to be debated in this Committee and in the entire Congress. But I do think that it is an important complement to the other components of this agenda and the improvements in supervision and regulation under existing authorities, and thus something that ought to be considered.

I am happy to answer any questions that you may have.

Chairman DODD. Thank you very much.

There will be three or four consecutive votes that are going to occur, so regretfully, we are going to have to recess, and when we get over there, there are going to be, 10-minute votes, not 15-minute votes. I apologize to our witnesses, but all of you have been here before in the past when this has occurred. We will have three or four votes—it may even be two, it may be a voice on one, so we may get back much more quickly, and we will pick up with Mr. Polakoff.

The Committee will stand in recess.

[Recess.]

Chairman DODD. Could I invite all of you to come back in, and let me tell you how we will proceed. I apologize to our witnesses. There is going to be another vote, but I thought we could complete the testimony from our witnesses, and by that time, the third vote might begin. I have been advised the members will stay over there for the vote rather than run back and forth. As I said, we will complete your testimony, and then we will engage in the questioning for the remainder of the time.

Mr. Polakoff, we welcome you. Thank you.

STATEMENT OF SCOTT M. POLAKOFF, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. POLAKOFF. Good morning, Chairman Dodd. Thank you for inviting me to testify on behalf of OTS on "Modernizing Bank Supervision and Regulation."

As you know, our current system of financial supervision is a patchwork with pieces that date back to the Civil War. If we were to start from scratch, no one would advocate establishing a system like the one we have, cobbled together over the last century and a half. The complexity of our financial markets has in some cases reached mind-boggling proportions. To effectively address the risks in today's financial marketplace, we need a modern, sophisticated system of regulation and supervision that applies evenly across the financial services landscape.

Our current economic crisis enforces the message that the time is right for an in-depth, careful review and meaningful, fundamental change. Any restructuring should take into account the lessons learned from this crisis. At the same time, the OTS recommendations that I am presenting here today do not represent a realignment of the current regulatory structure. Rather, they represent a fresh start using a clean slate. They represent the OTS

vision for the way financial services regulation in this country should be. In short, we are proposing fundamental changes that would affect virtually all of the current financial regulators.

It is important to note that these are high-level recommendations. Before adoption and implementation, many details would need to be worked out and many questions would need to be answered.

The OTS proposal for modernization has two basic elements. First, a set of guiding principles, and second, recommendations for Federal bank regulation, holding company supervision, and systemic risk regulation. So what I would like to do is offer the five guiding principles.

Number one, a dual banking system with Federal and State charters for banks.

Number two, a dual insurance system with Federal and State charters for insurance companies.

Number three, the institution's operating strategy and business model would determine its charter and identify its responsible regulatory agency. Institutions would not simply pick their regulator.

Number four, organizational and ownership options would continue, including mutual ownership, public and private stock entities, and Subchapter S corporations.

And number five, ensure that all entities offering financial products are subject to the consistent laws, regulations, and rigor of regulatory oversight.

Regarding our recommendations on regulatory structure, the OTS strongly supports the creation of a systemic risk regulator with authority and resources to accomplish the following three functions.

Number one, to examine the entire conglomerate.

Number two, to provide temporary liquidity in a crisis.

And number three, to process a receivership if failure is unavoidable.

For Federal bank regulation, the OTS proposes two charters, one for banks predominately focused on consumer and community banking products, including lending, and the other for banks primarily focused on commercial products and services. The business models of the commercial bank and the consumer and community bank are fundamentally different enough to warrant two distinct Federal banking charters. These regulators would each be the primary Federal supervisor for State chartered banks with the relevant business models.

A consumer and community bank regulator would close the gaps in regulatory oversight that led to a shadow banking system of uneven regulated mortgage companies, brokers, and consumer lenders that were significant causes of the current crisis. This regulator would also be responsible for developing and implementing all consumer protection requirements and regulations.

Regarding holding companies, the functional regulator of the largest entity within a diversified financial company would be the holding company regulator.

I realize I have provided a lot of information and I look forward to answering your questions, Mr. Chairman.

Chairman DODD. Thank you very, very much.

Mr. Smith, welcome to the Committee.

STATEMENT OF JOSEPH A. SMITH, JR., NORTH CAROLINA COMMISSIONER OF BANKS, AND CHAIR-ELECT OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. SMITH. Thank you, Mr. Chairman. I am Joe Smith. I am North Carolina Commissioner of Banks and Chair-Elect of the Conference of State Bank Supervisors, on whose behalf I am testifying. I very much appreciate this opportunity.

My colleagues and I have submitted to you written testimony. I will not read it to you today.

Chairman DODD. Thank you.

Mr. SMITH. I would like to emphasize a few points that are contained in it.

The first of these points is that proximity, or closeness to the consumers, businesses, and communities that deal with our banks is important. We acknowledge that a modern financial regulatory structure must deal with systemic risks presented by complex global institutions. While this is necessary, sir, we would argue that it is not itself sufficient.

A modern financial regulatory structure should also include, and as more than an afterthought, the community and regional institutions that are not systemically significant in terms of risk but that are crucial to effectively serving the diverse needs of our very diverse country. These institutions were organized to meet local needs and have grown as they have met such needs, both in our metropolitan markets and in rural and exurban markets, as well.

We would further suggest that the proximity of State regulators and attorneys general to the marketplace is a valuable asset in our efforts to protect consumers from fraud, predatory conduct, and other abuses. State officials are the first responders in the area of consumer protection because they are the nearest to the action and see the problems first. It is our hope that a modernized regulatory system will make use of the valuable market information that the States can provide in setting standards of conduct and will enhance the role of States in enforcing such standards.

To allow for this system to properly function, we strongly believe that Congress should overturn or roll back the OTS and OCC preemption of State consumer protection laws and State enforcement.

A second and related point that we hope you will consider is that the diversity of our banking and regulatory systems is a strength of each. One size does not fit all, either with regard to the size, scope, and business methods of our banks or the regulatory regime applicable to them.

We are particularly concerned that in addressing the problems of complex global institutions, a modernized financial system may inadvertently weaken community and regional banks by under-support for the larger institutions and by burdening smaller institutions with the costs of regulation that are appropriate for the large institutions, but not for the smaller regional ones.

We hope you agree with us that community and regional banks provide needed competition in our metropolitan markets and crucial financial services in our smaller and more isolated markets. A corollary of this view is that the type of regulatory regime that is

appropriate for complex global organizations is not appropriate for community and regional banks. In our view, the time has come for supervision and regulation that is tailored to the size, scope, and complexity of a regulated enterprise. One size should not and cannot be made to fit all.

I would like to make it clear that my colleagues and I are not arguing for preservation of the status quo. Rather, we are suggesting that a modernized regulatory system should include a cooperative federalism that incorporates both national standards for all market participants and shared responsibility for the development and enforcement of such standards. We would submit that the shared responsibility for supervising State charter banks is one example, current example, of cooperative federalism and that the developing partnership between State and Federal regulators under the Secure and Fair Enforcement for mortgage licensing, or SAFE Act, is another.

Chairman Dodd, my colleagues and I support this Committee's efforts to modernize our Nation's financial regulatory system. As always, sir, it is an honor to appear before you. I hope that our testimony is of assistance to the Committee and would be happy to answer any questions you may have. Thank you very, very much.

Chairman DODD. Thank you very much, Mr. Smith.

We don't say this often enough in the Committee. The tendency today is to use the word "bank," and I am worried about it becoming pejorative. There are 8,000 banks and I think there are 20—Governor Tarullo can correct me on this—that control about 70 to 80 percent of all the deposits in the country. The remaining 7,000-plus are regional or community banks. They do a terrific job and have been doing a great job. And the tendency to talk about lending institutions in broad terms is not fair to a lot of those institutions which have been very prudent in their behavior over the last number of years and it is important we recognize that from this side of the dais. And so your comments are appreciated.

Mr. Reynolds.

STATEMENT OF GEORGE REYNOLDS, CHAIRMAN, NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS, AND SENIOR DEPUTY COMMISSIONER, GEORGIA DEPARTMENT OF BANKING AND FINANCE

Mr. REYNOLDS. Chairman Dodd, I appear today on behalf of NASCUS, the professional association of State Credit Union Regulators. My comments focus solely on the credit union regulatory structure and four distinct principles vital to the future growth and safety and soundness of State chartered credit unions.

NASCUS believes regulatory reform must preserve charter choice and dual chartering, preserve the States' role in financial regulation, modernize the capital system for credit unions, and maintain strong consumer protections.

First, preserving charter choice is crucial to any regulatory reform proposal. Charter choice is maintained by an active system of federalism that allows for clear communications and coordination between State and Federal regulators. Congress must continue to recognize and affirm the distinct roles played by State and Federal regulatory agencies. The Nation's regulatory structure must enable

State credit union regulators to retain their regulatory authority over State-chartered credit unions. Further, it is important that new polices do not squelch the innovation and enhanced regulatory structure provided by the dual chartering system.

The second principle I will highlight is preserving the State's role in financial regulation. The dual chartering system is predicated on the rights of States to authorize varying powers for their credit unions. NASCUS supports State authority to empower credit unions to engage in activities under State-specific rules. States should continue to have the authority to create and to maintain appropriate credit union powers in any new regulatory reform structure. Preemption of State laws and the push for more uniform regulatory systems will negatively impact our Nation's financial services industry and ultimately consumers.

The third principle is the need to modernize the capital system of credit unions. We encourage Congress to include capital reform as part of the regulatory modernization process. State credit union regulators are committed to protecting credit union safety and soundness. Allowing credit unions to access supplemental capital would protect the credit union system and provide a tool for regulators if a credit union faces declining network or liquidity needs. Further, it will provide an additional layer of protection to the National Credit Union Share Insurance Fund, the NCUSIF, thereby maintaining credit unions' independence from the Federal Government and taxpayers.

A simple fix to the definition of "net worth" in the Federal Credit Union Act would authorize regulators the discretion, when appropriate, to allow credit unions to use supplemental capital.

The final principle I will discuss is the valuable role States play in consumer protection. Many consumer protection programs were designed by State legislators and State regulators to protect citizens in their States. The success of State programs have been recognized at the Federal level when like programs have been introduced. It is crucial that State legislatures have the primary role to enact consumer protection statutes for their residents and to promulgate and enforce State regulations.

I would also mention that both State and Federal credit unions have access to the NCUSIF. federally insured credit unions capitalize this fund by depositing 1 percent of their shares into the fund. This concept is unique to credit unions and it minimizes exposure to the taxpayers. Any modernized regulatory system should recognize the NCUSIF. NASCUS and others are concerned about any proposal to consolidate regulators and eliminate State and Federal credit union charters.

As Congress examines a regulatory reform system for credit unions, the following should be considered. Enhancing consumer choice provides a stronger financial regulatory system. Therefore, charter choice and dual chartering must be preserved. Preservation of the State's role in financial regulation is vital. Modernization of the capital system for credit unions is critical for safety and soundness. And strong consumer protection should be maintained, and these should be protected against Federal preemption.

NASCUS appreciates the opportunity to testify and share our priorities. We urge the Committee to be watchful of Federal pre-

emption and to remember the importance of dual chartering and charter choice in regulatory modernization. Thank you.

Chairman DODD. Thank you very much, Mr. Reynolds, and again, my appreciation to all of you here this morning. We are going to have an ongoing conversation with you as I know all of my colleagues are interested—deeply interested—in the subject matter of modernization of financial regulation. We are going to want to have as many conversations as we can with you as we move forward on how to develop these ideas. We all understand the critical importance of this and all of you can play a very critical role in helping us.

Let me begin, if I can, with the issue of regulatory arbitrage, because all of you in your testimony addressed this issue as forum shopping. In 1994, when this Committee considered legislation to comprehensively reform of the financial regulatory system, then-Treasury Secretary Lloyd Bentsen appeared before the Committee, and let me quote him for you on that day, some 15 years ago. He said, "What we are seeing is a situation that enables banks to shop for the most lenient Federal regulator."

In those very same hearings on that very same proposal, the Chairman of the Federal Reserve, at the time Alan Greenspan, said the following, and I am quoting him, "Every bank should have a choice of Federal regulator."

So let me ask the panel here very quickly, beginning with you, Mr. Dugan, with whom do you agree? Should financial institutions be allowed to choose their regulators, leading to a potential race to the bottom, or should we attempt to end the regulatory arbitrage that is going on?

Mr. DUGAN. Well, I guess what I would say is this. Institutions should not be able to, when they have a problem with that one regulator, to leave that regulator to go to another regulator where they think they are not going to have the problem.

I will say from the point of view of the OCC, we don't have any ability to stop someone from leaving, but we have ample authority to stop them from coming in and we exercise it. And so we will not allow someone to transfer in and become a national bank unless they have resolved their problems with their own institution and we make that clear, and we have had during my tenure as Comptroller several instances of companies wanting to come in and deciding not to when they realize that that would be the case. It is not a good situation to have people try to leave one problem to go to another.

I am not sure you have to have only one charter to solve that problem. I think there are other ways to solve it where it does occur and I think there can be some benefits that some charters offer over others that are not what I just spoke about, and in those cases, I think that is a good thing. But it has to be clear. To go to the competition at the bottom, I think is a bad thing.

Chairman DODD. Yes. Chairman Bair.

Ms. BAIR. Yes. I think the problems with regulatory arbitrage have been more severe regarding banks than nonbanks, especially on capital constraints—leverage constraints—certainly with regard to investment banks versus commercial banks, and bank mortgage lenders versus nonbank mortgage lenders with regard to lending

standards. So I think there needs to be some baseline standards that apply to all types of financial institutions, especially with consumer protection and basic prudential requirements, such as capital standards.

I think there are still some problems within the category of banks. We have four different primary regulators now and I think there have been some issues. There have been issues we have seen with banks converting charters because they fear perhaps the regulatory approach by one regulator. We have seen banks convert charters in order to get preemption, which is not always a good thing.

So I think there is more work to be done here. Part of that may be Congress's call in terms of whether they want to establish basic consumer protections that cannot be preempted—whether you want Federal protection to be a floor or a ceiling for consumer protection. I think among us as regulators, we could do more to formalize agreements among ourselves that we will respect each other's CAMELS ratings and enforcement actions even if a charter is converted to remove the bad incentives for charter conversion.

So I think there are some steps to be taken, but I do agree with what Joe said, we need both State and Federal charters. There is a long history of the dual banking system in the United States and I think that should be preserved.

Chairman DODD. You mentioned the four bank regulators, and I think Mr. Dugan made the point earlier that this could be a briefer hearing——

[Laughter.]

Chairman DODD. ——given the fact that we have the four regulators involved in all of this. Is this making any sense at all? And I am not jumping to one, but maybe the question ought to be what do we need out there to provide the safety and soundness and consumer protection. And I am not interested in just moving boxes around—take four and make it one—as attractive as that may seem to people, because that may defeat the very purpose of why we gather and talk about this issue.

But the question is a basic one. Do we have too many regulators here and has that contributed, in your view, Sheila, to some of the issues we are confronting?

Ms. BAIR. I think that you probably could have fewer bank regulators. I do think you need at least a national and a State charter. I think you should preserve the dual structure. But I also think in terms of the immediate crisis, the bigger problems are with the bank versus nonbank arbitrage, not arbitrage within the banking system.

Chairman DODD. Yes, Mr. Fryzel.

Mr. FRYZEL. Thank you, Senator. I agree with my colleagues that there should be the dual chartering system between State and Federal banks as well as credit unions. Chairman Bair says that there probably are too many bank regulators. Well, fortunately, we only have one credit union regulator, so I think that is something we should maintain.

But again, I think we need to look at where are the problems? Which regulator perhaps hasn't done the job that they should have done, and maybe that is where the correction should be. I think the

majority of regulators have done the best they possibly can considering what the circumstances are. I think they have taken the right types of moves to correct the situation that is out there with the economy the way it is.

But for restructuring, I think we need to see where is the problem. Is it with the banks? Is it with the insurance companies? Is it with other types of financial institutions, and address that. And then making that improvement, determine whether or not we need the systemic risk regulator above these other institutions.

Chairman DODD. Governor.

Mr. TARULLO. Thank you, Mr. Chairman. I agree with my colleagues that we should not undermine the dual banking system in the United States, and so you are going to have at least two kinds of charters. It does seem to me, though, that the question is not so much one of can an institution choose, but what constraints are placed upon that choice.

So, for example, under current law, with the improvements that were made to the Federal Deposit Insurance Act following the savings and loan crisis, there are now requirements on every federally insured institution that apply whether you are a State or a Federal bank. I think that Chairman Bair was alluding to some areas in which she might like to see more constraints within the capacity to choose, so that a bank cannot escape certain kinds of rules and regulations by moving from one charter to another.

Chairman DODD. Well, to make a distinction here, I do not know that anyone is really going to argue about the idea of having State-chartered and nationally chartered institutions, but are you suggesting having separate regulators, or could we talk about a common regulator and dual charters?

Mr. DUGAN. I think you have choices. Basically, of the four regulators of banks, you have two for Federal charters, two for State charters, and the question is: Does that make sense? You could have a single one for Federals; you could have a single one for States; you could have a single that cuts across all of them and still have two charters.

There are complexities and issues with respect to each of those, and I should not leave out you have 12 Federal Reserve banks.

Chairman DODD. No. I know.

Mr. DUGAN. Which is another set of people at the table.

Chairman DODD. Right.

Mr. DUGAN. My own view, I think there are too many. I agree with Chairman Bair. I do not think that was a substantial cause of the problems that we have seen, but if you are looking at creating more efficiency and providing a system that is more flexible and works better, I think you do not need—we do not have four FDAs.

Chairman DODD. Would you agree with that, Sheila, that you can have a common regulator and dual charters?

Ms. BAIR. Well, I think it is tricky with the State charter we should not leave out the 50 State regulators. The Fed and the FDIC partner with the State regulators in our examination activities. So I think you could certainly consolidate all the Federal oversight with one Federal regulator. We would still, I assume, if you preserve a State charter, have shared responsibilities with the

State regulator. And so there has been historical competition between national and State charters that——

Chairman DODD. Doesn't that lend itself to shopping again here? The point that Mr. Dugan raised here, that the FDA does not have a national regulator and a State regulator when it comes to food and drug safety. Why not financial products? Why shouldn't they be as safe?

Ms. BAIR. I think for the smaller banks, for the community banks, they like having the state option.

Chairman DODD. Yes.

Ms. BAIR. They like having the State option. They like having the regulator that is a little closer, more local to them, more accessible to them. So I think there are some benefits and I strongly support continuation of the community banking sector here, and I think maintaining the State charter is essential to that.

Chairman DODD. Let me jump——

Mr. POLAKOFF. Mr. Chairman, if I could offer—in our written testimony—and I tried to synopsize it in my oral—we believe the dual banking system, State and Federal, makes sense. But we believe that the business model and the strategy of the organization should then dictate what regulatory agency oversees it.

So from our perspective, there is a clear distinction between a commercial bank and a community and consumer bank. And it does not make a difference whether it is a Federal charter or State charter. Under our approach, we would submit to you that you have a Federal regulator and a Federal charter for commercial banks. And you have the same for community and consumer banks. And then if it is a State-chartered entity that fits one of those two business strategies, the relevant Federal regulator works with it.

So it retains the dual banking system. It prevents the ability of the individual institution to select a regulator. Instead, this schematic would suggest that the business strategy determines the regulator.

Chairman DODD. That is a good point. Let me finish up, and I apologize to my colleagues. I will just get the comments and then go quickly to the——

Mr. SMITH. I would say that as a State charterer who has good experience with both of our Federal colleagues, we need to say that the current State system involves what we have called constructive or cooperative federalism now, and State-chartered banks are not exempt or are not free from federally enforced standards.

Chairman DODD. Right.

Mr. SMITH. And to be frank, we are grateful we have been included in the FFIC because in that case we work with our Federal colleagues to establish standards that we understand have to apply across the board. As I say in my testimony, we understand we have got to raise our game. In other words, we understand that going forward, working with our Federal colleagues, we would like to have a place in setting national standards and in enforcing them. But I think actually even in light of the current problems we have, the system has, the State system, in partnership with the Fed and the FDIC, is holding up so far. We have got our issues, but we are holding up pretty well. So I think there is a question in the future

about our continuing to work more cooperatively with our Federal partners, and I think that can help.

Chairman DODD. Mr. Reynolds.

Mr. REYNOLDS. Well, my observation, as a regulator that has been involved in financial institution regulation for over 30 years, is that we do not have any tolerance for forum shopping; we do not have any tolerance for trying to arbitrage safety and soundness. And it has been my experience in dealing with other State regulators that that same approach applies.

I think the State system does provide choice, but I do not believe there is any tolerance for that type of behavior in a State system.

Chairman DODD. Thanks very much.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank all of you for your testimony and your service.

Ms. Bair, Chairman Bair, let me ask you this: Do you think that not having an entity that can do the overall resolution for complex entities is affecting the policies that we have in place right now as it relates to supporting them?

Ms. BAIR. It absolutely is. There is really no practical alternative to the course that has been set right now, because there is no flexibility for resolution.

Senator CORKER. So much of the actions that we are taking as a Congress and as an administration to support some of these entities have to do with the fact that we really do not have any way to unwind them in a logical way. Is that correct?

Ms. BAIR. I do agree with that.

Senator CORKER. I know the Chairman mentioned the potential of FDIC being the systemic regulator. What would be the things that the FDIC would need to do to move beyond bank resolution but into other complex entities like AIG, Lehman Brothers, and others?

Ms. BAIR. Right. Well, we think that if we had resolution authority, we actually should be separate from where we have the requirements for prudential supervision of systemic institutions. Those responsibilities are actually separated now, and I think it is a good check and balance to have the resolution authority with some back-up supervisory authority working in conjunction with the primary regulator who has responsibility for prudential supervision.

In terms of resolution authority, I think that the current system—that we would like—if we were given it, is a good one. We can set up bridge banks, or conservatorships to provide for the orderly unwinding of institutions. There is a clear set of priorities, so investors and creditors know in advance what the imposition of loss will be. We do have the flexibility to deviate from that, but it is an extraordinary process that includes a super majority of the FDIC Board, the Federal Reserve Board, the concurrence of the Secretary of the Treasury and the President. So it is a very extraordinary procedure to deviate from the baseline requirement to minimize cost.

So I think the model we have now is a good one and could be applied more broadly to complex financial organizations.

Senator CORKER. It sounds like in your opinion in a fairly easy way.

Ms. BAIR. Well, I think one easy step would be just to give us authority to resolve bank and thrift holding companies. I think that would be—I think there are going to be larger, more complex issues in terms of going beyond that category, what is systemic when you talk about insurance companies, hedge funds, other types of financial institutions. But, yes, I think that would be a relatively simple step that would give us all some additional flexibility, yes.

Senator CORKER. Thank you

Mr. Dugan, you know, we talk about capital requirements and institutions, but regardless of the capital that any particular institution has, if they make really bad loans or make really bad decisions, it really does not matter how much they have, as we have seen, right? Are we focusing enough on minimum lending standards as we think about the overall regulation of financial institutions?

Mr. DUGAN. I think that is a very good question. I think capital is not enough by itself. I think you are right. And as I mentioned in my testimony, in the area of mortgages, I think if we had had or if we would have in the future some sort of more national standard in the area of—and if I think of two areas going back that I wish we had over again 10 years ago, it is in the area of stated income or no-documentation loans, and it is in the area of loan-to-value ratios or the requirement for a significant downpayment. Those are underwriting standards. They are our loan standards, and I think if we had more of a national minimum, as, for example, they have had in Canada and as we had in the GSE statutes for GSE conforming loans, I think we would have had far fewer problems. Now, fewer people would have gotten mortgages, and there would have been fewer people that would have been able to purchase homes, and there would be pressure on affordability. But it would have been a more prudent, sound, underwriting standard that would have protected us from a lot of problems.

Senator CORKER. I hope as we move forward with this you will continue to talk about that, because I think that is a very important component that may be left by the wayside. And I hope that all of us will look at a cause-neutral solution going forward. Right now we are focused on home mortgages and credit default swaps. But we do not know what the next cause might be.

Mr. Tarullo, you mentioned something about credit default swaps, and I am not advocating this, but I am just asking the question. In light of the fact that it looks like as you go down the chain, I mean, we end up having far more credit default swap mechanisms in place than we have actual loans or collateral that is being insured, right? I mean, it is multiplied over and over and over. And it looks like that the person that is at the very end of the chain is kind of the greater fool, OK, because everybody keeps laying off.

Is there any thought about the fact that credit default swaps may be OK, but the only people who should enter into those arrangements ought to be people that actually have an interest in the actual collateral itself and that you do not, in essence, put in place this off-racetrack-betting mechanism that has nothing whatsoever

to do with the collateral that is being insured itself? Have there been any thoughts about that?

Mr. TARULLO. Senator, I think that issue has been investigated and discussed by a number of people, in and out of the Government. Here, I think, are the issues.

There is a group of market actors who have a reason why they want to hedge a particular exposure or instrument, and the most efficient way for them to do that is to have a credit default swap associated with a particular institution or product, even when they do not own the underlying product because there is a relationship.

The difficulty, as a lot of people have pointed out, would come in trying to craft a rule which would allow that to occur while ending the kind of practice that I think you are worried about, which is much less tethered to a hedging strategy.

I do think when it comes to credit default swaps, we can make a couple of observations, though. One, they do underscore, again, the importance of monitoring and overseeing the arenas in which big market actors come together. Making sure that there is a central counterparty, for example, helps to contain some of the risks associated with the use of credit default swaps.

And, second, the problems with credit default swaps that we associate with this crisis did not come from institutions that were being regulated by Mr. Dugan, for example, or bank holding companies being regulated by the Fed. What does that tell you? It tells us that although looking at the interaction of entities is important, you still should do good, solid supervision of particular institutions. And if they have capital requirements and liquidity requirements and good risk management practices, then whatever use a particular trade an entity is putting a credit default swap to, we will not allow them to acquire too much exposure.

Senator CORKER. Mr. Chairman, my time is up. Thank you.

Chairman DODD. Senator Warner. And let me just say what I am going to do, this vote has started. I am going to go over and make the vote and come right back. So if you finish up, Senator Merkley, you may have time for questions as well, and I will try and get right back with other members as well.

Senator Warner.

Senator WARNER. Well, Thank you, Mr. Chairman, and thank you for holding this hearing and for your leadership in the reform efforts that are going forward.

I know the subject today is how do we reform on a prospective basis, but in the interim, as we have seen with the public and congressional outrage over AIG and with certain other actions by a number of our institutions, until we get this new regulatory structure in place, what I think we keep hearing is, well, we do not really have any tools to stop these actions.

One area that I have had some folks talk to me about—and I would like to get your opinion—is that under the Federal Deposit Insurance Act—which obviously all of the Federal regulators have the ability to enforce, not only the FDIC but the OCC, OTS, and the Fed—my understanding is regulators do have at least the statutory ability to issue cease and desist orders to institutions or individuals if somebody has engaged in unsafe or unsound practices, if somebody has engaged in a breach of their fiduciary duty, or if

somebody has received financial gain or other benefits that show willful disregard for the safety and soundness of the institution.

And I understand that, you know, the case law is fairly narrow here, but my understanding of the remedies you have got is you can ban somebody from banking, you can get restitution, you can impose a series of other penalties. But, boy, oh, boy, with narrow case law, it sure does seem that some of the actions that have taken place—and, again, case in point being AIG, and I know the fact that it was offshore, off balance sheet, in the London derivatives entity, but it sure seems like this tool could be used or could be pushed because there sure has been a whole lot of activities that have led to either financial enrichment or unsound practices, at least in retrospect now. And I just question, you know, have you thought through this tool. Have you investigated it? Have you not used it because you felt that there would be—the case law would not allow it? And why not take a little bit of risk in pushing the edge, particularly with the amount of abuse and the amount of public outrage that we see today?

Mr. Polakoff, do you want to start? And I would love to hear from all of the regulators.

Mr. POLAKOFF. Senator, if I could offer some thoughts regarding AIG, as you know, September 15, 2008, with the Government's action, caused AIG to no longer be a savings and loan holding company. So 6 months have passed since that time.

I can assure that if AIG was still a savings and loan holding company, we would have taken enforcement action under safety and soundness to say those bonuses were an unsafe and unsound practice and would not have allowed it. But it is not a savings and loan holding company.

Senator WARNER. I know the Government owns it, but even though the fact that there is a Treasury-owned trust, you say that—I know you testified here a week ago that, yes, you had oversight over AIG and maybe you have missed a bit. And now you are saying you have no regulatory ability to take any of these actions?

Mr. POLAKOFF. Once the Government took ownership, by statute it is no longer a savings and loan holding company.

Senator WARNER. But the Government—again, I know you would know the law better than I, but I thought the Government has not taken full ownership, that there is still a trust in which the Treasury and others help put members. But you are saying—even though the trust is an independent trust, it is not owned entirely and controlled entirely by the Government. As an independent trust, wouldn't you still have regulatory——

Mr. POLAKOFF. No. Our legal analysis says that the control is with the Government. I mean, we would be thrilled if we could get to the legal status that it is still a savings and loan holding company. It would allow us to take action.

Senator WARNER. Let me hear from the regulators on the panel whether beyond just the AIG specific example, whether this tool—whether you have thought through using this tool as we have seen other actions, AIG being the most egregious, but there are other institutions that I think fall into that category. Ms. Bair?

Ms. BAIR. Well, I would say the FDI Act applies to depository institutions, and obviously AIG had a small thrift, a depository insti-

tution regulated by OTS, and OTS was their holding company regulator.

Senator WARNER. Right.

Ms. BAIR. But our authority as back-up supervisor and primary Federal regulator of nonmember State-chartered banks is only to the depository institution.

When we take a bank over as receiver or conservator, we have separate authorities to repudiate all employment contracts. Typically, the boards are gone, obviously. The senior management is generally let go. And those who were responsible for the bank's problems are typically let go as well.

We very aggressively pick and choose who we want to keep and who we think needs to leave when an institution fails and we become receiver or conservator. So we do use it in that context.

Again, that is just for a bank, the depository institution part, and AIG certainly was a much larger entity.

Senator WARNER. But since the Fed and the OCC also, I believe, enforce this act, have you thought through using this tool for actions that you may find to be unsafe or where individuals might have received financial benefit with willful disregard to the safety and soundness of the underlying institution?

Mr. TARULLO. I think, Senator, your question raises two questions: one about where we are now, but an important one about going forward as well.

As to where we are now in respect to the compensation issues, by and large, as you know, those have been for TARP recipient institutions; those have been things that are either congressionally mandated or put in place by the Treasury Department. And so far as I am aware, with respect to institutions over which the Fed has regulatory authority, there has not been thought of going beyond the congressional and Treasury policies on compensation.

I think, though, that the larger question you raise is one, again, of regulatory gaps. As Chairman Bair said, in order to be able to exercise any authority, you have got to have the basic supervisory structure in place. And so, thinking about where problems which anticipate today are going to arise underscores the importance of making sure that each of these systemically important institutions is, in fact, subject to the kinds of rules that you are talking about.

Senator WARNER. Mr. Dugan, I know our time has about expired, but I just——

Mr. DUGAN. Yes, well, we have a range of tools, of course, both informal and formal, for a number of different things. But in the compensation area, to find willful disregard that causes a safety and soundness problem is, in fact, a quite high standard to meet. There is separate authority under Part 30 of the Federal Deposit Insurance Act that the so-called safety and soundness standards that were adopted in FDICIA, also a somewhat lower standard but still tied to the safety and soundness of the institution, that possibly you could make a connection to. And we do look at these, but as I said, to make that connection to the safety and soundness is not an easy thing to do.

Senator WARNER. My only sense—and I would love to pursue this a bit more—is that we all understand we have got to fix this problem on a prospective basis. But there is still an interim time be-

tween now and when Congress would act and these new rules and regulations would be in place. I would just urge you to perhaps revisit with your legal staffs this tool because, as we have seen, it is not healthy for the public's confidence in the overall financial system when we see the kind of excesses and everybody saying we do not have any tools to go after this, when it appears there may be at least partial tools still here.

Ms. BAIR. And I just wanted to re-emphasize what I had indicated earlier about our lack of resolution authority that applies to the entire organization.

Senator WARNER. Absolutely. Very valid——

Ms. BAIR. The FDIC has very broad authority to repudiate these contracts at the discretion of the receiver/conservator. I think AIG is a good example. If the bank regulators had resolution authority of the entire organization, probably this problem would not——

Senator WARNER. Very, very valid point. But, again, we still have some interim period that may be a long period of months, and if the public has lost all confidence in the fairness and soundness of the actions of some actors in the financial community, it is going to make our challenge and task in terms of striking that appropriate balance between the free market system and appropriate regulatory oversight even more difficult going forward. So thank you very much.

Senator REED [presiding]. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

Very quick responses, because I understand it is 4 minutes until the closing of the vote. Chairman Bair, you noted the need to address the issue of "too big to fail," and I believe talked in your testimony about increasing financial obligations as the size of organizations creates greater risk and perhaps regulating the public funds available to very large financial institutions.

Do we need to also explore the issue of how mergers and acquisitions affect the growth of individual institutions? Is there any point in the process of a firm growing through mergers or acquisitions that this issue needs to be addressed? And I would open that up to any of you, and please speak quickly.

Ms. BAIR. Right, and I will speak quickly and turn it over to Dan because the Fed reviews merger and acquisition activity. But, yes, I think that is part of it. I think compensation tied to successful mergers and acquisitions, executive compensation tied to growth for the sake of growth is another area that I think has fed into this current problem we have.

Senator MERKLEY. Did I catch you right that executive compensation as it is tied into growth?

Ms. BAIR. As it is tied into merger activity and growth, yes, I think that help feeds the beast. I do.

Senator MERKLEY. Thank you.

Mr. TARULLO. Certainly, Senator, with respect to mergers under the Bank Holding Company Act, there ought to be and is scrutiny under the anti-trust laws to determine whether there are going to be anti-competitive consequences to the merger. But you should understand that the competition analysis as it is put forth in the statute does not in itself directly feed into the issues of size and systemic risk. And so there does need to be an independent focus on

systemic risk beyond the traditional anti-trust question of whether a merger would reduce competition in a particular market.

Senator MERKLEY. Does anyone else want to add to that?

Mr. POLAKOFF. Senator, I would just say real quick that for thrifts or savings and loan holding companies where there is a merger, there is absolutely an assessment of what the consolidated risk profile looks like and the competency of management. And I think all the regulators go through that analysis with a merger.

Senator MERKLEY. So you feel like this—in your case, you are saying it has really been addressed in the past, we have done a great job, and no need to change any particular approach to that issue?

Mr. POLAKOFF. When it comes to mergers, I think the regulators have the right powers to assess the consolidated risk profile of the company in deciding whether to approve it or not, yes, sir.

Senator MERKLEY. They have those powers. Have they exercised those powers?

Mr. POLAKOFF. Yes, sir.

Senator MERKLEY. Anyone else?

[No response.]

Senator MERKLEY. OK. I want to turn to the issue of consumer protection and how this feeds into the risk, kind of the retail issues. Certainly it is my view that the current crisis is an example of how failure to provide for adequate consumer protection compromises the safe and sound operation of financial institutions. What is your view of the role of consumer protection in supervision and regulation? And how effective do you think your particular agencies have been in addressing the consumer protection side? Whoever would like to jump into that.

Mr. POLAKOFF. I will jump in. I think, first of all, there is a keen connection between consumer protection and safety and soundness. That is one of the reasons that I believe all the regulatory agencies, as part of any safety and soundness examination, look at all of the consumer complaints. They keep a file. They look at them. They work through them, because there is a keen connection when consumers are complaining, they have some potential safety and soundness-related issues.

I think all of us—certainly OTS has a robust system for addressing consumer complaints. We have made a number of referrals, actually a large number of referrals to Justice for fair lending issues. And I think it is a trend that many of the agencies are seeing.

Mr. TARULLO. Senator, I would say that consumer protection is related both to safety and soundness and, as I suggested in my prepared remarks, to systemic risk.

With respect to how consumer protection is done recently, I have to say in the interest of full disclosure, as you know I have only been at the Fed for 6 weeks, and before that was an academic who was critical of the failure of our bank regulatory agencies to give as much attention to consumer protection as they ought to.

I do think in the last couple of years there has been renewed attention to it and that things have moved in a better direction. But I think it is something that everybody is going to need to continue to pay attention to.

Mr. SMITH. Senator, if I could respond to that briefly?

Senator MERKLEY. Please, Mr. Smith.

Mr. SMITH. On behalf of the States, I will say that with regard to the mortgage issue, for example, the State response to the mortgage issue may have been imperfect, and it may not have been complete. In North Carolina, we started addressing predatory lending in 1999. I would say that I think that the actions of State AGs and State regulators should have been and ought to be in the future, market information in assessing systemic risk ought to be taken into account. And I think this has not been done in the past.

Again, I do not claim that we are perfect. I do claim that we are closer to the market as a rule than our colleagues in the Federal Government. And I think we have something to add if we are allowed to add it. So I hope as we go forward, sir, the State role in consumer protection will be acknowledged and it will be given a chance to do more.

Senator MERKLEY. OK. Well, let me just close with this comment since my time is up. The comment that this issue has had robust attention—I believe, Mr. Polakoff, you made that—WAMU was a thrift. Countrywide was a thrift. On the ground, it does not look like anything close to robust regulation of consumer issues.

I will say I really want to applaud the Fed for the actions they took over subprime lending, their action regarding escrow for taxes and insurance, their addressing of abusive prepayment penalties, the ending of liar loans in subprime. But I also want to say that from the perspective of many folks on the ground, one of the key elements was booted down the road, and that was the yield spread premiums.

Just to capture this, when Americans go to a real estate agent, they have all kinds of protection about conflict of interest. But when they go to a broker, it is a lamb to the slaughter. That broker is being paid, unbeknownst to the customer is being paid proportionally to how bad a loan that consumer gets. And that conflict of interest, that failure to address it, the fact that essentially kickbacks are involved, results in a large number of our citizens, on the most important financial transaction of their life, ending up with a subprime loan rather than a prime loan. That is an outrage.

And I really want to encourage you, sir, in your new capacity to carry this conversation. The Fed has powers that it has not fully utilized. I do applaud the steps it has taken. And I just want to leave with this comment: that the foundation of so many families financially is their homes, and that we need to provide superb protections designed to strengthen our families, not deregulation or loose regulations designed for short-term profits.

Thank you.

Senator REED. Senator Johanns.

Senator JOHANNS. Thank you very much.

I am not even exactly certain who I direct this to, so I am hoping that you all have just enough courage to jump in and offer some thoughts about what I want to talk about today. As I was sitting here and listening to the great questioning from my colleague, the response to one of the questions was that we do make a risk assessment when there is a merger. We make an assessment as to the risk that is being taken on by this merger. And I sit here, I

have to tell you, and I think to myself, well, if it is working that well, how did we end up where we are at today?

So that leads me to these questions. The first one is, who has the authority, or does the authority exist for somebody to say that the sheer size of what we end up with poses a risk to our overall national, if not international economy, because you have got so many eggs in one basket that if your judgment is wrong about the risk assessment, you are not only wrong a little bit, you are wrong in a very magnificent sort of way. So who has that authority? Does that authority exist, and if it doesn't, should it exist?

Mr. TARULLO. Senator, subject to correction or qualification by my colleagues, I can say that at present, there is no existing authority to take that kind of top-down look at the entire system and to make a judgment as to whether there is systemic risk arising—again, not out of individual actions, but out of what is happening collectively.

Now, there is one point I should have made in my introductory remarks, and I will take your question as an opportunity to make it. We all need to be—I hope you are, and we certainly will be—we all need to be realistic about what we can achieve collectively, that is, everybody sitting here on the panel and all of you, in addressing this systemic risk issue. Because I don't think anybody should be under the illusion that simply by saying, oh, yes, systemic risk is important and everybody ought to pay more attention to it, that we are going to solve a lot of the really difficult analytic problems.

Now, we all remember what happened 4 or 5 years ago when some people, with great prescience, raised issues about whether risks were being created by what was going on in the subprime market. And at the same time, many other people came back and said, don't kill this market. So what in retrospect appears to everybody to be a clear case of over-leveraging and bad underwriting and a bubble and all the rest, in at least some cases in real time produces a big debate over whether you are killing the market or you are regulating in the interest of the system.

So that is not, I know, directly responsive to your question, but I do hope that everybody understands that this is going to be a challenge for us all going forward, to make sure that constraints are being placed where they ought to be, but to recognize that nobody wants to kill the process of credit allocation in the United States.

Senator JOHANNS. Could we agree, and I appreciate you offering that. I appreciate the candor of your testimony. Could we agree, members of the panel, that if we really wanted today to make an assessment, again, getting back to this, it just gets so big and there are so few left that we are putting the whole economy at risk if one of them fails, that there really isn't anybody who can step in and say, time out. We can't do that merger or whatever based upon that premise. Or is that a false assumption on my part? Yes, sir?

Mr. DUGAN. I would just make two points. One is, we do have on the banking side a Congressional limit on the amount, the share of deposits that you can have in the United States——

Senator JOHANNS. Right.

Mr. DUGAN. and that is an effective limit of a kind on growth. It doesn't prevent very large institutions, but it prevents—we still have, by worldwide standards, a quite deep consolidated U.S., or lack of concentrated U.S. industry. And, of course, you have the anti-trust limits. But there is nothing in the law that I am aware of that says just because you get large, other than what I just spoke about, that there is a limit on it.

And I would also say that there are large American companies that need large banks, and so you have to be careful if you put some other kind of limit on it that you wouldn't have large European or Asian institutions come and make large loans. So we have to——

Senator JOHANNS. Take the business away.

Mr. DUGAN. ——keep a balance here. There is a balance.

Senator JOHANNS. Yes. The second thought I want to throw out, and I am very close to being out of time here, and these are very complicated issues, but I would like a quick thought if the Chairman will indulge me.

Chairman DODD [presiding]. Certainly.

Senator JOHANNS. Let us say that you do have an institution. You have made your risk assessment. A merger has occurred. And all of a sudden you are looking at it and saying, boy, there were some things here that, if I had to do it over again, I would do it differently. Maybe they have gone a step, two, or three or four further than you anticipated they were going to, and now you can see the risk is growing and growing and growing to a dangerous level. Do we have in our system the cord we can pull that is the safety valve that says, again, in effect, time out. We are at a level where the risk is not acceptable for our economy.

Mr. TARULLO. Senator, I think with respect to a regulated institution, which I believe is the premise of your question, the answer is yes. If the institution is regulated, then somebody sitting at this table is going to have the authority to say, you are assuming too many risks and you need to reduce your exposures in a particular area, you need to increase your capital, you need to do better liquidity management, whatever the proper guidance might be.

The one footnote I place there again is that in order to get to that point, we need to make sure that people are aware of the risks, and sometimes just looking at it from the standpoint of the institution is completely adequate. It is always necessary. But there are these circumstances, and I think we have seen some of them in the last couple of years, where you do need to have a bit more of a system-wide perspective in order to know that something is a risk.

Senator JOHANNS. I will just wrap up with this thought, because I am out of time, and I will try to do so quickly. I think it is a real frustration for us here to be faced with these issues of, well, Mike, this is just way too big to allow it to fail, and, Mike, it is going to take taxpayers' money to unravel the risk that they have gotten themselves into and a lot of money. These are big institutions. It is going to take big money.

And so you can see from my questions what I am trying to do is if we are going to think about this in a global way—I certainly don't want to stall growth in this Nation. I mean, gosh, we are the greatest Nation on earth. But on the other hand, I would like to

think whatever we are doing, we are going to give some policymakers the ability and some regulators the ability to, in effect, say, time out.

Mr. TARULLO. Mr. Chairman, could I answer briefly?

Chairman DODD. Certainly.

Mr. TARULLO. Senator, I not only understand but sympathize with your perspective, and with respect to your closing remarks, here is what I would suggest back to you: A number of the instruments—I would say, if I can over-generalize, a lot of what is in the prepared, the long prepared testimony of people at this table today is a rehearsing of some of the instruments which are available to you. And I am sure you and your staff and your colleagues, after you go through them all, you are going to want to tweak some. You may not be in favor of others at all. But I think this is the opportunity that we all have, which is to take this moment, not only to do an internal self-examination, but also to say, OK, how are we going to revamp this system to put in place structures that avoid exactly the kind of situation you are talking about?

So just to use two, because I don't want to take up too much time, the resolution mechanism about which you have heard so much from Mr. Dugan, Ms. Bair, and me is really very important here precisely because of its association with a "too big to fail" institution. Making sure that systemically important institutions are regulated in a way that takes that systemic importance into account in the first instance, with the capital and liquidity requirements they have, will be steps along that road.

Chairman DODD. Thank you very much, and I totally agree with that. I think that is very, very important.

Senator Reed.

Senator REED. Well, thank you, Mr. Chairman.

I want to thank the witnesses. I have great respect for your efforts and your colleagues' efforts to enforce the laws and to provide the kind of stability and regulation necessary for a thriving financial system. I think I have seen Mr. Polakoff at least three times this week, so I know you put in a lot of hours in here as well as back in the office, so thank you for that.

Yesterday, we had a hearing based on a GAO report about the risk assessment capacities and capabilities of financial institutions, but one of the things that struck me is that perhaps either inadvertently or advertently, we have given you conflicting tasks. One is to maintain confidence in the financial system of the United States, but at the same time giving you the responsibility to expose those faults in the financial system to the public, to the markets, and also to Congress.

And I think in reflecting back over the last several years or months, what has seemed to trump a lot of decisions by all these agencies has been the need or the perceived need to maintain confidence in the system when, in fact, many regulators had grave doubts about the ability of the system to perform, the risks that were being assembled, the strategies that were being pursued. And I think if we don't at least confront that conflict or conundrum directly, we could reassign responsibilities without making a significant change in anything we do.

And so in that respect, I wonder if you have any kind of thoughts about this tradeoff between your role as cheerleaders for the banking system and your role as referees for the banking system. Mr. Dugan?

Mr. DUGAN. Well, I am not sure I would describe it as the cheerleader——

Senator REED. I think in some cases, we heard the cheers echoing through the halls.

Mr. DUGAN. I guess what I would say, Senator, is there is a tension with financial institutions that depend so heavily on confidence, particularly because of the run risk that was described earlier. And I am not just talking about depositors getting in line. I am talking about funding. That has always informed and is very deeply embedded in our whole system of financial regulation. There is much about what we do and how we do it that is by design confidential supervisory information and we do have to be careful in everything we do and how we talk about it, about not creating or making a situation worse.

And at the same time, the tension you quite rightly talk about is knowing that there are problems that need to be addressed and finding ways to address them in public forums without running afoul of that earlier problem, and it gets harder when we have bigger problems in a financial crisis like the one we have and we all have to work hard to get through that and to try to work with that tension, and I think we can do that by the kinds of hearings that you have had. I think we have to avoid commenting about specific open institutions, but there are many things we can talk about and get at and I think that is what we need to do.

Senator REED. Ms. Bair, and I will try to get around briefly because of the time limit. Ms. Bair?

Ms. BAIR. Well, I hope we are cheerleaders for depositors. I think we are all about stability and public confidence, so I think it is important to keep perspective, though, for all bank regulators, that what we do should always be tied to the broader public interest. It is not our job to protect banks. It is our job to protect the economy and the system, and to the extent our regulatory functions relate to that, that is how they should be focused.

I do think that the market is confused now because different situations have been handled in different ways, and I hate to sound like a Johnny-one-note, but I think a lot of it does come back to this inability to have a legal structure for resolving institutions once they get into trouble. I think whatever that structure might eventually look like, just clarity for the market—for investors and creditors—about how they will be treated and the consistency of the treatment, would go a long way to promoting financial stability and confidence.

Senator REED. Mr. Fryzel.

Mr. FRYZEL. Thank you, Senator. Paramount to NCUA is the safety and soundness of the funds of all our 90 million members in credit unions across this country, and in an effort to maintain their confidence is not an easy task, and we have made every effort to do so by public awareness campaigns. Certainly the action by Congress in raising the $250,000 limit has been fantastic in regards to the safety and their ability to think that their funds, or

to know that their funds are safe. We tried to draw the fine line in letting them know that, yes, there are problems in our financial structure, but we are dealing with them and we are going to use the tools that we have to make sure that things get better. And when this economy turns around, financial institutions are again going to be in the position where they are going to be able to serve these consumers in the way they have in the past.

So yes, Senator, it is a fine line, but I think it is one that we have to keep talking about. We cannot let anyone think that there are not problems out there. We have to tell them we are in a great country. This economy does come back and everything is going to be better in the future.

Senator REED. Mr. Tarullo.

Mr. TARULLO. Senator, I may have misunderstood. I understood you to be asking not about regulatory actions in the midst of the crisis, but in the period preceding it, when supervision is supposed to be ongoing. And I think there is a lot to the question that you asked, not so much because, I would say, of the conflict of interests as such between different roles, but because everybody tends to fall into a notion of what operating principles are for whatever period we may be in. And so people come to accept things. Bankers do, supervisors do, maybe even Members of Congress do—something that is ongoing, is precisely because it has been ongoing, thought to be an acceptable situation.

So I think from both our perspective and your perspective the challenge here is to figure out what kinds of mechanisms we put in place within agencies, between the Hill and agencies in legislation which force consideration of the kinds of emerging issues that we can't predict now because we don't know what the next crisis might look like, but which are going to be noticed by somebody along the way.

And while I really don't want to overstate the potential utility of a systemic risk regulator for the reasons I said earlier, I would say that in an environment in which an overall assessment of the system is an explicit part of the mandate of one or more entities in the U.S. Government, you at least increase the chances that that kind of disparate information gets pulled together and somebody has to focus on it. Now, what you do with it, that is another set of questions, but I think that gets you at least a little bit down the road.

Senator REED. Mr. Polakoff, and my time is expiring, so your brevity is appreciated.

Mr. POLAKOFF. I will be as short as possible, Senator. Thank you. We are not in the current situation we are in today because of actions over the last six to 12 months by the regulators, or in a lot of cases the bankers. It is from 3, 4, 5 years ago.

I think the notion of counter-cyclical regulation needs to be discussed at some point. When the economy is strong is when we should be our strongest in being aggressive, and when the economy is struggling, I think is when we need to be sure that we are not being too strong.

Any of us at this table can prevent a bank from failing. We can prevent banks from failing. But what will happen is people who deserve credit will not get credit because they will be on the bubble.

The thing I love about bank supervision is it is part art and it is part science, and I think what we are doing today is going to address the situation today. We have got to be careful we are doing the right thing for tomorrow and next year, as well.

Senator REED. Mr. Smith, and then Mr. Reynolds.

Mr. SMITH. Thank you, Senator. I agree with my friend, the Comptroller, that the two concepts of supervisory authority, on the one hand, and consumer protection, on the other, are intertwined. They should not be drawn apart.

I will say that in the State system, sir, we have the advantage of having a partner with friends in the Federal Government. We have cooperative federalism. That is a good thing, because our Federal friends help us and sometimes tell us things we don't want to know, particularly about consumer compliance, that makes our system of regulation stronger.

I would suggest, sir, that some of the actions the States have taken in consumer protection in the past, if they had been listened to, would have helped in terms of determining the systemic—understanding what the systemic risk of some activities in the marketplace were, and so I believe that as a part, as we say in our testimony, as part of an ongoing system of supervision, I would argue, and I will agree with, I believe, with Governor Tarullo, that you need—the fact that you have multiple regulators focusing on an issue can, in the proper circumstance, if there is cooperation, result in better regulation. The idea of a single regulator, I think, is inherently flawed.

Senator REED. Mr. Reynolds.

Mr. REYNOLDS. My comment would be that it is appropriate that we take a measured response. I agree with Mr. Polakoff's observation that regulators have the ability to tighten down on regulation to the point where we make credit availability an issue. On the other side, it is important that our role as safety and soundness regulators be the primary role that we play and that we are not in the business of being cheerleaders for the industry. I am certain that my bankers and my credit union managers in the State of Georgia don't regard me as a cheerleader.

Senator REED. My time has expired. Thank you.

Chairman DODD. Well, thank you, Senator, very much.

I should have taken note, and I apologize for not doing so, Senator Reed had a very good subcommittee hearing yesterday, and this is the seventh hearing we have had just this year on the subject matter of modernization of Federal regulations. We had dozens last year going back and examining the crisis as well as beginning to explore ideas on how to go forward. And so I am very grateful to Jack and the other subcommittee chairs who are meeting, as well. We have four hearings this week alone just on the subject matter, so it is very, very helpful and I thank Senator Reed for that.

Senator REED. Thank you, Mr. Chairman.

Chairman DODD. I am going to turn to Senator Menendez, but I want to come back to this notion about a supervisory capacity and consumer protection, because too often, the safety and soundness dominates the consumer protection debate and we have got to fig-

ure out a new direction—that can't go on, in my view. There has got to be a better way of dealing with this.

But let me turn to Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman, and Mr. Chairman, I have a statement for the record, so I hope that can be included.

Chairman DODD. It will be included.

Senator MENENDEZ. Mr. Chairman, I look forward to asking some questions specifically, but I want to turn first to Chairman Bair. I cannot pass up the opportunity, first to compliment you on a whole host of things you are doing on foreclosure mitigation and what not. I think you were ahead of the curve when others were not and really applaud you for that.

But I do have a concern. I have heard from scores of community banks who are saying, you know, we understand the need to rebuild the Federal Deposit Insurance Fund, but I understand when they say to me, look, we are not the ones who drove this situation. We have to compete against entities that are receiving TARP funds. We are not. And in some cases, we are looking at anywhere between 50 and 100 percent of profit.

Isn't there—I know that—I understand you are statutorily prohibited from discriminating large versus small, but in this once—and so I understand this is supposedly a one-time assessment. Wouldn't it be appropriate for us to give you the authority to vary this in a way that doesn't have a tremendous effect on the one entity, it seems to me, that is actually out there lending in the marketplace as best as they can?

Ms. BAIR. Well, a couple of things. We have signaled strongly that if Congress will move with raising our borrowing authority, we feel that that will give us a little more breathing room.

Senator MENENDEZ. With what? I am sorry, I didn't hear.

Ms. BAIR. If Congress raises our borrowing authority—Chairman Dodd and Senator Crapo have introduced a bill to do just that—if that can be done relatively soon, then we think we would have some flexibility to reduce the special assessment. Right now, we have built in a good cushion above what our loss projections would suggest would take us to zero because we think the borrowing authority does need to be raised. It has been at $30 billion since 1991. So we do think that needs to happen. But if it does get raised, we feel we could reduce our cushion a bit.

Also, the FDIC Board just approved a phase-out of our TLGP, what we call our TLGP Debt Guarantee Program. We are raising the cost of that program through surcharges which we will put into the Deposit Insurance Fund. This could also reduce the need for the special assessment and so we will be monitoring that very closely.

We have also asked for comment about whether we should change the assessment base for the special assessment. Right now, we use domestic deposits. If you used all bank assets, that would shift the burden to some of the larger institutions, because they rely less on deposits than the smaller institutions. So we are gathering comment on that right now. We will probably make a final decision in late May.

Increasing the borrowing authority plus we expect to get some significant revenue through this surcharge we have just imposed on our TLGP—most of the larger banks are the beneficiaries of that Debt Guarantee program—we think that will help a lot.

Senator MENENDEZ. Well, I look forward, Mr. Chairman, to working with you to try to make this happen, because these community banks are the ones that are actually out there still lending in communities at a time in which we generally don't see much credit available. But this is a huge blow to them and however we can—I will submit my own comments for the regulatory process, but however we can lighten the load, I think will be incredibly important.

Mr. Dugan, I want to pursue a couple of things with you. You recently said in a letter to the Congressional Oversight Panel, essentially defending your agency. Included in that letter is a chart of the ten worst, the lenders with the higher subprime and Alternate A foreclosure rates. Now, I see that three of them on this list have been originating entities under your supervision—Wells Fargo, Countrywide, and First Franklin. Can you tell us what your supervision of these entities told you during 2005 to 2007 about their practices?

Mr. DUGAN. Senator, as I said before, we certainly did have some institutions that were engaged in subprime lending, and what I said also is that it is a relatively smaller share of overall subprime lending in the home market and what you see. It was roughly ten to 15 percent of all subprime loans in 2005 and 2006, even though we have a much larger share of the mortgage market.

I think you will find that of the providers of those loans, the foreclosure rates were lower and were somewhat better underwritten, even though there were problem loans, and I don't deny that at all, and I would say that, historically, the commercial banks, both State and national, were much more heavily intensively regulating and supervising loans, including subprime loans. We had had a very bad experience 10 years ago or so with subprime credit cards, and as a result, we were not viewed as a particularly hospitable place to conduct subprime lending business.

So even with organizations that were complex bank holding companies, they tended to do their subprime lending in holding company affiliates rather than in the bank or in the subsidiary of the bank where we regulated them. We did have some, but it turned out it was a much smaller percentage of the overall system than the subprime loans that were actually done.

Senator MENENDEZ. Well, subprimes is one thing. The Alternate As is another. Let me ask you this. How many examiners, on-site examiners, did you recently have at Bank of America, at Citi, at Wachovia, at Wells?

Mr. DUGAN. It is different for each one of those, but we have—on-site examiners can vary in our largest banks from 50 to 70 examiners. It is a very substantial number, depending on which organization you are talking about.

Senator MENENDEZ. And what did they say to you about these major "too big to fail" lenders getting heavily into no-document and low-document loans?

Mr. DUGAN. Well, we were never the leader in no-document and low-document loans. We did do some of it. The whole Alt A market, by definition, was a lower-documentation market and it was a loan product that mostly was sold into secondary markets.

When I got and became Comptroller in 2005, we began to see the creeping situation where there were a number of layers of risk that were being added to all sorts of loans that we—our examiners were seeing, and that caused us to issue guidance on nontraditional mortgages, like payment option mortgages, which we were quite aggressively talking about the negative amortization in it as being not a good thing for the system, and that again we were quite vocal about pushing out of the national banks that were doing it.

Senator MENENDEZ. Well, let me ask you, you have twice been criticized by your own Inspector General for keeping, quote, "a light touch," light for too long when banks under your watch were getting in trouble. And I know you have consistently told us that you like to do things informally and in private with your banks. Do you think that changing that strategy makes sense in light of what we have gone through now?

Mr. DUGAN. I think I would say two things. The Inspector General does material loss reviews on all the agencies with respect to any bank that has more than a $25 million loss, and it is a good process, a healthy process, and we accept that constructive criticism. And they have talked about places where we could have moved more quickly with respect to a couple of institutions, and we agreed with that.

What I would say is we have, as supervisors, a range of tools that we can use that are both informal tools that Congress has given us and formal enforcement tools. And on that spectrum, we do different things depending on the circumstances to try to get actions and behavior corrected. And merely because something is not formal and public does not mean that we are not paying attention or getting things addressed or fixed.

Many times—many times—because we are on-site, have the presence, identify a problem, we can get things corrected quickly and efficiently without the need to go to a formal enforcement action. But we will not hesitate, if we have to, to take that action to fix those things.

So I think there are things that we constantly look about to correct and to improve our supervision using that range of tools.

Senator MENENDEZ. Mr. Chairman, if I may have just one more moment?

Chairman DODD. Just following up on the Senator's question, how many of those banks did you find that violated your guidelines? And if so, what were the punishments you meted out for them? Looking back, do you think you missed any of the violations?

Mr. DUGAN. It would range from things we have something that—if we see something early, any kind of bank examination that you go through, there are certain kinds of violations of law. Some are less serious and some are more serious. And at one end of the spectrum, we do something called "Matters requiring attention," which tells the directors we expect you to fix this and we want it fixed by the next time we come in.

Chairman DODD. Jump to the more serious ones.

Mr. DUGAN. Well, on that point, we saw 123 of them in that 4-year period, and we got 109 of them corrected within that period.

Chairman DODD. Were there punishments meted out?

Mr. DUGAN. Oh, yes. Not for those things, but we have other situations in which we took actions for mortgage fraud, for other kinds of mortgage-related actions where we had problems, and we have provided some statistics that I could certainly get that we have compiled for the enforcement hearing where we are testifying tomorrow.

Chairman DODD. I am sorry, Senator.

Senator MENENDEZ. No. Thank you, Senator Dodd. I appreciate it. Just one more line of questioning.

You know, we had a witness before the Committee, Professor McCoy of the University of Connecticut School of Law, and she made some statements that were, you know, pretty alarming to me. She said, "The OCC has asserted that national banks made only 10 percent of subprime loans in 2006. But this assertion fails to mention that national banks moved aggressively into Alternate-A low-documentation and no-documentation loans during the housing boom."

"Unlike OTS, the OCC did promulgate one rule in 2004 prohibiting mortgages to borrowers who could not afford to pay. However, the rule was vague in design and execution, allowing lax lending to proliferate at national banks and their mortgage lending subsidiaries through 2007."

"Despite the 2004 rules, through 2007, large national banks continued to make large quantities of poorly underwritten subprime loans and low- and no-documentation loans."

"The five largest U.S. banks in 2005 were all national banks and too big to fail. They too made heavy inroads into low- and no-documentation loans."

And so it just seems to me that some of the biggest bank failures have been under your agency's watch, and they, too, involved thrifts heavily into nil documents, low documents, Alternate A, and nontraditionals, and it is hard to make the case that we had an adequate job of oversight given those results.

We have heard a lot here about one of our problems is regulatory arbitrage. Don't you think that they chose your agency because they thought they would get a better break?

Mr. DUGAN. I do not and, Senator, I would be happy to respond to those specific allegations, and there are a number of them that were raised. I looked at that testimony, and there are a number of statistics which we flatly disagree with and that were compiled in a way that actually do not give a true picture of what was happening and what was not happening.

National banks increasingly have been involved in the supervision of mortgage loans. There is no doubt about that. But I would say that we have done a good job in that area—not perfect, but we think we have excellent, on-the-ground supervisors in that area, and it did not lead to all the kinds of problems in national banks, from national banks, that is——

Senator MENENDEZ. Well, I will submit the question for the record because the Chairman has been very generous with my time, but one of the things I would ask you is: What are you doing

in comparison to State regulators who, in fact—regulators of State depositories who, in fact, have much better performance rates, considerable better than yours?

Mr. DUGAN. Actually, that is not true. I have seen that chart, and I will provide——

Senator MENENDEZ. OK. So I would love to either sit down with you to get all that information——

Mr. DUGAN. I would welcome that.

Senator MENENDEZ. ——so we can dispel is not the case.

Thank you, Mr. Chairman.

Chairman DODD. Let me follow up on that, because it is a very important line of questioning. There were hundreds of thousands, we know now, of bad loans. Hundreds of thousands of them. You talk about 123 violations. I do not just focus the question on the OCC but also the FDIC, the OTS, the Fed. What was your experience? Obviously, Dan, you were not there at the time, but I would like to get some information, if I could, from the Fed as to what was going on. When you consider the hundreds of thousands of bad loans that are the root cause of why we are here today, the reason we are sitting here today is because of what happened under that framework and that time, going back 4 or 5 years ago, longer maybe. And so we have hundreds of thousands of bad loans that were issued, and it is awfully difficult to explain to people that out of that quantity, 123 violations are identified.

Mr. DUGAN. Well, let me say two things. One, I was referring to one particular kind of violation. There are others that we will be happy to submit for the record. But I think the more fundamental point is this: There were many of these loans that did not violate the law. They were just underwritten in a way with easier standards than they had been historically. And that was not necessarily a legal violation, but a prudential——

Chairman DODD. But shouldn't that have raised a red flag? You are the experts in this area, and you were watching people get loans with no documentation, these liar loans and so forth. Was anyone watching?

Mr. DUGAN. People were watching. I think what drove that initially—my own personal view on this—is that most of those loans were sold into the secondary market. They were not loans held on the books of the institutions that originated them. And so for someone to sell it and get rid of the risk, it did not look like it was something that was presenting the same kind of risk to the institution.

And if you go back and look at the time when house prices were rising and there were not high default rates on it, people were making the argument that these things are a good thing and provide more loans to more people.

It made our examiners uncomfortable. We eventually, I think too late, came around to the view that it was a practice that should not occur, and that is exactly why I was talking earlier, if we could do one thing—two things that we should have done as an underwriting standard earlier is, one, the low-documentation loans and the other is the decline in downpayments.

Chairman DODD. I want to ask the other panelists here with regard to Senator Menendez's line of questioning. The guidance is not

on the securitization of those loans or what happens with rating agencies. The guidance is on the origination of the loans, which is clearly the responsibility of the OCC. And so the fact that these things were sold later on is a point I take, but your responsibility is in origination, and origination involved this kind of behavior. I appreciate you providing us with numbers in one area, but I assume there are more numbers you can give us in other areas. I do not think you can get away by suggesting—I say this respectfully to you—that because they have not been held at the institution—as most of us here have a little gray hair on our head and have had our mortgage for years that you could not notice changes in the way mortgages were originated. On the other hand, when mortgages are kept with originators and you could look at them for 30 years if you wanted.

Mr. DUGAN. Right.

Chairman DODD. Obviously that is all changed. But your responsibility falls into origination, which is a very different question than what happens in terms of whether or not the mortgage is held at the institution or sold.

Mr. DUGAN. I totally agree with that point. The point I was really trying to make was we had a market where the securitization market got very powerful.

Chairman DODD. Right.

Mr. DUGAN. It was buying loans from people in the marketplace, standards reduced, particularly from nonbank brokers and mortgage originators that were providing those. Banks were competing with them, and people were not at that time suffering very significant losses on those loans because house prices were going up. And I think——

Chairman DODD. You cannot just look at losses. Is the practice acceptable?

Mr. DUGAN. I understand that, and I believe that we were too late getting to the notion, all of us, about getting at stated income practices and low-documentation loans. We did get to it, but it was after the horse had left the barn in a number of cases, and we should have gotten there earlier.

The point I was just trying to make to you, though, is that as these things were leaving the institution, they were less of a risk to that institution from a safety and soundness point of view.

Chairman DODD. We are going back around. Chairman Bair, let me ask you to comment on this as well.

Ms. BAIR. Well, I think John is right. These practices became far too pervasive. For the most part, the smaller State-chartered banks we regulate did not do this type of lending they do more traditional lending, and then obviously they do commercial real estate lending, which had a separate set of issues.

We had one specialty lender who we ordered out of the business in February of 2007. There have been a few others. We have had some other actions, and I would have to go back to the examination staff to get the details for you. But I was also concerned that even after the guidance on the nontraditional mortgages, which quite specifically said you are not going to do low-doc and no-doc anymore, that we still had very weak underwriting in 2007.

So I think that is a problem that all of us should look back on and try to figure out, because clearly by 2007 we knew this was epidemic in proportion, and the underwriting standards did not improve as well as you would have thought they should have, and the performance of those loans had been very poor as well. I do think we need to do a lot more——

Chairman DODD. Well, quickly the Fed and the OTS. I know it is a little difficult to ask you this question, Dan, because you were not there at the time, but any response to this point?

Mr. TARULLO. I do not, Senator, except as an external observer. But anything that you would like from the Fed, if you just——

Chairman DODD. Well, it might be helpful to find out whether or not there were violations, and punishments meted out at all. Again, many of us have heard over the last couple of years the complaint is that Congress in 1994 passed the HOEPA legislation which mandated that the Federal Reserve promulgate regulations to deal with fraudulent and deceptive residential mortgage practices. Not a single regulation was ever promulgated until the last year or so, and obviously that is seen as a major gap in terms of the responsibility of moving forward.

OTS quickly, do you have any——

Mr. POLAKOFF. Mr. Chairman, you are right. The private label securitization market, we could have done a better job in looking at the underwriting as those loans passed off the institution's books and into a securitization process. Yes, sir.

Chairman DODD. Senator Menendez, do you want to make any further comment on this point or not?

Senator MENENDEZ. I think, Mr. Chairman, you are on the road—you know, to me—and I know Mr. Tarullo was not there, but the Federal Reserve, you know, is at the forefront of what needed to be done because they had the ability to set the standard. And the lack of doing so, you know, is a major part of the challenge that we are facing today. But I appreciate it and I look forward to the follow-up.

Chairman DODD. Senator Bunning.

Senator BUNNING. Thank you. I hurried back, and I heard that Senator Menendez asked my question, but that is all right. This is for Sheila.

I am not used to angry bankers. I have had a great relationship with the Kentucky Association and their leaders, but I did a roundtable discussion in Paducah, Kentucky. Paducah, Kentucky, is a town of about 29,000 people. Two community bankers. One came to me and said, "We have just been assessed by the Federal Deposit Insurance Corporation, and guess what? We will not be profitable in 2009 because of that assessment." No bad loans, no nothing. No bad securities. They keep their mortgages in-house. Everything just like community bankers in most places do.

There was a gentleman from BB&T. Now, that is not a community bank. That is a much larger bank. The assessment for the community bank was $800,000, wiped out their total profitability. BB&T was $1.2 million. Now, that did not wipe out their profitability because they have many banks all over the country. But how can you explain to the American people that for doing your job and doing it well, you are being assessed your total profitability in

1 year to pay for those who did not do their job very well? Maybe you can explain that to me because I do not understand it.

Ms. BAIR. Well, deposit insurance has always been funded by industry assessments. The FDIC actually has never—we do have the full faith and credit of the U.S. Government backing us. We do have lines of credit——

Senator BUNNING. There are a lot of other ways that you could have done it.

Ms. BAIR. Well, sir, all banks that get deposit insurance pay for it. It is an expense that they need to factor in. And we have been signaling for some time that we will need to raise premiums. We are in a much more distressed economic environment. Our loss projections are going up, and I think most community banks agree that we should continue our industry-funded self-sufficiency and not turn to taxpayers.

We did not want to do the 20-basis-point special assessment, but our loss projections are going up significantly, and we felt it was necessary to maintain an adequate cushion above zero.

Senator BUNNING. For this one community bank, it was a 1,000-percent increase in their assessment.

Ms. BAIR. Well, I would be happy to go over those numbers with you.

Senator BUNNING. I will be glad to go over them, because she did. She went over them with me.

Ms. BAIR. OK. We would like to see that, because they are miscalculating what the assessment is.

I would say the base assessment is 12 to 16 basis points. The interim special assessment is 20 basis points. It is out for comment. It has not been finalized yet. We are hoping that through increasing our borrowing authority we can——

Senator BUNNING. Don't you have a line of credit with the Treasury? It seems like everybody else does, so I would assume that you do.

Ms. BAIR. We do. It is pretty low. It has not been raised since 1991, and we are working with Chairman Dodd and Senator Crapo to get it raised. But I would say the FDIC has never borrowed from Treasury to cover our losses. We have only borrowed once in our entire history. That was for short-term borrowing.

Senator BUNNING. We can print you some money. I mean, what the heck. It is printed by——

[Laughter.]

Senator BUNNING. Yesterday, our Chairman of the Fed announced $1.2 trillion—not billion but trillion dollars of printed money going out.

Ms. BAIR. Right.

Senator BUNNING. It is just scary.

Ms. BAIR. That is a policy call. I think a lot of community banks—Ken Guenther had an excellent blog yesterday he has obviously been long associated with community bankers—suggesting that it would not be in community bankers' interest, because right now they are not tarnished with the bailout brush. But if the FDIC starts going to taxpayers for our funding instead of relying on our industry assessments, I think that perception could change.

We are working very hard to reduce the special assessment. I have already said that if the borrowing authority is increased, we feel we can reduce it meaningfully. This week we approved a surcharge to a debt guarantee program we have that is heavily used by large institutions. We will put that surcharge into our deposit insurance fund and also use that to offset the 20-basis-point assessment.

So we are working hard to get it down. We want to get it down. But I do think the principle of industry funding is important to the history of the FDIC, and I think it is important to the reputation and confidence of community banks that they are not getting taxpayer assistance. They continue to stand behind their fund.

Senator BUNNING. Well, that all sounds really well and good. I would like to take you to that roundtable and let you——

Ms. BAIR. Senator, I have personally——

Senator BUNNING. ——explain that to those two bankers.

Ms. BAIR. I have talked to a lot of community bankers about this. I absolutely have. I would also like to share numbers with you, though, that show deposit insurance, even with the special assessments, is still very cheap compared to alternative sources of funding. Even with the special assessments, it is much cheaper than any other sources of funding that they would have to tap into.

Senator BUNNING. You have taken up all my time. I cannot ask another question—may I?

Chairman DODD. Sure.

Senator BUNNING. OK. The gentleman from the Federal Reserve is here. Thank you for being here. Do you or anybody else at the Fed have concerns about the Fed being the systemic risk regulator or payment system regulator? And where would you say would be the right place to place that task?

Mr. TARULLO. Senator, with respect to payment systems, I think there is a fair consensus at the Fed that some formal legal authority to regulate payment systems is important to have. As you probably know, *de facto* right now the Fed is able to exercise supervisory authority over payment systems. That is because of the peculiarity of the fact that the entities concerned are member banks of the Federal Reserve System. They have got supervisory authority. If their corporate form were to change, there would be some question about it, and payments, as you know, are historically and importantly related to the operation of the financial system.

Now, with respect to the systemic risk regulator, I think there is much less final agreement on either one of the questions that I think are implicit in what you asked. One, what should a systemic risk regulator do precisely? And, two, who should do it?

The one thing I would say—and I think this bears repeating, so I will look for occasions to say it again—is however the Congress comes down on this issue, I think that we need all to be clear, you need to be clear in the legislation, whoever you delegate tasks to needs to be clear, not just what exactly the authorities are, which is important, but also the expectations are, because we need to be clear as to what we think can be accomplished. You do not want to give responsibility without authority——

Senator BUNNING. Well, sometimes we give the responsibility and the authority——

Mr. TARULLO. That is correct.

Senator BUNNING. And it is not used, just the 1994 law when we handed the Fed the responsibility and it was 14 years before they promulgated one rule or regulation.

Mr. TARULLO. I agree. Believe me, Senator. That is something that I observed myself before I was in my present job. So I have got no——

Senator BUNNING. No, I am not faulting you, but I am just stating the fact that even when we are sometimes very clear in our demand that certain people regulate certain things, they have to take the ball and carry it then.

Mr. TARULLO. Absolutely. Absolutely correct. And so on the systemic risk regulator issue, there is a strong sense that if there is to be a systemic risk regulator, the Federal Reserve needs to be involved because of our function as lender of last resort, because of the mission of protecting financial stability. How that function is structured seems to me something that is open-ended because the powers in question need to be decided by the Congress. Let me give you one example of that.

It is very important that there be consolidated supervision of every systemically important institution. So with bank holding companies, that is not a problem, because we have already got that authority. But there are other institutions out there currently unregulated over which no existing agency has prudential, safety and soundness, supervisory authority.

Senator BUNNING. You realize that your two Chairmen came to us and told us that certain entities——

Mr. TARULLO. Right, absolutely.

Senator BUNNING. ——should not be regulated.

Mr. TARULLO. I am sorry. Which entity——

Senator BUNNING. Well, credit default swaps and other things that are related to that. Your past Chairman and your current Chairman.

Mr. TARULLO. OK, so I can—let me get to credit default swaps in a moment, but let me try to address the institution issue, because it is the case that we believe consolidated supervision is important for each institution. A consolidated——

Senator BUNNING. We maybe should make a regulator for each institution.

Mr. TARULLO. If there is a good prudential regulator for each systemically important institution, then you would not need a systemic regulator to fulfill that——

Senator BUNNING. That is correct.

Mr. TARULLO. I think that is——

Senator BUNNING. And we also would not have people too big to fail.

Mr. TARULLO. Well, you would hope that the regulation, including a resolution mechanism and the like, would be such as to contain that——

Senator BUNNING. That is what I mean.

Mr. TARULLO. Yes, exactly, Senator.

Senator BUNNING. Thank you.

Mr. TARULLO. OK, sure.

Chairman DODD. Thanks, Senator Bunning, for the question, I am not going to ask you to respond to this because I have taken a lot of your time already today, not to mention there was a little confusion with the votes we have had. But we want to define what we mean when we talk about a systemic risk regulator. Do you mean regulating institutions that are inherently systemically risky or important? Or are you talking about regulating systemically risky practices that institutions can engage in? Or are you talking about regulating or setting up a resolution structure so that when you have institutions like AIG and Lehman Brothers, you have got an alternative other than just pumping capital into them, as we did in the case of AIG?

I get uneasy about the fact that the Fed is the lender of last resort. Simultaneously the Fed now also falls into the capacity of being particularly in the last function, the resolution operation. It seems to me you get, like in the thrift crisis years ago, the regulator becomes also the one that also deals with these resolutions. I think that is an inherently dangerous path to go down. That is my instinct.

Mr. TARULLO. Let me just take 30 seconds, Senator. That little litany you had I think is right. I would just add one thing to it. You have got supervision of systemically important institutions not currently subject to supervision.

Chairman DODD. That could be one role.

Mr. TARULLO. That is one role. The second role, which you also identified, practices that are pervasive in an industry, no matter what the size of the entity, which rise to the level of posing true systemic risk—probably unusual, but certainly possible.

Chairman DODD. Right.

Mr. TARULLO. And I think we have seen it in the last couple of years.

Third is the resolution mechanism you spoke about. It seems to me that should not be included within the definition of system risk regulator. You could, under some configurations, have the same entity doing those two functions. I think what you would need is to ensure that the systemic regulator had a role in the decisions on resolving systemically important institutions, as Chairman Bair pointed out, such as under the systemic risk exception in the FDI Act that already exists.

The fourth function that I would add is the monitoring one. I understand that is a prerequisite for some of the other ones we talked about, but it also serves an independent purpose, and I think, if I am not mistaken, this is some of what Senator Reed has been getting at in the past—the need to focus on issues and get them out, get them discussed and get them reported.

Chairman DODD. Right.

Mr. TARULLO. So I think that is your choice, that you have got four functions there. My sense is that the resolution issue is not necessarily——

Chairman DODD. You could be right. And your fourth point, the private sector model where you have the official or the officer in the business doing the risk assessment. As I understand it, in a lot of these entities, they do not have the capacity to shut something down on their own except in very extreme cases. But they will ad-

vise the individuals who are engaging in that thing that their behavior is posing risks to their company. So it does not have the ability to say no, but it has the power or at least the information to warn.

I am a little uneasy about that because it just seems to me whether or not you are going to get the decisions that actually would shut things down when they arise. There are too many dots to connect to reach that point of shutting something down before it poses even greater risk.

Mr. TARULLO. Well, but you do, I think, Mr. Chairman, want—again, this is why it is important for Congress ultimately to decide what scope of authorities it wants somewhere, and then figure out where the best place to put them is. But that does require us all to make this judgment as to how broadly we want authority reaching and under what circumstances. As you can tell from my testimony, our view is that you do not want to displace the regular prudential supervision of all the agencies.

Chairman DODD. No.

Mr. TARULLO. This should be something which is an oversight mechanism on top of it in the general course of things. But as I think you have pointed out, you will sometimes have practices—and subprime mortgage lending that was either predatory or not well backed by good underwriting is a principal example—that became pervasive and should have been regulated earlier.

Chairman DODD. I have said over and over again I am sort of agnostic on all of this. I want to do what works. But if you ask me where I was inclining, it is on that point. I think you have got to watch practices. Just because something is called important does not mean it is. And there may be practices that may not seem important but are terribly important. And it seems to me we ought to be focusing on that, not at the exclusion of the other.

Let me ask the other panelists quickly to comment if they have—any comments on this from anyone else on this discussion? Sheila, do you have——

Mr. FRYZEL. I just have one comment. If the Congress takes the action and puts in place a systemic regulator, that is certainly not going to stop or prevent some of the problems that we have now out in the financial services industry.

As Chairman Bair talked about, the fact that she has asked for an increase in the lending from the Treasury, as we have at NCUA, which is paramount to us taking care of the problems between now and the time the systemic risk regulator is able to take over and watch over all of our industries. So that there are tools that we are going to be coming back to the Congress for between now and then that the regulators are going to need to solve the problems that are existing out there now. We still need things to get those solved.

Chairman DODD. Sheila, do you want to comment?

Ms. BAIR. Yes, I would—I agree with what you said about practices. I would only add that, to some extent, they are connected in that if the Federal Government or the agencies do not have the ability both to write rules—which we did have—and enforce those rules for all institutions, you still get the kind of dynamic we had

with mortgages where it started with the nonbanks creating competitive pressure on the banks to respond in kind.

And another thing that—you do not have the SEC and the CFTC here, but I think any discussion of regulatory restructuring needs to note the need for market regulation of the derivatives markets, especially the CDS markets.

Chairman DODD. We do not have a table big enough.

Ms. BAIR. That is not institution-specific, absolutely, but it is another area.

Chairman DODD. But I must say, I was sitting here looking at this and we are missing the CFTC and the SEC at this table. But in a sense, and I say this very respectfully, this is the problem. With all due respect, this is the problem. In a sense, we talk about too big to fail in the sense of private institutions. But in a sense, we have a bureaucracy or a regulatory structure and so forth, that is too big to succeed because it is so duplicative.

And I can understand there is a value in that, in terms of protecting some things, but we are having the SEC next week testify before the Committee.

But if I wanted to capture in a photograph what is the essence of the problem, I can't. And this is the problem. And this is what we've got to sort out in a way that provides some clarity to the process as we go forward.

By the way, there is going to be a hearing at 2 o'clock—I know that is what all of you want to hear—on deposit insurance that Senator Johnson is hosting in 538 of the Dirksen Building.

[Laughter.]

Chairman DODD. That will be good news for our panelists, we know I have got to wrap up here as we are getting near 2 o'clock.

We are going to proceed on this, I would say to Chairman Bair as well, and we are trying to resolve some other issues, if we can, in going forward. I know you are aware of that. Obviously, we are very interested in getting the legislation adopted, and we will move quickly.

Any other further comment on this last point? And then I want to end, if not? Yes, John.

Mr. DUGAN. Senator, I would just agree with your point. It is not obvious that, in many cases, the gathering of the information is not really the most important thing you need to do. For example, if you had hedge funds, it is not clear you would want to go in and regulate them like you regulate a bank. You might want to find out what they were doing, how they were doing it, have some authority to take some action if you had to.

But the gathering of information, understanding what they do, was completely absent during the current crisis with respect to nonbanks, and it is a really important thing that you are talking about, to learn what people are doing. So that is a fundamental building block.

Chairman DODD. Thank you.

I can see you chafing. Go ahead, Governor.

Mr. TARULLO. Just one point on that. This is what I meant earlier about being clear about where they go, where authority——

Chairman DODD. We need the mic on.

Mr. TARULLO. I am sorry. Because if you say you are a systemic risk regulator, you are responsible for everything, no matter where it may happen. But there is not a regular system in place for overseeing a particular market or overseeing particular institutions. That is when I think you risk having things falling between the cracks and expectations not being met.

And so I come back to the point I opened with, that is why there needs to be an agenda for systemic stability which takes into account each of the roles that the various agencies will play.

Chairman DODD. Well, I thank you. There are additional questions I will submit for the record, and I know my colleagues will, as well. We are going to be very engaged with all of you over the coming weeks on this matter. As I said, we have got more hearings to hold on this, the SEC next week. We have had seven already. And I thank each and every one of you for your participation. It has been very, very helpful here this morning.

The Committee will stand adjourned.

[Whereupon, at 1:40 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JIM BUNNING

Thank you, Mr. Chairman. This is a very important hearing, and I hope our witnesses will give us some useful answers. AIG has been in the news a lot this week, but it is not the only problem in our financial system. Other firms, including some regulated by our witnesses, have failed or been bailed out.

We all want to make any changes we can that will prevent this from happening again. But before we jump to any conclusions about what needs to be done to prevent similar problems in the future, we need to consider whether any new regulations will really add to stability or just create a false sense of security.

For example, I am not convinced that if the Fed had clear power to oversee all of AIG they would have noticed the problems or done anything about it. They clearly did not do a good enough job in regulating their holding companies, as we discussed at the Securities Subcommittee hearing yesterday. Their poor performance should throw cold water on the idea of giving them even more responsibility.

Finally, I want to say a few words about the idea of a risk regulator. While the idea sounds good, there are several questions that must be answered to make such a plan work. First, we have to figure out what risk is and how to measure it. This crisis itself is evidence that measuring risk is not as easy as it sounds. Second, we need to consider what to do about that risk. In other words, what powers would that regulator have, and how do you deal with international companies? Third, how do we keep the regulator from always being a step behind the markets? Do we really believe the regulator will be able to recruit the talent needed to see and understand risk in an ever-changing financial system on government salaries? Finally, will the regulator continue the expectation of government rescue whenever things go bad?

We should at least consider if we can accomplish the goal of a more stable system by making sure the parties to financial deals bear the consequences of their actions and thus act more responsibly in the first place.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY,
OFFICE OF THE COMPTROLLER OF THE CURRENCY

MARCH 19, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate this opportunity to discuss reforming the regulation of our financial system.

Recent turmoil in the financial markets, the unprecedented distress and failure of large financial firms, the mortgage and foreclosure crises, and growing numbers of problem banks—large and small—have prompted calls to reexamine and revamp thenation's financial regulatory system. The crisis raises legitimate questions about whether our existing complex system has both redundancies and gaps that significantly compromise its effectiveness. At the same time, any restructuring effort that goes forward should be carefully designed to avoid changes that undermine the parts of our current regulatory system that work best.

To examine this very important set of issues, the Committee will consider many aspects of financial regulation that extend beyond bank regulation, including the regulation of government-sponsored enterprises, insurance companies, and the intersection of securities and commodities markets. Accordingly, my testimony today focuses on key areas where I believe the perspective of the OCC—with the benefit of hindsight from the turmoil of the last two years—can most usefully contribute to the Committee's deliberations. Specifically, I will discuss the need to—

- improve the oversight of systemic risk, especially with respect to systemically important financial institutions that are not banks;
- establish a better process for stabilizing, resolving or winding down such firms;
- reduce the number of bank regulators, while preserving a dedicated prudential supervisor;
- enhance mortgage regulation; and
- improve consumer protection regulation while maintaining its fundamental connection to prudential supervision.

Improving Systemic Risk Oversight

The unprecedented events of the past year have brought into sharp focus the issue of systemic risk, especially in connection with the failures or near failures of

large financial institutions. Such institutions are so large and so intertwined with financial markets and other major financial institutions that the failure of one could cause a cascade of serious problems throughout the financial system—the very essence of systemic risk.

Years ago, systemically significant firms were generally large banks, and our regime of extensive, consolidated supervision of banks and bank holding companies—combined with the market expertise provided by the Federal Reserve through its role as central bank—provided a means to address the systemic risk presented by these institutions. More recently, however, large nonbank financial institutions like AIG, Fannie Mae and Freddie Mac, Bear Stearns, and Lehman began to present similar risks to the system as large banks. Yet these nonbank firms were subject to varying degrees and different kinds of government oversight. In addition, no one regulator had access to risk information from these nonbank firms in the same way that the Federal Reserve has with respect to bank holding companies. The result, I believe, was that the risk these firms presented to the financial system as a whole could not be managed or controlled until their problems reached crisis proportions.

One suggested way to address this problem going forward would be to assign one agency the oversight of systemic risk throughout the financial system. This approach would fix accountability, centralize data collection, and facilitate a unified approach to identifying and addressing large risks across the system. Such a regulator could also be assigned responsibility for identifying as systemically significant those institutions whose financial soundness and role in financial intermediation is important to the stability of U.S. and global markets.

But the single systemic regulator approach would also face challenges due to the diverse nature of the firms that could be labeled systemically significant. Key issues would include the type of authority that should be provided to the regulator; the types of financial firms that should be subject to its jurisdiction; and the nature of the new regulator's interaction with existing prudential supervisors. It would be important, for example, for the systemic regulatory function to build on existing prudential supervisory schemes, adding a systemic point of view, rather than replacing or duplicating regulation and supervisory oversight that already exists. How this would be done would need to be evaluated in light of other restructuring goals, including providing clear expectations for financial institutions and clear responsibilities and accountability for regulators; avoiding new regulatory inefficiencies; and considering the consequences of an undue concentration of responsibilities in a single regulator.

It has been suggested that the Federal Reserve Board should serve as the single agency responsible for systemic risk oversight. This makes sense given the comparable role that the Board already plays with respect to our largest banking companies; its extensive involvement with capital markets and payments systems; and its frequent interaction with central banks and supervisors from other countries.

If Congress decides to take this approach, however, it would be necessary to define carefully the scope of the Board's authority over institutions other than the bank holding companies and state-chartered member banks that it already supervises. Moreover, the Board has many other critical responsibilities, including monetary policy, discount window lending, payments system regulation, and consumer protection rulewriting. Adding the broad role of systemic risk overseer raises the very real concerns of the Board taking on too many functions to do all of them well, while at the same time concentrating too much authority in a single government agency. The significance of these concerns would depend very much on both the scope of the new responsibilities as systemic risk regulator, and any other significant changes that might be made to its existing role as the consolidated bank holding company supervisor.

Let me add that the contours of new systemic authority may need to vary depending on the nature of the systemically significant entity. For example, prudential regulation of banks involves extensive requirements with respect to risk reporting, capital, activities limits, risk management, and enforcement. The systemic supervisor might not need to impose all such requirements on all types of systemically important firms. The ability to obtain risk information would be critical for all such firms, but it might not be necessary, for example, to impose the full array of prudential standards, such as capital requirements or activities limits on all types of systemically important firms, *e.g.,* hedge funds (assuming they were subject to the new regulator's jurisdiction). Conversely, firms like banks that are already subject to extensive prudential supervision would not need the same level of oversight as firms that are not—and if the systemic overseer were the Federal Reserve Board, very little new authority would be required with respect to banking companies, given the Board's current authority over bank holding companies.

It also may be appropriate to allocate different levels of authority to the systemic risk overseer at different points in time depending on whether financial markets are functioning normally, or are instead experiencing unusual stress or disruption. For example, in a stable economic environment, the systemic risk regulator might focus most on obtaining and analyzing information about risks. Such additional information and analysis would be valuable not only for the systemic risk regulator, but also for prudential supervisors in terms of their understanding of firms' exposure to risks occurring in other parts of the financial services system to which they have no direct access. And it could facilitate the implementation of supervisory strategies to address and contain such risk before it increased to unmanageable levels.

On the other hand, in times of stress or disruption it may be appropriate to authorize the systemic regulator to take actions ordinarily reserved for prudential supervisors, such as imposing specific conditions or requirements on operations of a firm. Such authority would need to be crafted to ensure flexibility, but the triggering circumstances and process for activating the authority should be clear. Mechanisms for accountability also should be established so that policymakers, regulated entities, and taxpayers can understand and evaluate appropriate use of the authority.

Let me make one final point about the systemic risk regulator. Our financial system's "plumbing"—the major systems we have for clearing payments and settling transactions—are not now subject to any clear, overarching regulatory system because of the variety in their organizational form. Some systems are clearinghouses or banking associations subject to the Bank Service Company Act. Some are securities clearing agencies or agency organizations pursuant to the securities or commodities laws. Others are chartered under the corporate laws of states. [1]

Certain of these payment and settlement systems are systemically significant for the liquidity and stability of our financial markets, and I believe these systems should be subjected to overarching federal supervision to reduce systemic risk. One approach to doing so was suggested in the 2008 Treasury Blueprint, which recommended establishing a new federal charter for systemically significant payment and settlement systems and authorizing the Federal Reserve Board to supervise them. I believe this approach is appropriate given the Board's extensive experience with payment system regulation.

Resolving Systemically Significant Firms

Events of the past year also have highlighted the lack of a suitable process for resolving systemically significant financial firms that are not banks. U.S. law has long provided a unique and well developed framework for resolving distressed and failing banks that is distinct from the federal bankruptcy regime. Since 1991, this unique framework, administered by the Federal Deposit Insurance Corporation, has also provided a mechanism to address the problems that can arise with the potential failure of a systemically significant bank—including, if necessary to protect financial stability, the ability to use the bank deposit insurance fund to prevent uninsured depositors, creditors, and other stakeholders of the bank from sustaining loss.

Unfortunately, no comparable framework exists for resolving most systemically significant financial firms that are not banks, including systemically significant holding companies of banks. Such firms must therefore use the normal bankruptcy process unless they can obtain some form of extraordinary government assistance to avoid the systemic risk that might ensue from failure or the lack of a timely and orderly resolution. While the bankruptcy process may be appropriate for resolution of certain types of firms, it may take too long to provide certainty in the resolution of a systemically significant firm, and it provides no source of funding for those situations where substantial resources are needed to accomplish an orderly solution. As a result, in the last year as a number of large nonbank financial institutions faced potential failure, government agencies have had to improvise with various other governmental tools to address systemic risk issues at nonbanks, sometimes with solutions that were less than ideal.

This gap needs to be addressed with an explicit statutory regime for facilitating the resolution of systemically important nonbank companies as well as banks. This new statutory regime should provide tools that are similar to those the FDIC currently has for resolving banks, including the ability to require certain actions to stabilize a firm; access to a significant funding source if needed to facilitate orderly dispositions, such as a significant line of credit from the Treasury; the ability to wind down a firm if necessary, and the flexibility to guarantee liabilities and provide open

[1] For a description of the significance of payment and settlement systems and the various forms under which they are organized in the United States, see U.S. Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure 100–103 (March 2008) (2008 Treasury Blueprint).

institution assistance if necessary to avoid serious risk to the financial system. In addition, there should be clear criteria for determining which institutions would be subject to this resolution regime, and how to handle the foreign operations of such institutions.

One possible approach to a statutory change would be to simply extend the FDIC's current authority to nonbanks. That approach would not appear to be appropriate given the bank-centric nature of the FDIC's mission and resources. The deposit insurance fund is paid for by assessments on insured banks, with a special assessment mechanism available for certain losses caused by systemically important banks. It would not be fair to assess only banks for problems at nonbanks. In addition, institutional conflicts may arise when the insurer must fulfill the dual mission of protecting the insurance fund and advancing the broader U.S. Government interests at stake when systemically significant institutions require resolution. Indeed, important changes have recently been proposed to improve the FDIC's systemic risk assessment process to provide greater equity when the FDIC's protective actions extend beyond the insured depository institution to affiliated entities that are not banks.

A better approach may be to provide the new authority to the new systemic risk regulator, in combination with the Treasury Department, given the likely need for a substantial source of government funds. The new systemic risk regulator would by definition have systemic risk responsibility, and the Treasury has direct accountability to taxpayers. If the systemic risk regulator were the Federal Reserve, then the access to discount window funding would also provide a critical resource to help address significant liquidity problems. It is worth noting that, in most other countries, it has been the Treasury Department or its equivalent that has provided extraordinary assistance to systemically important financial firms during this crisis, whether in the form of capital injections, government guarantees, or more significant government ownership.

Reducing the Number of Bank Regulators

It is clear that the United States has too many bank regulators. We have four federal regulators, 12 Federal Reserve Banks, and 50 state regulators, nearly all of which have some type of overlapping supervising responsibilities. This system is largely the product of historical evolution, with different agencies created for different legitimate purposes reflecting a much more segmented banking system from the past. No one would design such a system from scratch, and it is fair to say that, at times, it has not been the most efficient way to establish banking policy or supervise banks.

Nevertheless, the banking agencies have worked hard over the years to make the system function appropriately despite its complexities. On many occasions, the diversity in perspectives and specialization of roles has provided real value. And from the perspective of the OCC, I do not believe that our sharing of responsibilities with other agencies has been a primary driver of recent problems in the banking system.

That said, I recognize the considerable interest in reducing the number of bank regulators. The impulse to simplify is understandable, and it may well be appropriate to streamline our current system. But we ought not approach the task by prejudging the appropriate number of boxes on the organization chart. The better approach is to determine what would be achieved if the number of regulators were reduced. What went wrong in the current crisis that changes in regulatory structure (rather than regulatory standards) will fix? Will accountability be enhanced? Will the change result in greater efficiency and consistency of regulation? Will gaps be closed so that opportunities for regulatory arbitrage in the current system are eliminated? Will overall market regulation be improved?

In this context, while there is arguably an agreement on the need to reduce the number of bank regulators, there is no such consensus on what the right number is or what their roles should be. Some have argued that we should have just one regulator responsible for bank supervision, and that it ought to be a new agency such as the Financial Services Agency in the UK, or that all such responsibilities should be consolidated in our central bank, the Federal Reserve Board. Let me explain why I don't think either of these ideas is the right one for our banking system.

The fundamental problem with consolidating all supervision in a new, single independent agency is that it would take bank supervisory functions away from the Federal Reserve Board. In terms of the normal turf wars among agencies, it may sound strange for the OCC to take this position. But as the central bank and closest agency we have to a systemic risk regulator, I believe the Board needs the window it has into banking organizations that it derives from its role as bank holding company supervisor. More important, given its substantial role and direct experience with respect to capital markets, payments systems, the discount window, and inter-

national supervision, the Board provides unique resources and perspective to bank holding company supervision.

Conversely, I believe it also would be a mistake to move all direct banking supervision to the Board, or even all such supervision for the most systemically important banks. The Board has many other critical responsibilities, including monetary policy, discount window lending, payments system regulation, and consumer protection rulewriting. Consolidating all banking supervision there as well would raise a serious concern about the Board taking on too many functions to do all of them well. There would also be a very real concern about concentrating too much authority in a single government agency. And both these concerns would be amplified substantially if the Board were also designated the new systemic risk regulator and took on supervisory responsibilities for systemically significant payment and clearing systems.

Most important, moving all supervision to the Board would lose the very real benefit of having an agency whose sole mission is bank supervision. That is, of course, the sole mission of the OCC, and I realize that, coming from the Comptroller, support for preserving a dedicated prudential banking supervisor may be portrayed by some as merely protecting turf. That would be unfortunate, because I strongly believe that the benefits of dedicated supervision are real. Where it occurs, there is no confusion about the supervisor's goals and objectives, and no potential conflict with competing objectives. Responsibility is well defined, and so is accountability. Supervision takes a back seat to no other part of the organization, and the result is a strong culture that fosters the development of the type of seasoned supervisors that are needed to confront the many challenges arising from today's banking business.

In the case of the OCC, I would add that our role as the front-line, on-the-ground prudential supervisor is complementary to the current role of the Federal Reserve Board as the consolidated holding company regulator. This model has allowed the Board to use and rely on our work to perform its role as supervisor for complex banking organizations that are often involved in many businesses other than banking. Such a model would also work well with respect to any new authority provided to a systemic risk regulator, whether or not the Board is assigned that role.

In short, there are a number of options for reducing the number of bank regulators, and many detailed issues involved with each. It is not my intent to address these issues in detail in this testimony, but instead to make two fundamental and related points about changes to the banking agency regulatory structure. While it is important to preserve the Federal Reserve Board's role as a holding company supervisor, it is equally if not more important to preserve the role of a dedicated, front-line prudential supervisor for our nation's banks.

Enhanced Mortgage Regulation

The current financial crisis began and continues with problems arising from poorly underwritten residential mortgages, especially subprime mortgages. While these lending practices have been brought under control, and federal regulators have taken actions to prevent the worst abuses, more needs to be done. As part of any regulatory reform to address the crisis, Congress should establish a mortgage regulatory regime that ensures that the mortgage crisis is never repeated.

A fundamental reason for poorly underwritten mortgages was the lack of consistent regulation for mortgage providers. Depository institution mortgage providers—whether state or federally chartered—were the most extensively regulated, by state and federal banking supervisors. Mortgage providers affiliated with depository institutions were less regulated, primarily by federal holding company supervisors, but also by state mortgage regulators. Mortgage providers not affiliated with depository institutions—including mortgage brokers and lenders—were the least regulated by far, with no direct supervision at the federal level, and limited ongoing supervision at the state level.

The results have been predictable. As the 2007 Report of the Majority Staff of the Joint Economic Committee recognized, "[s]ince brokers and mortgage companies are only weakly regulated, another outcome [of the increase in subprime lending] was a marked increase in abusive and predatory lending."[2] Nondepository institution mortgage providers originated the overwhelming preponderance of subprime and "Alt-A" mortgages during the crucial 2005–2007 period, and the loans they originated account for a disproportionate percentage of defaults and foreclosures nationwide, with glaring examples in the metropolitan areas hardest hit by the foreclosure

[2] Majority Staff of the Joint Economic Committee, 110th Cong., Report and Recommendations on the Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here 17 (October 2007).

crisis. For example, a recent analysis of mortgage loan data prepared by OCC staff, from a well-known source of mortgage loan data, identified the 10 mortgage originators with the highest number of subprime and Alt-A mortgage foreclosures—in the 10 metropolitan statistical areas (MSAs) experiencing the highest foreclosure rates in the period 2005–2007. While each type of mortgage originator has experienced elevated levels of delinquencies and defaults in recent years, of the 21 firms comprising the "worst 10" in those "worst 10" MSAs, the majority—accounting for nearly 60 percent of nonprime mortgage loans and foreclosures—were exclusively supervised by the states.[3]

In view of this experience, Congress should take at least two actions in connection with regulatory reform. First, it should establish national mortgage standards that would apply consistently regardless of originator, similar to the mortgage legislation that passed the House of Representatives last year. In taking this extraordinary step, Congress should provide flexibility to regulators to implement the statutory standards through regulations that protect consumers and balance the need for conservative underwriting with the equally important need for access to affordable credit.

Second, Congress should also ensure that the new standards are applied and enforced in a comparable manner, again, regardless of originator. This objective can be accomplished relatively easily for mortgages provided by depository institutions or their affiliates: federal banking regulators have ample authority to ensure compliance through ongoing examination and supervision reinforced by broad enforcement powers. The objective is not so easily achieved with nonbank mortgage providers regulated exclusively by the states, however. The state regime for regulating mortgage brokers and lenders typically focuses on licensing, rather than ongoing examination and supervision, and enforcement by state agencies typically targets problems after they have become severe, not before. That difference between the federal and state regimes can result in materially different levels of compliance, even with a common federal standard. As a result, it will be important to develop a mechanism to facilitate a level of compliance at the state level that is comparable to compliance of depository institutions subject to federal standards. The goal should be robust national standards that are applied consistently to all mortgage providers.

Enhanced Consumer Protection Regulation

Effective protection for consumers of financial products and services is a vital part of financial services regulation. In the OCC's experience, and as the mortgage crisis illustrates, safe and sound lending practices are integral to consumer protection. Indeed, contrary to several recent proposals, we believe that the best way to implement consumer protection regulation of banks—the best way to protect consumers—is to do so through prudential supervision. Let me explain why.

First, prudential supervisors' continual presence in banks through the examination process puts them in the very best position to ensure compliance with consumer protection requirements established by statute and regulation. Examiners are trained to detect weaknesses in banks' policies, systems, and procedures for implementing consumer protection mandates, and they gather information both on-site and off-site to assess bank compliance. Their regular communication with the bank occurs through examinations at least once every 18 months for smaller institutions, supplemented by quarterly calls with management, and for the very largest banks consumer compliance examiners are on site every day. We believe this continual supervisory presence creates especially effective incentives for consumer protection compliance, as well as allowing examiners to detect compliance failures much earlier than would otherwise be the case.

Second, prudential supervisors have strong enforcement powers and exceptional leverage over bank management to achieve corrective action. Banks are among the most extensively supervised firms in any type of industry, and bankers understand very well the range of negative consequences that can ensue from defying their regulator. As a result, when examiners detect consumer compliance weaknesses or failures, they have a broad range of tools to achieve corrective action, from informal comments to formal enforcement action—and banks have strong incentives to move back into compliance as expeditiously as possible.

Indeed, behind the scenes and without public fanfare, bank supervision results in significant reforms to bank practices and remedies for their customers—and it can do so much more quickly than litigation, formal enforcement actions, or other publicized events. For example, as part of the supervisory process, bank examiners

[3] Letter from Comptroller of the Currency John Dugan to Elizabeth Warren, Chair, Congressional Oversight Panel, February 12, 2009, at *http://www.occ.treas.gov/ftp/occ_copresponse_021209.pdf.*

identify weaknesses in areas pertaining both to compliance and safety and soundness by citing MRAs—"matters requiring attention"—in the written report of examination. An MRA describes a problem, indicates its cause, and requires the bank to implement a remedy before the matter can be closed. In the period between 2004 and 2007, OCC examiners cited 123 mortgage-related MRAs. By the end of 2008, satisfactory corrective action had been taken with respect to 109 of those MRAs, without requiring formal enforcement actions. Corrective actions were achieved for issues involving mortgage underwriting, appraisal quality, monitoring of mortgage brokers, and other consumer-related issues. We believe this type of extensive supervision and early warning oversight is a key reason why the worst form of subprime lending practices did not become widespread in the national banking system.

Third, because examiners are continually exposed to the practical effects of implementing consumer protection rules for bank customers, the prudential supervisory agency is in the best position to formulate and refine consumer protection regulations for banks. Indeed, while most such rule-writing authority is currently housed in the Federal Reserve Board, we believe that the rule-writing process would benefit by requiring more formal consultation with other banking supervisors that have substantial supervisory responsibilities in this area.

Recently, alternative models for financial product consumer protection regulation have been suggested. One is to remove all consumer protection regulation and supervision from prudential supervisors, instead consolidating such authority in a new federal agency. This model would be premised on an SEC-style regime of registration and licensing for all types of consumer credit providers, with standards set and compliance achieved through enforcement actions by a new agency. The approach would rely on self-reporting by credit providers, backstopped by enforcement or judicial actions, rather than ongoing supervision and examination.

The attractiveness of this alternative model is that it would centralize authority and accountability in a single agency, which could write rules that would apply uniformly to financial services providers, whether or not they are depository institutions. Because the agency would focus exclusively on consumer protection, proponents also argue that such a model eliminates the concern sometimes expressed that prudential supervisors neglect consumer protection in favor of safety and soundness supervision.

But the downside of this approach is considerable. It would not have the benefits of on-site examination and supervision and the very real leverage that bank supervisors have over the banks they regulate. That means, we believe, that compliance is likely to be less effective. Nor would this approach draw on the practical expertise that examiners develop from continually assessing the real-world impact of particular consumer protection rules—an asset that is especially important for developing and adjusting such rules over time. More troubling, the ingredients of this approach—registration, licensing and reliance on enforcement actions to achieve compliance with standards—is the very model that has proved inadequate to protect consumers doing business with state regulated mortgage lenders and brokers.

Finally, I do not agree that the banking agencies have failed to give adequate attention to the consumer protection laws that they have been charged with implementing. For example, predatory lending failed to gain a foothold in the banking industry precisely because of the close supervision commercial banks, both state and national, received. But if Congress believes that the consumer protection regime needs to be strengthened, the best answer is not to create a new agency that would have none of the benefits of a prudential supervisor. Instead, the better approach is a crisp Congressional mandate to already responsible agencies to toughen the applicable standards and close any gaps in regulatory coverage. The OCC and the other prudential bank supervisors will rigorously apply them. And because of the tools we have that I've already mentioned, banks will comply more readily and consumers will be better protected than would be the case with mandates applied by a new federal agency.

Conclusion

My testimony today reflects the OCC's views on several key aspects of regulatory reform. We would be happy provide more details or additional views on other issues at the Committee's request.

PREPARED STATEMENT OF SHEILA C. BAIR

CHAIRMAN,

FEDERAL DEPOSIT INSURANCE CORPORATION

MARCH 19, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the need to modernize and reform our financial regulatory system.

The events that have unfolded over the past two years have been extraordinary. A series of economic shocks have produced the most challenging financial crisis since the Great Depression. The widespread economic damage has called into question the fundamental assumptions regarding financial institutions and their supervision that have directed our regulatory efforts for decades. 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. In addition, the significant growth of unsupervised financial activities outside the traditional banking system has hampered effective regulation.

Our current system has clearly failed in many instances to manage risk properly and to provide stability. U.S. regulators have broad powers to supervise financial institutions and markets and to limit many of the activities that undermined our financial system, but there are significant gaps, most notably regarding very large insurance companies and private equity funds. However, we must also acknowledge that 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. Perhaps most importantly, failure to ensure that financial products were appropriate and sustainable for consumers has caused significant problems not only for those consumers but for the safety and soundness of financial institutions. Moreover, some parts of the current financial system, for example, over the counter derivatives, are by statute, mostly excluded from federal regulation.

In the face of the current crisis, regulatory gaps argue for some kind of comprehensive regulation or oversight of all systemically important financial firms. But, the failure to utilize existing authorities by regulators casts doubt on whether simply entrusting power in a single systemic risk regulator will sufficiently address the underlying causes of our past supervisory failures. We need to recognize that simply creating a new systemic risk regulator is a not a panacea. The most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of these institutions similar to that which exists for FDIC insured banks. In short, we need an end to too big to fail.

It is time to examine the more fundamental issue of whether there are economic benefits to institutions whose failure can result in systemic issues for the economy. Because of their concentration of economic power and interconnections through the financial system, the management and supervision of institutions of this size and complexity has proven to be problematic. Taxpayers have a right to question how extensive their exposure should be to such entities.

The problems of supervising large, complex financial institutions are compounded by the absence of procedures and structures to effectively resolve them in an orderly fashion when they end up in severe financial trouble. Unlike the clearly defined and proven statutory powers that exist for resolving insured depository institutions, the current bankruptcy framework available to resolve large complex nonbank financial entities and financial holding companies was not designed to protect the stability of the financial system. This is important because, in the current crisis, bank holding companies and large nonbank entities have come to depend on the banks within the organizations as a source of strength. Where previously the holding company served as a source of strength to the insured institution, these entities now often rely on a subsidiary depository institution for funding and liquidity, but carry on many systemically important activities outside of the bank that are managed at a holding company level or nonbank affiliate level.

While the depository institution could be resolved under existing authorities, the resolution would cause the holding company to fail and its activities would be unwound through the normal corporate bankruptcy process. Without a system that provides for the orderly resolution of activities outside of the depository institution, the failure of a systemically important holding company or nonbank financial entity will create additional instability as claims outside the depository institution become completely illiquid under the current system.

In the case of a bank holding company, the FDIC has the authority to take control of only the failing banking subsidiary, protecting the insured depositors. However, many of the essential services in other portions of the holding company are left outside of the FDIC's control, making it difficult to operate the bank and impossible to continue funding the organization's activities that are outside the bank. In such a situation, where the holding company structure includes many bank and nonbank subsidiaries, taking control of just the bank is not a practical solution.

If a bank holding company or nonbank financial holding company is forced into or chooses to enter bankruptcy for any reason, the following is likely to occur. In a Chapter 11 bankruptcy, there is an automatic stay on most creditor claims, with the exception of specified financial contracts (futures and options contracts and certain types of derivatives) that are subject to termination and netting provisions, creating illiquidity for the affected creditors. The consequences of a large financial firm filing for bankruptcy protection are aptly demonstrated by the Lehman Brothers experience. As a result, neither taking control of the banking subsidiary or a bankruptcy filing of the parent organization is currently a viable means of resolving a large, systemically important financial institution, such as a bank holding company. This has forced the government to improvise actions to address individual situations, making it difficult to address systemic problems in a coordinated manner and raising serious issues of fairness.

My testimony will examine some steps that can be taken to reduce systemic vulnerabilities by strengthening supervision and regulation and improving financial market transparency. I will focus on some specific changes that should be undertaken to limit the potential for excessive risk in the system, including identifying systemically important institutions, creating incentives to reduce the size of systemically important firms and ensuring that all portions of the financial system are under some baseline standards to constrain excessive risk taking and protect consumers. I will explain why an independent special failure resolution authority is needed for financial firms that pose systemic risk and describe the essential features of such an authority. I also will suggest improvements to consumer protection that would improve regulators' ability to stem fraud and abusive practices. Next, I will discuss other areas that require legislative changes to reduce systemic risk—the over-the-counter (OTC) derivatives market and the money market mutual fund industry. And, finally, I will address the need for regulatory reforms related to the originate-to-distribute model, executive compensation in banks, fair-value accounting, credit rating agencies and counter-cyclical capital policies.

Addressing Systemic Risk

Many have suggested that the creation of a systemic risk regulator is necessary to address key flaws in the current supervisory regime. According to the proposals, this new regulator would be tasked with monitoring large or rapidly increasing exposures—such as to sub-prime mortgages—across firms and markets, rather than only at the level of individual firms or sectors; and analyzing possible spillovers among financial firms or between firms and markets, such as the mutual exposures of highly interconnected firms. Additionally, the proposals call for such a regulator to have the authority to obtain information and examine banks and key financial market participants, including nonbank financial institutions that may not be currently subject to regulation. Finally, the systemic risk regulator would be responsible for setting standards for capital, liquidity, and risk management practices for the financial sector.

Changes in our regulatory and supervisory approach are clearly warranted, but Congress should proceed carefully and deliberately in creating a new systemic risk regulator. Many of the economic challenges we are facing continue and new aspects of interconnected problems continue to be revealed. It will require great care to address evolving issues in the midst of the economic storm and to avoid unintended consequences. In addition, changes that build on existing supervisory structures and authorities—that fill regulatory voids and improve cooperation—can be implemented more quickly and more effectively.

While I fully support the goal of having an informed, forward looking, proactive and analytically capable regulatory community, looking back, if we are honest in our assessment, it is clear that U.S. regulators already had many broad powers to su-

pervise financial institutions and markets and to limit many of the activities that undermined our financial system. For various reasons, these powers were not used effectively and as a consequence supervision was not sufficiently proactive.

There are many examples of situations in which existing powers could have been used to prevent the financial system imbalances that led to the current financial crisis. For instance, supervisory authorities have had the authority under the Home Ownership and Equity Protection Act to regulate the mortgage industry since 1994. Comprehensive new regulations intended to limit the worst practices in the mortgage industry were not issued until well into the onset of the current crisis. Failure to address lax lending standards among nonbank mortgage companies created market pressure on banks to also relax their standards. Bank regulators were late in addressing this phenomenon.

In other important examples, federal regulatory agencies have had consolidated supervisory authority over institutions that pose a systemic risk to the financial system; yet they did not to exercise their authorities in a manner that would have enabled them to anticipate the risk concentrations in the bank holding companies, investment bank holding companies and thrift holding companies they supervise. Special purpose financial intermediaries—such as structured investment vehicles (SIVs)—played an important role in funding and aggregating the credit risks that are at the core of the current crisis. These intermediaries were formed outside the banking organizations so banks could recognize asset sales and take the assets off the balance sheet, or remotely originate assets to keep off the balance sheet and thereby avoid minimum regulatory capital and leverage ratio constraints. Because they were not on the bank's balance sheet and to the extent that they were managed outside of the bank by the parent holding company, SIVs escaped scrutiny from the bank regulatory agencies.

With hindsight, all of the regulatory agencies will focus and find ways to better exercise their regulatory powers. Even though the entities and authorities that have been proposed for a systemic regulator largely existed, the regulatory community did not appreciate the magnitude and scope of the potential risks that were building in the system. Having a systemic risk regulator that would look more broadly at issues on a macro-prudential basis would be of incremental benefit, but the success of any effort at reform will ultimately rely on the willingness of regulators to use their authorities more effectively and aggressively.

The lack of regulatory foresight was not specific to the United States. As a recent report on financial supervision in the European Union noted, financial supervisors frequently did not have, and in some cases did not insist on obtaining—or received too late—all of the relevant information on the global magnitude of the excess leveraging that was accumulating in the financial system.[1] Further, they did not fully understand or evaluate the size of the risks, or share their information properly with their counterparts in other countries. The report concluded that insufficient supervisory and regulatory resources combined with an inadequate mix of skills as well as different systems of national supervision made the situation worse. In interpreting this report, it is important to recall that virtually every European central bank is required to assess and report economic and financial system conditions and anticipate emerging financial-sector risks.

With these examples in mind, we should recognize that while establishing a systemic risk regulator is important, it is far from clear that it will prevent a future systemic crisis.

Limiting Risk by Limiting Size and Complexity

Before considering the various proposals to create a systemic risk regulator, Congress should examine a more fundamental question of whether there should be limitations on the size and complexity of institutions whose failure would be systemically significant. Over the past two decades, a number of arguments have been advanced about why financial organizations should be allowed to become larger and more complex. These reasons include being able to take advantage of economies of scale and scope, diversifying risk across a broad range of markets and products, and gaining access to global capital markets. It was alleged that the increased size and complexity of these organizations could be effectively managed using new innovations in quantitative risk management techniques. Not only did institutions claim that they could manage these new risks, they also argued that often the combination of diversification and advanced risk management practices would allow them to operate with markedly lower capital buffers than were necessary in smaller, less-sophisticated institutions. Indeed many of these concepts were inherent in the Basel

[1] European Union, Report of the High-level Group on Financial Supervision in the EU, J. de Larosiere, Chairman, Brussels, 25 February 2009.

II Advanced Approaches, resulting in reduced capital requirements. In hindsight, it is now clear that the international regulatory community relied too heavily on diversification and risk management when setting minimum regulatory capital requirements for large complex financial institutions.

Notwithstanding expectations and industry projections for gains in financial efficiencies, economies of scale seem to be reached at levels far below the size of today's largest financial institutions. Also, efforts designed to realize economies of scope have not lived up to their promise. In some instances, the complex institutional combinations permitted by the Gramm-Leach-Bliley (GLB) legislation were unwound because they failed to realize anticipated economies of scope. The latest studies of economies produced by increased scale and scope find that most banks could improve their cost efficiency more by concentrating their efforts on reducing operational inefficiencies.

There also are limits to the ability to diversify risk using securitization, structured finance and derivatives. No one disputes that there are benefits to diversification for smaller and less-complex institutions, but as institutions become larger and more complex, the ability to diversify risk is diminished. When a financial system includes a small number of very large complex organizations, the system cannot be well-diversified. As institutions grow in size and importance, they not only take on a risk profile that mirrors the risk of the market and general economic conditions, but they also concentrate risk as they become the only important counterparties to many transactions that facilitate financial intermediation in the economy. The fallacy of the diversification argument becomes apparent in the midst of financial crisis when these large complex financial organizations—because they are so interconnected—reveal themselves as a source of risk in the system.

Managing the Transition to a Safer System

If large complex organizations concentrate risk and do not provide market efficiencies, it may be better to address systemic risk by creating incentives to encourage a financial industry structure that is characterized by smaller and therefore less systemically important financial firms, for instance, by imposing increasing financial obligations that mirror the heightened risk posed by large entities.

Identifying Systemically Important Firms

To be able to implement and target the desired changes, it becomes important to identify characteristics of a systemically important firm. A recent report by the Group of Thirty highlights the difficulties that are associated with a fixed common definition of what comprises a systemically important firm. What constitutes systemic importance is likely to vary across national boundaries and change over time. Generally, it would include any firm that constitutes a significant share of their market or the broader financial system. Ultimately, identification of what is systemic will have to be decided within the structure created for systemic risk regulation, but at a minimum, should rely on triggers based on size and counterparty concentrations.

Increasing Financial Obligations To Reflect Increasing Risk

To date, many large financial firms have been given access to vast amounts of public funds. Obviously, changes are needed to prevent this situation from reoccurring and to ensure that firms are not rewarded for becoming, in essence, too big to fail. Rather, they should be required to offset the potential costs to society.

In contrast to the capital standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both size and complexity. In addition, they should be subject to higher Prompt Corrective Action (PCA) limits under U.S. laws. Regulators should judge the capital adequacy of these firms, taking into account off-balance-sheet assets and conduits as if these risks were on balance sheet.

Next Steps

Currently, not all parts of the financial system are subject to federal regulation. Insurance company regulation is conducted at the state level. There is, therefore, no federal regulatory authority specifically designed to provide comprehensive prudential supervision for large insurance companies. Hedge funds and private equity firms are typically designed to operate outside the regulatory structures that would otherwise constrain their leverage and activities. This is of concern not only for the safety and soundness of these unregulated firms, but for regulated firms as well. Some of banking organizations' riskier strategies, such as the creation of SIVs, may have been driven by a desire to replicate the financial leverage available to less regulated entities. Some of these firms by virtue of their gross balance sheet size or by their dominance in particular markets can pose systemic risks on their own ac-

cord. Many others are major participants in markets and business activities that may contribute to a systemic collapse. This loophole in the regulatory net cannot continue. It is important that all systemically important financial firms, including hedge funds, insurance companies, investment banks, or bank or thrift holding companies, be subject to prudential supervision, including across the board constraints on the use of financial leverage.

New Resolution Procedures

There is clearly a need for a special resolution regime, outside the bankruptcy process, for financial firms that pose a systemic risk, just as there is for commercial banks and thrifts. As noted above, beyond the necessity of capital regulation and prudential supervision, having a mechanism for the orderly resolution of institutions that pose a systemic risk to the financial system is critical. Creating a resolution regime that could apply to any financial institution that becomes a source of systemic risk should be an urgent priority.

The differences in outcomes from the handling of Bear Stearns and Lehman Brothers demonstrate that authorities have no real alternative but to avoid the bankruptcy process. When the public interest is at stake, as in the case of systemically important entities, the resolution process should support an orderly unwinding of the institution in a way that protects the broader economic and taxpayer interests, not just private financial interests.

In creating a new resolution regime, we must clearly define roles and responsibilities and guard against creating new conflicts of interest. In the case of banks, Congress gave the FDIC backup supervisory authority and the power to self-appoint as receiver, recognizing there might be conflicts between a primary regulators' prudential responsibilities and its willingness to recognize when an institution it supervises needs to be closed. Thus, the new resolution authority should be independent of the new systemic risk regulator.

This new authority should also be designed to limit subsidies to private investors (moral hazard). If financial assistance outside of the resolution process is granted to systemically important firms, the process should be open, transparent and subject to a system of checks and balances that are similar to the systemic-risk exception to the least-cost test that applies to insured financial institutions. No single government entity should be able to unilaterally trigger a resolution strategy outside the defined parameters of the established resolution process.

Clear guidelines for this process are needed and must be adhered to in order to gain investor confidence and protect public and private interests. First, there should be a clearly defined priority structure for settling claims, depending on the type of firm. Any resolution should be subject to a cost test to minimize any public loss and impose losses according to the established claims priority. Second, it must allow continuation of any systemically significant operations. The rules that govern the process, and set priorities for the imposition of losses on shareholders and creditors should be clearly articulated and closely adhered to so that the markets can understand the resolution process with predicable outcomes.

The FDIC's authority to act as receiver and to set up a bridge bank to maintain key functions and sell assets offers a good model. A temporary bridge bank allows the government to prevent a disorderly collapse by preserving systemically significant functions. It enables losses to be imposed on market players who should appropriately bear the risk. It also creates the possibility of multiple bidders for the bank and its assets, which can reduce losses to the receivership.

The FDIC has the authority to terminate contracts upon an insured depository institution's failure, including contracts with senior management whose services are no longer required. Through its repudiation powers, as well as enforcement powers, termination of such management contracts can often be accomplished at little cost to the FDIC. Moreover, when the FDIC establishes a bridge institution, it is able to contract with individuals to serve in senior management positions at the bridge institution subject to the oversight of the FDIC. The new resolution authority should be granted similar statutory authority in the resolution of financial institutions.

Congress should recognize that creating a new separate authority to administer systemic resolutions may not be economic or efficient. It is unlikely that the separate resolution authority would be used frequently enough to justify maintaining an expert and motivated workforce as there could be decades between systemic events. While many details of a special resolution authority for systemically important financial firms would have to be worked out, a new systemic resolution regime should be funded by fees or assessments charged to systemically important firms. In addition, consistent with the FDIC's powers with regard to insured institutions, the resolution authority should have backup supervisory authority over those firms which it may have to resolve.

Consumer Protection

There can no longer be any doubt about the link between protecting consumers from abusive products and practices and the safety and soundness of the financial system. Products and practices that strip individual and family wealth undermine the foundation of the economy. As the current crisis demonstrates, increasingly complex financial products combined with frequently opaque marketing and disclosure practices result in problems not just for consumers, but for institutions and investors as well.

To protect consumers from potentially harmful financial products, a case has been made for a new independent financial product safety commission. Certainly, more must be done to protect consumers. We could support the establishment of a new entity to establish consistent consumer protection standards for banks and nonbanks. However, we believe that such a body should include the perspective of bank regulators as well as nonbank enforcement officials such as the FTC. However, as Congress considers the options, we recommend that any new plan ensure that consumer protection activities are aligned and integrated with other bank supervisory information, resources, and expertise, and that enforcement of consumer protection rules for banks be left to bank regulators.

The current bank regulation and supervision structure allows the banking agencies to take a comprehensive view of financial institutions from both a consumer protection and safety-and-soundness perspective. Banking agencies' assessments of risks to consumers are closely linked with and informed by a broader understanding of other risks in financial institutions. Conversely, assessments of other risks, including safety and soundness, benefit from knowledge of basic principles, trends, and emerging issues related to consumer protection. Separating consumer protection regulation and supervision into different organizations would reduce information that is necessary for both entities to effectively perform their functions. Separating consumer protection from safety and soundness would result in similar problems.

Our experience suggests that the development of policy must be closely coordinated and reflect a broad understanding of institutions' management, operations, policies, and practices—and the bank supervisory process as a whole. Placing consumer protection policy-setting activities in a separate organization, apart from existing expertise and examination infrastructure, could ultimately result in less effective protections for consumers.

One of the fundamental principles of the FDIC's mission is to serve as an independent agency focused on maintaining consumer confidence in the banking system. The FDIC plays a unique role as deposit insurer, federal supervisor of state nonmember banks and savings institutions, and receiver for failed depository institutions. These functions contribute to the overall stability of and consumer confidence in the banking industry. With this mission in mind, if given additional rulemaking authority, the FDIC is prepared to take on an expanded role in providing consumers with stronger protections that address products posing unacceptable risks to consumers and eliminate gaps in oversight.

Under the Federal Trade Commission (FTC) Act, only the Federal Reserve Board (FRB) has authority to issue regulations applicable to banks regarding unfair or deceptive acts or practices, and the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) have sole authority with regard to the institutions they supervise. The FTC has authority to issue regulations that define and ban unfair or deceptive acts or practices with respect to entities other than banks, savings and loan institutions, and federal credit unions. However, the FTC Act does not give the FDIC authority to write rules that apply to the approximately 5,000 entities it supervises—the bulk of state banks—nor to the OCC for their 1,700 national banks. Section 5 of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce." It applies to all persons engaged in commerce, whether banks or nonbanks, including mortgage lenders and credit card issuers. While the "deceptive" and "unfair" standards are independent of one another, the prohibition against these practices applies to all types of consumer lending, including mortgages and credit cards, and to every stage and activity, including product development, marketing, servicing, collections, and the termination of the customer relationship.

In order to further strengthen the use of the FTC Act's rulemaking provisions, the FDIC has recommended that Congress consider granting Section 5 rulemaking authority to all federal banking regulators. By limiting FTC rulemaking authority to the FRB, OTS and NCUA, current law excludes participation by the primary federal supervisors of about 7,000 banks. The FDIC's perspective—as deposit insurer and as supervisor for the largest number of banks, many of whom are small community banks—would provide valuable input and expertise to the rulemaking process. The same is true for the OCC, as supervisor of some of the nation's largest banks. As

a practical matter, these rulemakings would be done on an interagency basis and would benefit from the input of all interested parties.

In the alternative, if Congress is inclined to establish an independent financial product commission, it should leverage the current regulatory authorities that have the resources, experience, and legislative power to enforce regulations related to institutions under their supervision, so it would not be necessary to create an entirely new enforcement infrastructure. In fact, in creating a financial products safety commission, it would be beneficial to include the FDIC and principals from other financial regulatory agencies on the commission's board. Such a commission should be required to submit periodic reports to Congress on the effectiveness of the consumer protection activities of the commission and the bank regulators.

Whether or not Congress creates a new commission, it is essential that there be uniform standards for financial products whether they are offered by banks or nonbanks. These standards must apply across all jurisdictions and issuers, otherwise gaps create competitive pressures to reduce standards, as we saw with mortgage lending standards. Clear standards also permit consistent enforcement that protects consumers and the broader financial system.

Finally, in the on-going process to improve consumer protections, it is time to examine curtailing federal preemption of state consumer protection laws. Federal preemption of state laws was seen as a way to improve efficiencies for financial firms who argued that it lowered costs for consumers. While that may have been true in the short run, it has now become clear that abrogating sound state laws, particularly regarding consumer protection, created an opportunity for regulatory arbitrage that frankly resulted in a "race-to-the-bottom" mentality. Creating a "floor" for consumer protection, based on either appropriate state or federal law, rather than the current system that establishes a ceiling on protections would significantly improve consumer protection. Perhaps reviewing the existing web of state and federal laws related to consumer protections and choosing the most appropriate for the "floor" could be one of the initial priorities for a financial products safety commission.

Changing the OTC Market and Protecting of Money Market Mutual Funds

Two areas that require legislative changes to reduce systemic risk are the OTC derivatives market and the money market mutual fund industry.

Credit Derivatives Markets and Systemic Risk

Beyond issues of size and resolution schemes for systemically important institutions, recent events highlight the need to revisit the regulation and oversight of credit derivative markets. Credit derivatives provide investors with instruments and markets that can be used to create tremendous leverage and risk concentration without any means for monitoring the trail of exposure created by these instruments. An individual firm or a security from a sub-prime, asset-backed or other mortgage-backed pool of loans may have only $50 million in outstanding par value and yet, the over-the-counter markets for credit default swaps (CDS) may create hundreds of millions of dollars in individual CDS contracts that reference that same debt. At the same time, this debt may be referenced in CDS Index contracts that are created by OTC dealers which creates additional exposure. If the referenced firm or security defaults, its bond holders will likely lose some fraction of the $50 million par value, but CDS holders face losses that are many times that amount.

Events have shown that the CDS markets are a source of systemic risk. The market for CDS was originally set up as an inter-bank market to exchange credit risk without selling the underlying loans, but it has since expanded massively to include hedge funds, insurance companies, municipalities, public pension funds and other financial institutions. The CDS market has expanded to include OTC index products that are so actively traded that they spawned a Chicago Board of Trade futures market contract. CDS markets are an important tool for hedging credit risk, but they also create leverage and can multiply underlying credit risk losses. Because there are relatively few CDS dealers, absent adequate risk management practices and safeguards, CDS markets can also create counterparty risk concentrations that are opaque to regulators and financial institutions.

Our views on the need for regulatory reform of the CDS and related OTC derivatives markets are aligned with the recommendations made in the recent framework proposed by the Group of Thirty. OTC contracts should be encouraged to migrate to trade on a nationally regulated exchange with centralized clearing and settlement systems, similar in character to those of the futures and equity option exchange markets. The regulation of the contracts that remain OTC-traded should be subject to supervision by a national regulator with jurisdiction to promulgate rules and standards regarding sound risk management practices, including those needed to manage counterparty credit risk and collateral requirements, uniform close-out

practices, trade confirmation and reporting standards, and other regulatory and public reporting standards that will need to be established to improve market transparency. For example, OTC dealers may be required to report selected trade information in a Trade Reporting and Compliance Engine (TRACE)-style system, which would be made publicly available. OTC dealers and exchanges should also be required to report information on large exposures and risk concentrations to a regulatory authority. This could be modeled in much the same way as futures exchanges regularly report qualifying exposures to the Commodities Futures Trading Commission. The reporting system would need to provide information on concentrations in both short and long positions.

Money Market Mutual Funds

Money market mutual funds (MMMFs) have been shown to be a source of systemic risk in this crisis. Two similar models of reform have been suggested. One would place MMMFs under systemic risk regulation, which would provide permanent access to the discount window and establish a fee-based insurance fund to prevent losses to investors. The other approach, offered by the Group of 30, would segment the industry into MMMFs that offer bank-like services and assurances in maintaining a stable net asset value (NAV) at par from MMMFs that that have no explicit or implicit assurances that investors can withdraw funds on demand at par. Those that operate like banks would be required to reorganize as special-purpose banks, coming under all bank regulations and depositor-like protections. But, this last approach will only be viable if there are restrictions on the size of at-risk MMMFs so that they do not evolve into too-big-to-fail institutions.

Regulatory Issues

Several issues can be addressed through the regulatory process including, the originate-to-distribute business model, executive compensation in banks, fair-value accounting, credit rating agency reform and counter-cyclical capital policies.

The Originate-To-Distribute Business Model

One of the most important factors driving this financial crisis has been the decline in value, liquidity and underlying collateral performance of a wide swath of previously highly rated asset backed securities. In 2008, over 221,000 rated tranches of private-label asset-backed securitizations were downgraded. This has resulted in a widespread loss of confidence in agency credit ratings for securitized assets, and bank and investor write-downs on their holdings of these assets.

Many of these previously highly rated securities were never traded in secondary markets, and were subject to little or no public disclosure about the characteristics and ongoing performance of underlying collateral. Financial incentives for short-term revenue recognition appear to have driven the creation of large volumes of highly rated securitization product, with insufficient attention to due diligence, and insufficient recognition of the risks being transferred to investors. Moreover, some aspects of our regulatory framework may have encouraged banks and other institutional investors in the belief that a highly rated security is, *per se,* of minimal risk.

Today, in a variety of policy-making groups around the world, there is consideration of ways to correct the incentives that led to the failure of the originate-to-distribute model. One area of focus relates to disclosure. For example, rated securitization tranches could be subject to a requirement for disclosure, in a readily accessible format on the ratings-agency Web sites, of detailed loan-level characteristics and regular performance reports. Over the long term, liquidity and confidence might be improved if secondary market prices and volumes of asset backed securities were reported on some type of system analogous to the Financial Industry Regulatory Authority's Trade Reporting and Compliance Engine that now captures such data on corporate bonds.

Again over the longer term, a more sustainable originate-to-distribute model might result if originators were required to retain "skin-in-the-game" by holding some form of explicit exposure to the assets sold. This idea has been endorsed by the Group of 30 and is being actively explored by the European Commission. Some in the United States have noted that there are implementation challenges of this idea, such as whether we can or should prevent issuers from hedging their exposure to their retained interests. Acknowledging these issues and correcting the problems in the originate-to-distribute model is very important, and some form of "skin-in-the-game" requirement that goes beyond the past practices of the industry should continue to be explored.

Executive Compensation In Banks

An important area for reform includes the broad area of correcting or offsetting financial incentives for short-term revenue recognition. There has been much discus-

sion of how to ensure financial firms' compensation systems do not excessively reward a short-term focus at the expense of longer term risks. I would note that in the Federal Deposit Insurance Act, Congress gave the banking agencies the explicit authority to define and regulate safe-and-sound compensation practices for insured banks and thrifts. Such regulation would be a potentially powerful tool but one that should be used judiciously to avoid unintended consequences.

Fair-Value Accounting

Another broad area where inappropriate financial incentives may need to be addressed is in regard to the recognition of potentially volatile noncash income or expense items. For example, many problematic exposures may have been driven in part by the ability to recognize mark-to-model gains on OTC derivatives or other illiquid financial instruments. To the extent such incentives drove some institutions to hold concentrations of illiquid and volatile exposures, they should be a concern for the safety-and-soundness of individual institutions. Moreover, such practices can make the system as a whole more subject to boom and bust. Regulators should consider taking steps to limit such practices in the future, perhaps by explicit quantitative limits on the extent such gains could be included in regulatory capital or by incrementally higher regulatory capital requirements when exposures exceed specified concentration limits.

For the immediate present, we are faced with a situation where an institution confronted with even a single dollar of credit loss on its available-for-sale and held-to-maturity securities, must write down the security to fair value, which includes not only recognizing the credit loss, but also the liquidity discount. We have expressed our support for the idea that FASB should consider allowing institutions facing an other-than-temporary impairment (OTTI) loss to recognize the credit loss in earnings but not the liquidity discount. We are pleased that the Financial Accounting Standards Board this week has issued a proposal that would move in this direction.

Credit Rating Agency Reform

The FDIC generally agrees with the Group of 30 recommendation that regulatory policies with regard to Nationally Recognized Securities Rating Organizations (NRSROs) and the use their ratings should be reformed. Regulated entities should do an independent evaluation of credit risk products in which they are investing. NRSROs should evaluate the risk of potential losses from the full range of potential risk factors, including liquidity and price volatility. Regulators should examine the incentives imbedded in the current business models of NRSROs. For example, an important strand of work within the Basel Committee on Banking Supervision that I have supported for some time relates to the creation of operational standards for the use of ratings-based capital requirements. We need to be sure that in the future, our capital requirements do not incent banks to rely blindly on favorable agency credit ratings. Preconditions for the use of ratings-based capital requirements should ensure investors and regulators have ready access to the loan level data underlying the securities, and that an appropriate level of due diligence has been performed.

Counter-Cyclical Capital Policies

At present, regulatory capital standards do not explicitly consider the stage of the economic cycle in which financial institutions are operating. As institutions seek to improve returns on equity, there is often an incentive to reduce capital and increase leverage when economic conditions are favorable and earnings are strong. However, when a downturn inevitably occurs and losses arising from credit and market risk exposures increase, these institutions' capital ratios may fall to levels that no longer appropriately support their risk profiles.

Therefore, it is important for regulators to institute counter-cyclical capital policies. For example, financial institutions could be required to limit dividends in profitable times to build capital above regulatory minimums or build some type of regulatory capital buffer to cover estimated through-the-cycle credit losses in excess of those reflected in their loan loss allowances under current accounting standards. Through the Basel Committee on Banking Supervision, we are working to strengthen capital to raise its resilience to future episodes of economic and financial stress. Furthermore, we strongly encourage the accounting standard-setters to revise the existing accounting model for loan losses to better reflect the economics of lending activity and enable lenders to recognize credit impairment earlier in the credit cycle.

Conclusion

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial institutions, especially those that are systemically impor-

tant to the financial system. The choices facing Congress in this task are complex, made more so by the fact that we are trying to address problems while the whirlwind of economic problems continues to engulf us. While the need for some reforms is obvious, such as a legal framework for resolving systemically important institutions, others are less clear and we would encourage a thoughtful, deliberative approach. 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 institutions—especially those that pose a systemic risk to the financial system.

I would be pleased to answer any questions from the Committee.

PREPARED STATEMENT OF MICHAEL E. FRYZEL

CHAIRMAN,
NATIONAL CREDIT UNION ADMINISTRATION

MARCH 19, 2009

Introduction

As Chairman of the National Credit Union Administration (NCUA), I appreciate this opportunity to provide my position on "Modernizing Bank Supervision and Regulation." Federally insured credit unions comprise a small but important part of the financial institution community, and NCUA's perspective on this matter will add to the overall understanding of the needs of the credit union industry and the members they serve.[1]

As NCUA Chairman, I agree with the need for establishing a regulatory oversight entity (systemic risk regulator) whose responsibilities would include monitoring the financial institution regulators and issuing principles-based regulations and guidance. I envision this entity would be responsible for establishing general safety and soundness guidance for federal financial regulators under its control while the individual federal financial regulators would implement and enforce the established guidelines in the institutions they regulate. This entity would also monitor systemic risk across institution types. For this structure to be effective for federally insured credit unions, the National Credit Union Share Insurance Fund (NCUSIF) must remain independent of the Deposit Insurance Fund to maintain the dual regulatory and insurance roles for the NCUA that have been tested and proven to work in the credit union industry for almost 40 years.

The NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. It performs this important public function by examining all federal credit unions, participating in the examination and supervision of federally insured state chartered credit unions in coordination with state regulators, and insuring federally insured credit union members' accounts. In its statutory role as the administrator of the NCUSIF, the NCUA insures and supervises 7,806 federally insured credit unions, representing 98 percent of all credit unions and approximately 88 million members.[2]

Overall, federally insured, natural person credit unions maintained reasonable financial performance in 2008. As of December 31, 2008, federally insured credit unions maintained a strong level of capital with an aggregate net worth ratio of 10.92 percent.[3] While earnings decreased from prior levels due to the economic downturn, federally insured credit unions were able to post a 0.30 percent return on average assets in 2008.[4] Delinquency was reported at 1.37 percent, while net charge-offs was 0.84 percent.[5] Shares in federally insured credit unions grew at 7.71 percent with membership growing at 2.01 percent, and loans growing at 7.08 percent.[6]

Federally Insured Credit Unions Require Separate Oversight

Federally insured credit unions' unique cooperative, not-for-profit structure and statutory mandate of serving people of modest means necessitate a customized approach to their regulation and supervision. The NCUA should remain an inde-

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[1] 12 U.S.C. §1759. Unlike other financial institutions, credit unions may only serve individuals within a restricted field of membership. Other financial institutions serve customers that generally have no membership interest.

[2] Approximately 162 state-chartered credit unions are privately insured and are not subject to NCUA oversight. Based on December 31, 2008, Call Report (NCUA Form 5300) data.

[3] Based on December 31, 2008, Call Report (NCUA Form 5300) data.

[4] *Ibid.*

[5] *Ibid.*

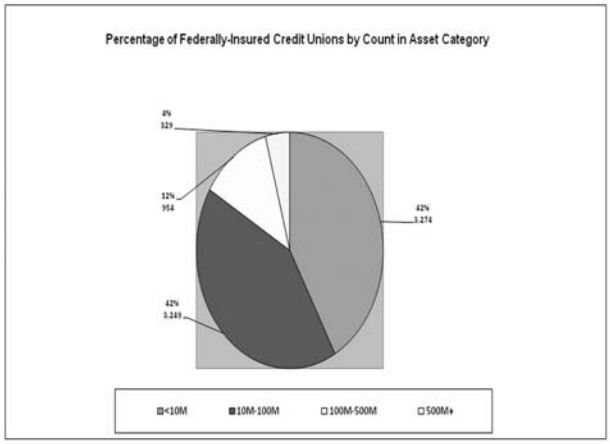
[6] *Ibid.*

pendent agency to preserve the credit union model and protect credit union members as mandated by Congress. An agency responsible for all financial institutions might focus on the larger financial institutions where the systemic risk predominates, potentially to the detriment of smaller federally insured credit unions. As federally insured credit unions are generally the smaller, less complex institutions in a consolidated financial regulator arrangement, the unique character of credit unions would quickly be lost, absorbed by the for-profit model and culture of the banking system.

Federally insured credit unions fulfill a specialized role in the domestic marketplace; one that Congress acknowledged is important in assuring consumers have access to basic financial services such as savings and affordable credit products. Loss of federally insured credit unions as a type of financial institution would limit access to these affordable financial services for persons of modest means. Federally insured credit unions serve an important competitive check on for-profit institutions by providing low-cost products and services. Some researchers estimate the competitive presence of credit unions save bank customers $4.3 billion annually.[7] Research also shows that in many markets, credit unions provide a lower cost alternative to abusive and predatory lenders. The research describes the fees, rates, and terms of the largest United States credit card providers in comparison to credit cards issued by credit unions with similar purchase interest rates but with fewer fees, lower fees, lower default rates, and clearer disclosures. The details of credit union credit card programs show credit card lending is sustainable without exorbitant penalties and misleading terms and conditions.[8]

Federally insured credit unions provide products geared to the modest consumer at a reasonable price, such as very small loans and low-minimum balance savings products that many banks do not offer. Credit unions enter markets that other financial institutions have not entered or abandoned because these markets were not profitable or there were more lucrative markets to pursue.[9] Loss of credit unions would reduce service to underserved consumers and hinder outreach and financial literacy efforts.

When comparing the size and complexity of federally insured credit unions to banks, even the largest federally insured credit unions are small in comparison. As shown in the graph below, small federally insured credit unions make up the majority of the institutions the NCUA insures.



[7] An Estimate of the Influence of Credit Unions on Bank CD and Money Market Deposits in the U.S.—Idaho State University, January 2005. Also, An Analysis of the Benefits of Credit Unions to Bank Loan Customers—American University, January 2005.

[8] Blindfolded Into Debt: A Comparison of Credit Card Costs and Conditions at Banks and Credit Unions. The Woodstock Institute, July 2005.

[9] Increase in Bank Branches Shortchanges Lower-Income and Minority Communities: An Analysis of Recent Growth in Chicago Area Bank Branching. The Woodstock Institute, February 2005, Number 27.

Eighty-four percent of federally insured credit unions have less than $100 million in assets as opposed to 38 percent of the institutions that the Federal Deposit Insurance Corporation (FDIC) insures with the same asset size.[10] Total assets in the entire federally insured credit union industry are less than the individual total assets of some of the nation's largest banks.[11]

Specialized Supervision

In recognition of the importance of small federally insured credit unions to their memberships, the NCUA established an Office of Small Credit Union Initiatives to foster credit union development, particularly in the expansion of services provided by small federally insured credit unions to all eligible members. Special purpose programs have helped preserve the viability of several institutions by providing access to training, grant assistance, and mentoring.[12]

The NCUA has developed expertise to effectively supervise federally insured credit unions. The agency has a highly trained examination force that understands the intricacies and nuances of federally insured credit unions and their operations.

The NCUA's mission includes serving and maintaining a safe, secure credit union community. In order to accomplish this, the NCUA has put in place specialized programs such as the National Examination Team to supervise federally insured credit unions showing a higher risk to the NCUSIF, Subject Matter Examiners to address specific areas of risk, and Economic Development Specialists to provide hands-on assistance to small federally insured credit unions.

NCUA's Tailored Guidance Approach

The systemic risk regulator would set the general safety and soundness guidelines, while the NCUA would monitor and enforce the specific rules for the federally insured credit union industry. For example, the NCUA has long recognized the safety and soundness issues regarding real estate lending. Real estate lending makes up fifty-four percent of federally insured credit unions' lending portfolio. As a result, the NCUA has provided federally insured credit unions detailed guidance regarding this matter. The below chart outlines the regulatory approach taken with real estate lending.

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[10] FDIC Quarterly Banking Profile—Fourth Quarter 2008.

[11] December 31, 2008, total assets for federally insured credit unions equaled $813.44 billion, while total assets for federally insured banks equaled $13.85 trillion. Based on December 31, 2008, Call Report (NCUA Form 5300) data and FDIC Quarterly Banking Profile—Fourth Quarter 2008.

[12] NCUA 2007 Annual Report.

Date	Title	Summary
June 1991	Letter to Credit Unions #124	Provides guidelines for developing and maintaining an effective real estate lending portfolio, and addressing both interest rate and credit risk associated with real estate lending.
August 1995	Letter to Credit Unions #174	Discusses potential advantages and disadvantages to federally-insured credit unions of risk-based lending[13] programs or programs where subprime credit could be offered. The letter also included a whitepaper discussing the importance of consumer compliance issues related to risk-based lending and the federally-insured credit unions' obligations under the Equal Credit Opportunity Act, Fair Housing Act, and the Fair Credit Reporting Act.
June 1999	Letter to Credit Unions 99-CU-05	Restates that soundly managed risk-based lending programs are a way to reach out to all members. Explained a federally-insured credit union's capital adequacy would be evaluated considering the volume and type of risk-based lending pursued and the adequacy of the credit union's risk management program.
August 1999	Letter to Credit Unions 99-CU-12	Stresses the importance of proper balance sheet risk management for real estate loan products and formally introduced such tools as GAP analysis, income simulation models, Net Economic Value, and other Asset Liability Management concepts.
September 2003	Letter to Credit Unions 03-CU-15	Reemphasizes the importance of properly monitoring and managing an increasing portfolio of fixed-rate mortgage products.
September 2004	Letter to Credit Unions 04-CU-13	Refocuses the industry's attention to proper credit risk management of lending, including real estate lending, in the wake of alternative lending arrangements to increase lending opportunities. Outlines the NCUA's underwriting expectations for federally-insured credit union engaged in subprime lending, noting the need to focus on borrowers' ability to repay loans as structured.
May 2005	Letter to Credit Unions 05-CU-07	Focuses industry attention to an increasing concentration of Home Equity Lines of Credit (HELOCs) and close-end home equity loans. This guidance was issued jointly with the other banking agencies.

October 2005	Letter to Credit Unions 05-CU-15	Addresses the use of alternative or exotic mortgage products to afford housing in areas of high housing value appreciation, as well as an apparent transition to more liberal mortgage credit standards in general. The NCUA developed guidance for staff focusing on the evolution of products in the mortgage market, the unusual volume of originations of variable rate mortgage products in a low interest rate environment, and the market trend toward liberalization of underwriting standards was included as an attachment.
October 2006	Letter to Credit Unions 06-CU-16	Addresses risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. While nontraditional and subprime mortgage lending were not major components of federally-insured lending portfolios, the letter cautions federally-insured credit unions on the potential "ripple effect" to their asset quality if some of their members have these types of loans at other financial institutions. Also, discusses prudent underwriting and risk management practices for nontraditional mortgage loans. Issued jointly with the Federal Financial Institutions Examination Council (FFIEC).[14]
April 2007	Letter to Credit Unions 07-CU-06	Encourages financial institutions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations. Explains that prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. Issued jointly with the FFIEC.
July 2007	Letter to Credit Unions 07-CU-09	Addresses emerging risks and lending practices associated with certain subprime adjustable rate mortgage products that can cause payment shock to consumers. While these types of loans did not appear prevalent in the credit union industry, the letter again cautions federally-insured credit unions on the potential "ripple effect" to their asset quality. Issued jointly with the FFIEC.

March 2008	Letter to Credit Unions 08-CU-5	Encourages federally-insured credit unions servicing securitized subprime adjustable rate residential mortgages to utilize the HOPE NOW[151] alliance's loan modification standards to report foreclosure prevention efforts.
June 2008	Letter to Credit Unions 08-CU-14	Provides all federally-insured credit unions with the final *Interagency Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products*, particularly those products that offer a low introductory "teaser" rate that could lead to payment shock when associated interest rates reset. Issued jointly with the FFIEC.
August 2008	Letter to Credit Unions 08-CU-19	Re-emphasizes the importance of proper due diligence over third-party relationships, specifically as they relate to the use of mortgage brokers and correspondents.
August 2008	Letter to Credit Unions 08-CU-20	Shares guidance with federally-insured credit unions that was released to the NCUA examiners. Guidance discusses several of the current risks facing the credit union industry, provides guidance for assessing mortgage portfolio risk management, and recommends best practices for conducting risk focused supervision and monitoring.
December 2008	Letter to Credit Unions 08-CU-25	Provides guidance related to holding foreclosed properties as Foreclosed and Repossessed Assets and encourages federally-insured credit unions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations.

[13] Risk-based lending involves setting a tiered pricing structure that assigns loan rates based upon an individual's credit risk. A tiered pricing structure enables federally-insured credit unions to make more loans to disadvantaged, lower income, or credit-challenged individuals.

[14] The FFIEC includes the Board of Governors of the Federal Reserve (FRB), the Federal Deposit Insurance Corporation (FDIC), the NCUA, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the State Liaison Committee (SLC).

[15] HOPE NOW is an alliance between counselors, servicers, investors, and others formed under the direction of the Department of Treasury and the Department of Housing and Urban Affairs in 2007, which serves to maximize outreach efforts to homeowners in distress to help them stay in their homes.

As demonstrated by the guidance issued, the NCUA proactively addresses issues with the industry as they evolve and as they specifically apply to federally insured credit unions. Due to federally insured credit unions' unique characteristics, the NCUA should be maintained as a separate regulator under an overseeing entity to ensure the vital sector of federally insured credit unions is not "lost in the shuffle" of the financial institution industry as a whole.

Maintain Separate Insurance Fund

Funds from federally insured credit unions have established the NCUSIF. The required deposit is calculated at least annually at one percent of each federally insured credit union's insured shares. The fund is commensurate with federally insured credit unions' equity interests and the risk level in the industry. The small institutions that make up the vast majority of federally insured credit unions should not be required to pay for the risk taken on by the large conglomerates. The NCUA has a successful record of regulating federal credit union charters and also serving as insurer for all federally insured credit unions. This structure has stood the test of time, encompassing various adverse economic cycles. The NCUA is the only regulator with this 100 percent dual regulator/insurer role. The overall reporting to a single regulatory body creates a level of efficiency for federally chartered credit unions in managing the regulatory relationship. This unique role has allowed the NCUA to develop economies of scale as a federal agency.

The July 1991 Government Accountability Office (GAO) report to Congress considered whether NCUA's insurance function should be separated from the other functions of chartering, regulating, and supervising credit unions. The GAO concluded "[s]eparation of NCUSIF from NCUA's chartering, regulation, and supervision responsibilities would not, on the basis of their analyses, by itself guarantee either strong supervision or insurance fund health. And such a move could result in additional and duplicative oversight costs. In addition, it could be argued that a regulator/supervisor without insurance responsibility has less incentive to concern itself with the insurance costs, should an institution fail." [16]

The 1997 Treasury study reached conclusions similar to the GAO report. The Treasury study discussed the unique capitalization structure of the NCUSIF and how it fits the cooperative nature of federally insured credit unions and offered the following: [17]

> We found no compelling case for removing the Share Insurance Fund from the NCUA's oversight and transferring it to another federal agency such as the FDIC. The NCUA maintains some level of separation between its insurance activities and its other responsibilities by separating the operating costs of the Fund from its noninsurance expenses. [18]
>
> Under the current structure, the NCUA can use supervision to control risks taken by credit unions—providing an additional measure of protection for the Fund. We also believe that separating the Fund from the NCUA could: (1) reduce the regulator's incentives to concern itself with insurance costs, should an institution fail; (2) create possible confusion over the roles and responsibilities of the insurer and of the regulator; and (3) place the insurer in the situation of safeguarding the insurance fund without having control over the risks taken by the insured entities. [19]
>
> The financing structure of the Share Insurance Fund fits the cooperative character of credit unions. Because credit unions must expense any losses to the Share Insurance Fund, they have an incentive to monitor each other and the Fund. This financing structure makes transparent the financial support that healthier credit unions give to the members of failing credit unions. Credit unions understand this aspect of the Fund and embrace it as a reflection of their cooperative character. [20]

The unique dual regulatory role in which the NCUA operates has proven successful in the credit union industry. At no time under this structure has the credit union system cost the American taxpayers any money.

Federally Insured Credit Unions Demonstrate Unique Characteristics

Federally insured credit unions are unique financial institutions that exist to serve the needs of their members. The statutory and regulatory frameworks in

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[16] GAO, July 1991 Study.
[17] Treasury, December 1997 Study of Credit Unions.
[18] Treasury, December 1997 Study of Credit Unions, page 52.
[19] *Ibid,* page 52.
[20] *Ibid,* page 58.

which federally insured credit unions operate reflect their uniqueness and are significantly different from that of other financial institutions. Comments that follow in this section provide specific examples for federal credit unions. However, most of the examples also apply to federally insured state chartered credit unions because of their similar organization as institutions designed to promote thrift.[21]

One Member One Vote

The federal credit union charter is the only federal financial charter in the United States that gives every member an equal voice in how their institution is operated regardless of the amount of shares on deposit with its "one member, one vote" cooperative structure.[22] This option allows federal credit unions to be democratically governed. The federal credit union charter provides an important pro-consumer alternative in the financial services industry.

Field of Membership

Federal credit unions are not-for-profit, member-owned cooperatives that exist to provide their members with the best possible rates and service. A federal credit union is chartered to serve a field of membership that shares a common bond such as the employees of a company, members of an association, or a local community. Therefore, federal credit unions may not serve the general public like other financial institutions and the federal credit unions' activities are largely limited to domestic activities, which has minimized the impact of globalization in the federal credit union industry. Due to this defined and limited field of membership, federal credit unions have less ability to grow into large institutions as demonstrated by 84 percent of federally insured credit unions having less than $100 million in assets.[23]

Volunteer Board of Directors

Federal credit unions are managed largely on a volunteer basis. The board of directors for each federal credit union consists of a volunteer board of directors elected by, and from the membership.[24] By statute, no member of the board may be compensated as such; however, a federal credit union may compensate one individual who serves as an officer of the board.[25]

Consumer Protection

The Federal Credit Union Act requires federal credit union boards of directors to appoint not less than three members or more than five members to serve as members of the supervisory committee.[26] The purpose of the supervisory committee is to ensure independent oversight of the board of directors and management and to advocate the best interests of the members. The supervisory committee either performs or contracts with a third-party to perform an annual audit of the federal credit union's books and records.[27] The supervisory committee also plays an important role as the member advocate.

As the member advocate, the supervisory committee is charged with reviewing member complaints.[28] Complaints cover a broad spectrum of areas, including annual meeting procedures, dividend rates and terms, and credit union services. Regardless of the nature of the complaint, NCUA requires supervisory committees to conduct a full and complete investigation. When addressing member complaints, supervisory committees will determine the appropriate course of action after thoroughly reviewing the unique circumstances surrounding each complaint.[29]

This committee and function of member advocacy are unique to federal credit unions. No member of the supervisory committee can be compensated.[30]

Regulatory Limitations

While there have been significant changes in the financial services environment since 1934 when the Federal Credit Union Act was implemented, federal credit unions have only had modest gains in the breadth of services offered relative to the broad authorities and services of other financial institutions. By virtue of their enabling legislation along with regulations established by the NCUA, federal credit

[21] 12 U.S.C. §1781(c)(1)(E).
[22] 12 U.S.C. §1760.
[23] Based on December 31, 2008, Call Report (NCUA Form 5300) data.
[24] 12 U.S.C. §1761(a).
[25] 12 U.S.C. §1761(c).
[26] 12 U.S.C. §1761b.
[27] 12 U.S.C. §1761d.
[28] As noted in the preamble of final rule incorporating the standard federal credit union bylaws into NCUA Rules and Regulations Part 701.
[29] Supervisory Committee Guide, Chapter 4, Publication 4017/8023 Revised December 1999.
[30] 12 U.S.C. §1761.

unions are more restricted in their operation than other financial institutions. A discussion of some of these limitations follows.

Investment Limitations

Federal credit unions have relatively few permissible investment options. Investments are largely limited to United States debt obligations, federal government agency instruments, and insured deposits.[31] Federal credit unions cannot invest in a diverse range of higher yielding products, including commercial paper and corporate debt securities. Also, federal credit unions have limited authority for broker-dealer relationships.[32] These limitations have helped credit unions weather the current economic downturn.

Affiliation Limitations

Federal credit unions are much more limited than other financial institutions in the types of businesses in which they engage and in the kinds of affiliates with which they deal. Federal credit unions cannot invest in the shares of an insurance company or control another financial depository institution. Also, they cannot be part of a financial services holding company and become affiliates of other depository institutions or insurance companies. Federal credit unions are limited to only the powers established in the Federal Credit Union Act.[33]

Capital Limitations

Unlike other financial institutions, federal credit unions cannot issue stock to raise additional capital.[34] Also, federal credit unions have borrowing authority limited to 50 percent of paid-in and unimpaired capital and surplus.[35]

A federal credit union can only build net worth through its retained earnings, unless it is a low-income designated credit union that can accept secondary capital contributions.[36] Federally insured credit unions must also hold 200 basis points more in capital than other federally insured financial institutions in order to be considered "well-capitalized" under federal "Prompt Corrective Action" laws.[37] In addition, federal credit unions must transfer their earnings to net worth and loss reserve accounts or distribute it to their membership through dividends, relatively lower loan rates, or relatively lower fees.

Lending Limitations

Federal credit unions are not permitted to charge a prepayment penalty in any type of loan whether consumer or business.[38] With the exception of certain consumer mortgage loans, federal credit unions cannot make loans with a maturity greater than 15 years.[39] Also, federal credit unions are subject to a federal statutory usury, currently set at 18 percent, which is unique among federally chartered financial institutions and far more restrictive than state usury laws.[40]

While federal credit unions have freedom in making consumer and mortgage loans to members, except with regard to limits to one borrower and loan-to-value restrictions, they are severely restricted in the kind and amount of member business loans they can underwrite. Some member business lending limits include restrictions on the total amount of loans, loan to value requirements, construction loan limits, and maturity limits.[41]

Access to Credit

Despite regulatory constraints, federally insured credit unions continue to follow their mission of providing credit to persons of modest means. Amid the tightening credit situation facing the nation, federally insured credit unions have continued to fulfill their members' borrowing needs. While other types of lenders severely curtailed credit, federally insured credit unions experienced a 7.08 percent loan growth in 2008.

Credit unions remain fundamentally different from other forms of financial institutions based on their member-owned, democratically operated, not-for-profit cooper-

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[31] NCUA Rules and Regulations Part 703.
[32] NCUA Rules and Regulations Part 703.
[33] 12 U.S.C. §1757.
[34] 12 U.S.C. §1790d(b)(1)(B)(i).
[35] 12 U.S.C. §1757(9).
[36] 12 U.S.C. §1790d(o)(2)(B).
[37] 12 U.S.C. §1790d.
[38] 12 U.S.C. §1757(5)(viii).
[39] 12 U.S.C. §1757(5).
[40] 12 U.S.C. §1757(5)(A)(vi).
[41] 12 U.S.C. §1757a and NCUA Rules and Regulations Part 723.

ative structure. Loss of credit unions as a type of financial institution would severely limit the access to financial services for many Americans.

Regulatory Framework Recommendation

I agree with the need for establishing a regulatory oversight entity to help mitigate risk to our nation's financial system. It is my recommendation that Congress maintain multiple financial regulators and charter options to enable the continued checks and balances such a structure produces. The oversight entity's main functions should be to establish broad safety and soundness principles and then monitor the individual financial regulators to ensure the established principles are implemented. This structure also allows the oversight entity to set objective-based standards in a more proactive manner, and would help alleviate competitive conflict detracting from the resolution of economic downturns. This type of structure would also promote uniformity in the supervision of financial institutions while affording the preservation of the different segments of the financial industry, including the credit union industry.

Conclusions

Federally insured credit union service remains focused on providing basic and affordable financial services to members. Credit unions are an important, but relatively small, segment of the financial institution industry serving a unique niche.[42] As a logical extension to this, the NCUSIF, which is funded by the required insurance contributions of federally insured credit unions, should be kept separate from any bank insurance fund. This would maintain an appropriate level of diversification in the financial system.

While the NCUA could be supportive of a regulatory oversight entity, the agency should maintain its dual regulatory functions of regulator and insurer in order to ensure the federally insured credit union segment of the financial industry is preserved.

PREPARED STATEMENT OF DANIEL K. TARULLO

MEMBER,

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MARCH 19, 2009

Chairman Dodd, Ranking Member Shelby, and other Members of the Committee, I appreciate this opportunity to present the views of the Federal Reserve Board on the important issue of modernizing financial supervision and regulation.

For the last year and a half, the U.S. financial system has been under extraordinary stress. Initially, this financial stress precipitated a sharp downturn in the U.S. and global economies. What has ensued is a very damaging negative feedback loop: The effects of the downturn—rising unemployment, declining profits, and decreased consumption and investment—have exacerbated the problems of financial institutions by reducing further the value of their assets. The impaired financial system has, in turn, been unable to supply the credit needed by households and businesses alike.

The catalyst for the current crisis was a broad-based decline in housing prices, which has contributed to substantial increases in mortgage delinquencies and foreclosures and significant declines in the value of mortgage-related assets. However, the mortgage sector is just the most visible example of what was a much broader credit boom, and the underlying causes of the crisis run deeper than the mortgage market. They include global imbalances in savings and capital flows, poorly designed financial innovations, and weaknesses in both the risk-management systems of financial institutions and the government oversight of such institutions.

While stabilizing the financial system to set the stage for economic recovery will remain its top priority in the near term, the Federal Reserve has also begun to evaluate regulatory and supervisory changes that could help reduce the incidence and severity of future financial crises. Today's Committee hearing is a timely opportunity for us to share our thinking to date and to contribute to your deliberations on regulatory modernization legislation.

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[42] As of December 31, 2008, approximately $14.67 trillion in assets were held in federally insured depository institutions. Banks and other savings institutions insured by the FDIC held $13.85 trillion, or 94.44 percent of these assets. Credit unions insured by the NCUSIF held $813.44 billion, or 5.56 percent of all federally insured assets.

Many conclusions can be drawn from the financial crisis and the period preceding it, ranging across topics as diverse as capital adequacy requirements, risk measurement and management at financial institutions, supervisory practices, and consumer protection. In the Board's judgment, one of the key lessons is that the United States must have a comprehensive strategy for containing systemic risk. This strategy must be multifaceted and involve oversight of the financial system as a whole, and not just its individual components, in order to improve the resiliency of the system to potential systemic shocks. In pursuing this strategy, we must ensure that the reforms we enact now are aimed not just at the causes of our current crisis, but at other sources of risk that may arise in the future.

Systemic risk refers to the potential for an event or shock triggering a loss of economic value or confidence in a substantial portion of the financial system, with resulting major adverse effects on the real economy. A core characteristic of systemic risk is the potential for contagion effects. Traditionally, the concern was that a run on a large bank, for example, would lead not only to the failure of that bank, but also to the failure of other financial firms because of the combined effect of the failed bank's unpaid obligations to other firms and market uncertainty as to whether those or other firms had similar vulnerabilities. In fact, most recent episodes of systemic risk have begun in markets, rather than through a classic run on a bank. A sharp downward movement in asset prices has been magnified by certain market practices or vulnerabilities. Soon market participants become uncertain about the values of those assets, an uncertainty that spreads to other assets as liquidity freezes up. In the worst case, liquidity problems become solvency problems. The result has been spillover effects both within the financial sector and from the financial sector to the real economy.

In my remarks, I will discuss several components of a broad policy agenda to address systemic risk: consolidated supervision, the development of a resolution regime for systemically important nonbank financial institutions; more uniform and robust authority for the prudential supervision of systemically important payment and settlement systems; consumer protection; and the potential benefits of charging a governmental entity with more express responsibility for monitoring and addressing systemic risks in the financial system. In elaborating this agenda, I will both discuss the actions the Federal Reserve is taking under existing authorities and identify areas in which we believe legislation is needed.

Effective Consolidated Supervision of Systemically Important Firms

For the reasons I have just stated, supervision of individual financial firms is not a sufficient condition for fostering financial stability. But it is surely a necessary condition. Thus a first component of an agenda for systemic risk regulation is that each systemically important financial firm be subject to effective consolidated supervision. This means ensuring both that regulatory requirements apply to each such firm and that the consequent supervision is effective.

As to the issue of effectiveness, many of the current problems in the banking and financial system stem from risk-management failures at a number of financial institutions, including some firms under federal supervision. Clearly, these lapses are unacceptable. The Federal Reserve has been involved in a number of exercises to understand and document the risk-management lapses and shortcomings at major financial institutions, including those undertaken by the Senior Supervisors Group, the President's Working Group on Financial Markets, and the multinational Financial Stability Forum. [1]

Based on the results of these and other efforts, the Federal Reserve is taking steps to improve regulatory requirements and risk management at regulated institutions. Our actions have covered liquidity risk management, capital planning and capital adequacy, firm-wide risk identification, residential lending, counterparty credit exposures, and commercial real estate. Liquidity and capital have been given special attention.

The crisis has undermined previous conventional wisdom that a company, even in stressed environments, may readily borrow funds if it can offer high-quality collateral. For example, the inability of Bear Stearns to borrow even against U.S. government securities helped cause its collapse. As a result, we have been working to bring about needed improvements in institutions' liquidity risk-management prac-

[1] See Senior Supervisors Group (2008), "Observations on Risk Management Practices during the Recent Market Turbulence" March 6, *www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf*; President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments," March 13, *www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf*; and Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7, *www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf.*

tices. Along with our U.S. supervisory colleagues, we are closely monitoring the liquidity positions of banking organizations—on a daily basis for the largest and most critical firms—and are discussing key market developments and our supervisory analyses with senior management. We use these analyses and findings from examinations to ensure that liquidity and funding management, as well as contingency funding plans, are sufficiently robust and incorporate various stress scenarios. Looking beyond the present period, we also have underway a broader-ranging examination of liquidity requirements.

Similarly, the Federal Reserve is closely monitoring the capital levels of banking organizations on a regular basis and discussing our evaluation with senior management. As part of our supervisory process, we have been conducting our own analysis of loss scenarios to anticipate the potential future capital needs of institutions. These needs may arise from, among other things, future losses or the potential for off-balance-sheet exposures and assets to come on balance sheet. Here, too, we have been discussing our analyses with bankers and ensuring that their own internal analyses reflect a broad range of scenarios and capture stress environments that could impair solvency. We have intensified efforts to evaluate firms' capital planning and to bring about improvements where needed.

Going forward, we will need changes in the capital regime as the financial environment returns closer to normal conditions. Working with other domestic and foreign supervisors, we must strengthen the existing capital rules to achieve a higher level and quality of required capital. Institutions should also have to establish strong capital buffers above current regulatory minimums in good times, so that they can weather financial market stress and continue to meet customer credit needs. This is but one of a number of important ways in which the current pro-cyclical features of financial regulation should be modified, with the aim of counteracting rather than exacerbating the effects of financial stress. Finally, firms whose failure would pose a systemic risk must be subject to especially close supervisory oversight of their risk-taking, risk management, and financial condition, and be held to high capital and liquidity standards.

Turning to the reach of consolidated supervision, the Board believes there should be statutory coverage of all systemically important financial firms—not just those affiliated with an insured bank as provided for under the Bank Holding Company Act of 1956 (BHC Act). The current financial crisis has highlighted a fact that had become more and more apparent in recent years—that risks to the financial system can arise not only in the banking sector, but also from the activities of financial firms that traditionally have not been subject to the type of consolidated supervision applied to bank holding companies. For example, although the Securities and Exchange Commission (SEC) had authority over the broker-dealer and other SEC-registered units of Bear Stearns and the other large investment banks, it did not have statutory authority to supervise the diversified operations of these firms on a consolidated basis. Instead, the SEC was forced to rely on a voluntary regime for monitoring and addressing the capital and liquidity risks arising from the full range of these firms' operations.

In contrast, all holding companies that own a bank—regardless of size—are subject to consolidated supervision for safety and soundness purposes under the BHC Act.[2] A robust consolidated supervisory framework, like the one embodied in the BHC Act, provides a supervisor the tools it needs to understand, monitor and, when appropriate, restrain the risks associated with an organization's consolidated or group-wide activities. These tools include the authority to establish consolidated capital requirements for the organization, obtain reports from and conduct examinations of the organization and any of its subsidiaries, and require the organization or its subsidiaries to alter their risk-management practices or take other actions to address risks that threaten the safety and soundness of the organization.

Application of a similar regime to systemically important financial institutions that are not bank holding companies would help promote the safety and soundness of these firms and the stability of the financial system generally. It also is worth considering whether a broader application of the principle of consolidated supervision would help reduce the potential for risk taking to migrate from more-regulated to less-regulated parts of the financial sector. To be fully effective, consolidated

[2] Through the exploitation of a loophole in the BHC Act, certain investment banks, as well as other financial and nonfinancial firms, acquired control of a federally insured industrial loan company (ILC) while avoiding the prudential framework that Congress established for the corporate owners of other full-service insured banks. For the reasons discussed in prior testimony before this Committee, the Board continues to believe that this loophole in current law should be closed. See Testimony of Scott G. Alvarez, General Counsel of the Board, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Oct. 4, 2007.

supervisors must have clear authority to monitor and address safety and soundness concerns in all parts of an organization. Accordingly, specific consideration should be given to modifying the limits currently placed on the ability of consolidated supervisors to monitor and address risks at an organization's functionally regulated subsidiaries.

Improved Resolution Processes

The importance of extending effective consolidated supervision to all systemically important firms is, of course, linked to the perception of market participants that such firms will be considered too-big-to-fail, and will thus be supported by the government if they get into financial difficulty. This perception has obvious undesirable effects, including possible moral hazard effects if firms are able to take excessive risks because of market beliefs that they can fall back on government assistance. In addition to effective supervision of these firms, the United States needs improved tools to allow the orderly resolution of systemically important nonbank financial firms, including a mechanism to cover the costs of the resolution if government assistance is required to prevent systemic consequences. In most cases, federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, this framework does not sufficiently protect the public's strong interest in ensuring the orderly resolution of nondepository financial institutions when a failure would pose substantial systemic risks.

Developing appropriate resolution procedures for potentially systemic financial firms, including bank holding companies, is a complex and challenging task that will take some time to complete. We can begin, however, by learning from other models, including the process currently in place under the Federal Deposit Insurance Act (FDIA) for dealing with failing insured depository institutions and the framework established for Fannie Mae and Freddie Mac under the Housing and Economic Recovery Act of 2008. Both models allow a government agency to take control of a failing institution's operations and management, act as conservator or receiver for the institution, and establish a "bridge" institution to facilitate an orderly sale or liquidation of the firm. The authority to "bridge" a failing institution through a receivership to a new entity reduces the potential for market disruption, limits the value-destruction impact of a failure, and—when accompanied by haircuts on creditors and shareholders—mitigates the adverse impact of government intervention on market discipline.

Any new resolution regime would need to be carefully crafted. For example, clear guidelines are needed to define which firms could be subject to the new, alternative regime and the process for invoking that regime, analogous perhaps to the procedures for invoking the so called systemic risk exception under the FDIA. In addition, given the global operations of many large and diversified financial firms and the complex regulatory structures under which they operate, any new resolution regime must be structured to work as seamlessly as possible with other domestic or foreign insolvency regimes that might apply to one or more parts of the consolidated organization.

In addition to developing an alternative resolution regime for systemically critical financial firms, policymakers and experts should carefully review whether improvements can be made to the existing bankruptcy framework that would allow for a faster and more orderly resolution of financial firms generally. Such improvements could reduce the likelihood that the new alternative regime would need to be invoked or government assistance provided in a particular instance to protect financial stability and, thereby, could promote market discipline.

Oversight of Payment and Settlement Systems

As suggested earlier, a comprehensive strategy for controlling systemic risk must focus not simply on the stability of individual firms. Another element of such a strategy is to provide close oversight of important arenas in which firms interact with one another. Payment and settlement systems are the foundation of our financial infrastructure. Financial institutions and markets depend upon the smooth functioning of these systems and their ability to manage counterparty and settlement risks effectively. Such systems can have significant risk-reduction benefits—by improving counterparty credit risk management, reducing settlement risks, and providing an orderly process to handle participant defaults—and can improve transparency for participants, financial markets, and regulatory authorities. At the same time, these systems inherently centralize and concentrate clearing and settlement risks. Thus, if a system is not well designed and able to appropriately manage the risks arising from participant defaults or operational disruptions, significant liquidity or credit problems could result.

Well before the current crisis erupted, the Federal Reserve was working to strengthen the financial infrastructure that supports trading, payments, clearing, and settlement in key financial markets. Because this infrastructure acts as a critical link between financial institutions and markets, ensuring that it is able to withstand—and not amplify—shocks is an important aspect of reducing systemic risk, including the very real problem of institutions that are too big or interconnected to be allowed to fail in a disorderly manner.

The Federal Reserve Bank of New York has been leading a major joint initiative by the public and private sectors to improve arrangements for clearing and settling credit default swaps (CDS) and other over-the-counter (OTC) derivatives. As a result, the accuracy and timeliness of trade information has improved significantly. In addition, the Federal Reserve, working with other supervisors through the President's Working Group on Financial Markets, has encouraged the development of well-regulated and prudently managed central clearing counterparties for OTC trades. Along these lines, the Board has encouraged the development of two central counterparties for CDS in the United States—ICE Trust and the Chicago Mercantile Exchange. In addition, in 2008, the Board entered into a memorandum of understanding with the SEC and the Commodity Futures Trading Commission to promote the application of common prudential standards to central counterparties for CDS and to facilitate the sharing of information among the agencies with respect to such central counterparties. The Federal Reserve also is consulting with foreign financial regulators regarding the development and oversight of central counterparties for CDS in other jurisdictions to promote the application of consistent prudential standards.

The New York Federal Reserve Bank, in conjunction with other domestic and foreign supervisors, continues its effort to establish increasingly stringent targets and performance standards for OTC market participants. In addition, we are working with market participants to enhance the resilience of the triparty repurchase agreement (repo) market. Through this market, primary dealers and other major banks and broker-dealers obtain very large amounts of secured financing from money market mutual funds and other short-term, risk-averse investors.[3] We are exploring, for example, whether a central clearing system or other improvements might be beneficial for this market, given the magnitude of exposures generated and the vital importance of the market to both dealers and investors.

Even as we pursue these and similar initiatives, however, the Board believes additional statutory authority is needed to address the potential for systemic risk in payment and settlement systems. Currently, the Federal Reserve relies on a patchwork of authorities, largely derived from our role as a banking supervisor, as well as on moral suasion to help ensure that critical payment and settlement systems have the necessary procedures and controls in place to manage their risks. By contrast, many major central banks around the world have an explicit statutory basis for their oversight of these systems. Given how important robust payment and settlement systems are to financial stability, and the functional similarities between many payment and settlement systems, a good case can be made for granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems.

The Federal Reserve has significant expertise regarding the risks and appropriate risk management practices at payment and settlement systems, substantial direct experience with the measures necessary for the safe and sound operation of such systems, and established working relationships with other central banks and regulators that we have used to promote the development of strong and internationally accepted risk management standards for the full range of these systems. Providing such authority would help ensure that these critical systems are held to consistent and high prudential standards aimed at mitigating systemic risk.

Consumer Protection

Another lesson of this crisis is that pervasive consumer protection problems can signal, and even lead to, trouble for the safety and soundness of financial institutions and for the stability of the financial system as a whole. Consumer protection in the area of financial services is not, and should not be, limited to practices with potentially systemic consequences. However, as we evaluate the range of measures that can help contain systemic problems, it is important to recognize that good consumer protection can play a supporting role by—among other things—promoting sound underwriting practices.

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[3] Primary dealers are broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York. The New York Reserve Bank's Open Market Desk engages in trades on behalf of the Federal Reserve System to implement monetary policy.

Last year the Board adopted new regulations under the Home Ownership and Equity Protection Act to enhance the substantive protections provided high-cost mortgage customers, such as requiring tax and insurance escrows in certain cases and limiting the use of prepayment penalties. These rules also require lenders providing such high-cost loans to verify the income and assets of a loan applicant and prohibit lenders from making such a loan without taking into account the ability of the borrower to repay the loan from income or assets other than the home's value. More recently, the Board adopted new rules to protect credit card customers from a variety of unfair and deceptive acts and practices. The Board will continue to update its consumer protection regulations as appropriate to provide households with the information they need to make informed credit decisions and to address new unfair and deceptive practices that may develop as practices and products change.

Systemic Risk Authority

One issue that has received much attention recently is the possible benefit of establishing a systemic risk authority that would be charged with monitoring, assessing and, if necessary, curtailing systemic risks across the entire U.S. financial system.

At a conceptual level, expressly empowering a governmental authority with responsibility to help contain systemic risks should, if implemented correctly, reduce the potential for large adverse shocks and limit the spillover effects of those shocks that do occur, thereby enhancing the resilience of the financial system. However, no one should underestimate the challenges involved with developing or implementing a supervisory and regulatory program for systemic risks. Nor should the establishment of such an authority be viewed as a panacea that will eliminate periods of significant stress in the financial markets and so reduce the need for the other important reforms that I have discussed.

The U.S. financial sector is extremely large and diverse—with value added amounting to nearly $1.1 trillion or 8 percent of gross domestic product in 2007. Systemic risks may arise across a broad range of firms or markets, or they may be concentrated in just a few key institutions or activities. They can occur suddenly, such as from a rapid and substantial decline in asset prices, even if the probability of their occurrence builds up slowly over time. Moreover, as the current crisis has illustrated, systemic risks may arise at nonbank entities (for example, mortgage brokers), from sectors outside the traditional purview of federal supervision (for example, insurance firms), from institutions or activities that are based in other countries or operate across national boundaries, or from the linkages and interdependencies among financial institutions or between financial institutions and markets. And, while the existence of systemic risks may be apparent in hindsight, identifying such risks *ex ante* and determining the proper degree of regulatory or supervisory action needed to counteract a particular risk without unnecessarily hampering innovation and economic growth is a very challenging assignment for any agency or group of agencies.[4]

For these reasons, any systemic risk authority would need a sophisticated, comprehensive and multi-disciplinary approach to systemic risk. Such an authority likely would require knowledge and experience across a wide range of financial institutions and markets, substantial analytical resources to identify the types of information needed and to analyze the information obtained, and supervisory expertise to develop and implement the necessary supervisory programs.

To be effective, however, these skills would have to be combined with a clear statement of expectations and responsibilities, and with adequate powers to fulfill those responsibilities. While the systemic risk authority should be required to rely on the information, assessments, and supervisory and regulatory programs of existing financial supervisors and regulators whenever possible, it would need sufficient powers of its own to achieve its broader mission—monitoring and containing systemic risk. These powers likely would include broad authority to obtain information—through data collection and reports, or when necessary, examinations—from a range of financial market participants, including banking organizations, securities firms, key financial market intermediaries, and other financial institutions that currently may not be subject to regular federal supervisory reporting requirements.

How might a properly constructed systemic risk authority use its expertise and authorities to help monitor, assess, and mitigate potentially systemic risks within the financial system? There are numerous possibilities. One area of natural focus for a systemic risk authority would be the stability of systemically critical financial

[4] For example, while the existence of supranormal profits in a market segment may be an indicator of supranormal risks, it also may be the result of innovation on the part of one or more market participants that does not create undue risks to the system.

institutions. It also likely would need some role in the setting of standards for capital, liquidity, and risk-management practices for financial firms, given the importance of these matters to the aggregate level of risk within the financial system. By bringing its broad knowledge of the interrelationships between firms and markets to bear, the systemic risk authority could help mitigate the potential for financial firms to be a source of, or be negatively affected by, adverse shocks to the system.

It seems most sensible that the role of the systemic risk authority be to complement, not displace, that of a firm's consolidated supervisor (which, as I noted earlier, all systemically critical financial institutions should have). Under this model, the firm's consolidated supervisor would continue to have primary responsibility for the day-to-day supervision of the firm's risk management practices, including those relating to compliance risk management, and for focusing on the safety and soundness of the individual institution.

Another key issue is the extent to which a systemic risk authority would have appropriately calibrated ability to take measures to address specific practices identified as posing a systemic risk—in coordination with other supervisors when possible, or independently if necessary. For example, there may be practices that appear sound when considered from the perspective of a single firm, but that appear troublesome when understood to be widespread in the financial system, such as if these practices reveal the shared dependence of firms on particular forms of uncertain liquidity.

Other activities that a systemic risk authority might undertake include: (1) monitoring large or rapidly increasing exposures—such as to subprime mortgages—across firms and markets; (2) assessing the potential for deficiencies in evolving risk-management practices, broad-based increases in financial leverage, or changes in financial markets or products to increase systemic risks; (3) analyzing possible spillovers between financial firms or between firms and markets, for example through the mutual exposures of highly interconnected firms; (4) identifying possible regulatory gaps, including gaps in the protection of consumers and investors, that pose risks for the system as a whole; and (5) issuing periodic reports on the stability of the U.S. financial system, in order both to disseminate its own views and to elicit the considered views of others.

Thus, there are numerous important decisions to be made on the substantive reach and responsibilities of a systemic risk regulator. How such an authority, if created, should be structured and located within the federal government is also a complex issue. Some have suggested the Federal Reserve for this role, while others have expressed concern that adding this responsibility would overburden the central bank. The extent to which this new responsibility might be a good match for the Federal Reserve, acting either alone or as part of a collective body, depends a great deal on precisely how the Congress defines the role and responsibilities of the authority, and how well they complement those of the Federal Reserve's long-established core missions.

Nevertheless, as Chairman Bernanke has noted, effectively identifying and addressing systemic risks would seem to require some involvement of the Federal Reserve. As the central bank of the United States, the Federal Reserve has a critical part to play in the government's responses to financial crises. Indeed, the Federal Reserve was established by the Congress in 1913 largely as a means of addressing the problem of recurring financial panics. The Federal Reserve plays such a key role in part because it serves as liquidity provider of last resort, a power that has proved critical in financial crises throughout modern history. In addition, the Federal Reserve has broad expertise derived from its other activities, including its role as umbrella supervisor for bank and financial holding companies and its active monitoring of capital markets in support of its monetary policy and financial stability objectives.

It seems equally clear that each financial regulator must be involved in a successful overall strategy for containing systemic risk. In the first place, of course, appropriate attention to systemic issues in the normal regulation of financial firms, markets, and practices may itself support this strategy. Second, the information and insight gained by financial regulators in their own realms of expertise will be important contributions to the demanding job of analyzing inchoate risks to financial stability. Still, while a collective process will surely be valuable in assessing systemic risk, it will be important to assign clearly any responsibilities and authorities for actual systemic risk regulation, since shared authority without clearly delineated responsibility for action is sometimes a prescription for inaction.

Conclusion

I have tried today to identify the elements of an agenda for limiting the potential for financial crises, including actions that the Federal Reserve is taking to address

systemic risks and several measures that Congress should consider to make our financial system stronger and safer. In doing so, we must avoid responding only to the current crisis, but must instead fashion a system that will be up to the challenge of regulating a dynamic and innovative financial system. We at the Federal Reserve look forward to working with the Congress on legislation that meets these objectives.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

May 19, 2009

DANIEL K. TARULLO
MEMBER OF THE BOARD

The Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing to you to follow up on some questions that you raised at the March 19, 2009, hearing on Modernizing Bank Supervision and Regulation conducted by the Senate Banking, Housing, and Urban Affairs Committee. Specifically, you asked about the Federal Reserve's supervisory actions concerning residential mortgage loan origination problems that have been a significant factor in causing the current financial crisis.

As you noted during the hearing, I have been at the Board only since late January and thus have no personal knowledge of Board practices prior to this period. However, Board staff has provided me with considerable background so I could respond to your questions.

I have enclosed a listing of Federal Reserve formal and informal supervisory actions issued for 2006 through 2008 involving institutions that we supervise. Many of these actions were based on safety and soundness considerations and were designed to require that the institution correct practices that may have involved lax lending and credit administration, improve its capital and liquidity positions, and the like. Few of the formal or informal actions specifically note residential mortgage loan origination problems as matters that required remedial action. There are several reasons that the Board's supervisory remedial actions generally pertain to other matters.

Most significantly, the Federal Reserve is not the primary federal regulator for many institutions that concentrated on originating residential mortgage loans, particularly in the sub-prime segment where problems have been particularly acute. The Federal Reserve is the primary federal regulator for 862 state chartered commercial banks that are members of the Federal Reserve System (as of the end of 2008), out of a total of 7,501 insured commercial banks (this figure does not include thrifts). State member banks hold only approximately 14.7 percent of the total assets of insured commercial banks (again not including thrifts, which are significant residential mortgage loan originators).

Moreover, several of the largest state member banks have little or no retail presence, and focus primarily on trading activities, and securities custody and processing operations. Most of the rest are small and mid-size community banks that avoided many of the origination practices that have led to the residential mortgage crisis.

The Federal Reserve also supervises bank holding companies and their non-bank subsidiaries, and foreign banking organizations. There are bank holding companies and some foreign banking organizations that do have extensive mortgage and other consumer lending operations in non-bank subsidiaries. Historically, the Federal Reserve did not extensively examine these non-bank subsidiaries, principally because these entities were subject to the jurisdiction of state regulators and the Federal Trade Commission, like their competitors who were not affiliated with banking organizations. Congress established this policy in the 1999 Gramm-Leach-Bliley Act, which, in contrast to the broad visitation powers that bank supervisors have over insured institutions, specifically included language narrowing the Board's examination authority over non-bank subsidiaries. In particular, the Gramm-Leach-Bliley Act states that the Board's authority to examine these entities only permits the Board "to monitor compliance with … Federal law that the Board has *specific jurisdiction to enforce* against such … subsidiary…." 12 U.S.C. § 1844(c)(2)(iii)(emphasis added). As noted above, specific and primary jurisdiction to enforce compliance with the federal lending-related consumer protection laws with respect to non-bank companies, including non-bank subsidiaries of bank holding companies, rests with the Federal Trade Commission or the Department of Housing and Urban Development.

This limitation led to a lengthy debate as to whether examinations of non-bank subsidiaries for compliance with various federal consumer protection laws were outside the Board's authority. It was not until 2006, that the Board determined that this language could be interpreted to permit the non-bank subsidiaries of bank holding companies to be examined for compliance with these statutes. Subsequently, the Board--in conjunction with the Office of Thrift Supervision, the Federal Trade Commission and various state agencies--began a pilot consumer protection compliance review as part of an interagency project to enhance the supervision of subprime mortgage lenders. Under the pilot project, the agencies coordinated consumer protection compliance reviews at selected entities with significant subprime mortgage operations, some of which were nonbank subsidiaries of bank holding companies. These reviews included targeted evaluations of mortgage underwriting standards, risk management strategies, and compliance with certain consumer protection laws. We are currently assessing the results of the pilot project. The results will inform the Board's decision-making as to how it may supervise these entities in the future.

With respect to subprime mortgage lending, and mortgage lending in general, the Federal Reserve has taken several regulatory steps since 2006 to address identified problems. In July 2008, using its authority under the Home Ownership and Equity Protection Act, the Board issued final rules that establish sweeping new regulatory protections for consumers in the residential mortgage market. Importantly, the Board's new rules apply to all mortgage lenders, not just depository institutions supervised by the federal banking and thrift agencies. In response to specific problems observed in the subprime mortgage market, some restrictions in the final rules apply only to higher-priced mortgage loans. Other provisions, however, apply to all mortgage

loans secured by a consumer's principal dwelling. In addition to rules that protect consumers from unfair or abusive lending and mortgage servicing practices, the Board also adopted rules governing mortgage advertisements to ensure they provide accurate and balanced information and do not contain misleading or deceptive representations. A third component of the final rules ensures that for all types of mortgage loans, consumers receive transaction-specific cost disclosures early enough to use while shopping for credit. Board staff is currently drafting examination procedures that will be used by consumer compliance examiners to test compliance with these new rules. The procedures will be available prior to the effective date of the regulations.

In addition, the Board is working with other federal agencies and state banking authorities to implement the registration requirements for residential mortgage loan originators employed by federally supervised institutions, as required by the SAFE Act. Under the Act, an individual is prohibited from engaging in loan origination without obtaining and maintaining annually a unique identifier and either a license and registration as a state-licensed loan originator or a registration as a federal loan originator. Overall, when fully implemented at the state and federal levels, the SAFE Act will provide for increased accountability and tracking of loan originators in a publicly accessible database.

Please let me know if I can provide further information on Board policies and practices in this area.

Sincerely,

David K. Fauller

FEDERAL RESERVE FORMAL AND INFORMAL ACTIONS

	2008	2007	2006
[redacted]			
Remedial Actions Against Institutions (does not include penalties assessed for flood insurance violations)	41	13	14
Actions Against Individuals	9	11	10
[redacted]			
Remedial Actions against institutions	230	86	90
[redacted]	3	8	4

PREPARED STATEMENT OF SCOTT M. POLAKOFF

ACTING DIRECTOR,
OFFICE OF THRIFT SUPERVISION

MARCH 19, 2009

Introduction

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision (OTS) on Modernizing Bank Supervision and Regulation.

It has been pointed out many times that our current system of financial supervision is a patchwork with pieces that date to the Civil War. If we were to start from scratch, no one would advocate establishing a system like the one we have cobbled together over the last century and a half. The complexity of our financial markets has in some cases reached mind-boggling proportions. To effectively address the risks in today's financial marketplace, we need a modern, sophisticated system of regulation and supervision that applies evenly across the financial services landscape.

The economic crisis gripping this nation and much of the rest of the world reinforces the theme that the time is right for an in-depth, careful review and meaningful, fundamental change. Any restructuring should take into account the lessons learned from this crisis.

Of course, the notion of regulatory reform is not new. When financial crisis strikes, it is natural to look for the root causes and logical fixes, asking whether the nation's regulatory framework allowed problems to occur, either because of gaps in oversight, a lack of vigilance, or overlaps in responsibilities that bred a lack of accountability.

Since last year, a new round of studies, reports and recommendations have entered the public arena. In one particularly notable study in January 2009—Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U. S. Financial Regulatory System—the Government Accountability Office (GAO) listed four broad goals of financial regulation:

- Ensure adequate consumer protections,
- Ensure integrity and fairness of markets,
- Monitor the safety and soundness of institutions, and
- Ensure the stability of the overall financial system.

The OTS recommendations discussed in this testimony align with those goals.

Although a review of the current financial services regulatory framework is a necessary exercise, the OTS recommendations do not represent a realignment of the current regulatory system. Rather, these recommendations represent a fresh start, using a clean slate. They present the OTS vision for the way financial services regulation in this country should be. Although they seek to remedy some of the problems of the past, they do not simply rearrange the current regulatory boxes. What we are proposing is fundamental change that would affect virtually all of the current federal financial regulators.

It is also important to note that these are high-level recommendations. Before adoption and implementation, many details would need to be worked out and many questions would need to be answered. To provide all of those details and answer all of those questions would require reams beyond the pages of this testimony.

The remaining sections of the OTS testimony begin by describing the problems that led to the current economic crisis. We also cite some of the important lessons learned from the OTS's perspective. The testimony then outlines several principles for a new regulatory framework before describing the heart of the OTS proposal for reform.

What Went Wrong?

The problems at the root of the financial crisis fall into two groups, nonstructural and structural. The nonstructural problems relate to lessons learned from the current economic crisis that have been, or can be, addressed without changes to the regulatory structure. The structural problems relate to gaps in regulatory coverage for some financial firms, financial workers and financial products.

Nonstructural Problems

In assessing what went wrong, it is important to note that several key issues relate to such things as concentration risks, extraordinary liquidity pressures, weak risk management practices, the influence of unregulated entities and product markets, and an over-reliance on models that relied on insufficient data and faulty as-

sumptions. All of the regulators, including the OTS, were slow to foresee the effects these risks could have on the institutions we regulate. Where we have the authority, we have taken steps to deal with these issues.

For example, federal regulators were slow to appreciate the severity of the problems arising from the increased use of mortgage brokers and other unregulated entities in providing consumer financial services. As the originate-to-distribute model became more prevalent, the resulting increase in competition changed the way all mortgage lenders underwrote loans, and assigned and priced risk. During the then booming economic environment, competition to originate new loans was fierce between insured institutions and less well regulated entities. Once these loans were originated, the majority of them were removed from bank balance sheets and sold into the securitization market. These events seeded many residential mortgage-backed securities with loans that were not underwritten adequately and that would cause significant problems later when home values fell, mortgages became delinquent and the true value of the securities became increasingly suspect.

Part of this problem stemmed from a structural issue described in the next section—inadequate and uneven regulation of mortgage companies and brokers—but some banks and thrifts that had to compete with these companies also started making loans that were focused on the rising value of the underlying collateral, rather than the borrower's ability to repay. By the time the federal bank regulators issued the nontraditional mortgage guidance in September 2006, reminding insured depository institutions to consider borrowers' ability to repay when underwriting adjustable-rate loans, numerous loans had been made that could not withstand a severe downturn in real estate values and payment shock from changes in adjustable rates.

When the secondary market stopped buying these loans in the fall of 2007, too many banks and thrifts were warehousing loans intended for sale that ultimately could not be sold. Until this time, bank examiners had historically looked at internal controls, underwriting practices and serviced loan portfolio performance as barometers of safety and soundness. In September 2008, the OTS issued guidance to the industry reiterating OTS policy that for all loans originated for sale or held in portfolio, savings associations must use prudent underwriting and documentation standards. The guidance emphasized that the OTS expects loans originated for sale to be underwritten to comply with the institution's approved loan policy, as well as all existing regulations and supervisory guidance governing the documentation and underwriting of residential mortgages. Once loans intended for sale were forced to be kept in the institutions' portfolios, it reinforced the supervisory concern that concentrations and liquidity of assets, whether geographically or by loan type, can pose major risks.

One lesson from these events is that regulators should consider promulgating requirements that are counter-cyclical, such as conducting stress tests and lowering loan-to-value ratios during economic upswings. Similarly, in difficult economic times, when house prices are not appreciating, regulators could permit loan-to-value (LTV) ratios to rise. Other examples include increasing capital and allowance for loan and lease losses in times of prosperity, when resources are readily available.

Another important nonstructural problem that is recognizable in hindsight and remains a concern today is the magnitude of the liquidity risk facing financial institutions and how that risk is addressed. As the economic crisis hit banks and thrifts, some institutions failed and consumers whose confidence was already shaken were overtaken in some cases by panic about the safety of their savings in insured accounts at banks and thrifts. This lack of consumer confidence resulted in large and sudden deposit drains at some institutions that had serious consequences. The federal government has taken several important steps to address liquidity risk in recent months, including an increase in the insured threshold for bank and thrift deposits.

Another lesson learned is that a lack of transparency for consumer products and complex instruments contributed to the crisis. For consumers, the full terms and details of mortgage products need to be understandable. For investors, the underlying details of their investments must be clear, readily available and accurately evaluated. Transparency of disclosures and agreements should be addressed.

Some of the blame for the economic crisis has been attributed to the use of "mark-to-market" accounting under the argument that this accounting model contributes to a downward spiral in asset prices. The theory is that as financial institutions write down assets to current market values in an illiquid market, those losses reduce regulatory capital. To eliminate their exposure to further write-downs, institutions sell assets into stressed, illiquid markets, triggering a cycle of additional sales at depressed prices. This in turn results in further write-downs by institutions holding similar assets. The OTS believes that refining this type of accounting is better than suspending it. Changes in accounting standards can address the concerns of

those who say fair value accounting should continue and those calling for its suspension.

These examples illustrate that nonstructural problems, such as weak underwriting, lack of transparency, accounting issues and an over-reliance on performance rather than fundamentals, all contributed to the current crisis.

Structural Problems

The crisis has also demonstrated that gaps in regulation and supervision that exist in the mortgage market have had a negative impact on the world of traditional and complex financial products. In recent years, the lack of consistent regulation and supervision in the mortgage lending area has become increasingly apparent.

Independent mortgage banking companies are state-chartered and regulated. Currently, there are state-by-state variations in the authorities of supervising agencies, in the level of supervision by the states and in the licensing processes that are used. State regulation of mortgage banking companies is inconsistent and varies on a number of factors, including where the authority for chartering and oversight of the companies resides in the state regulatory structure.

The supervision of mortgage brokers is even less consistent across the states. In response to calls for more stringent oversight of mortgage lenders and brokers, a number of states have debated and even enacted licensing requirements for mortgage originators. Last summer, a system requiring the licensing of mortgage originators in all states was enacted into federal law. The S.A.F.E. Mortgage Licensing Act in last year's Housing and Economic Recovery Act is a good first step. However, licensing does not go far enough. There continues to be significant variation in the oversight of these individuals and enforcement against the bad actors.

As the OTS has advocated for some time, one of the paramount goals of any new framework should be to ensure that similar bank or bank-like products, services and activities are scrutinized in the same way, whether they are offered by a chartered depository institution, or an unregulated financial services provider. The product should receive the same review, oversight and scrutiny regardless of the entity offering the product. Consumers do not understand—nor should they need to understand—distinctions between the types of lenders offering to provide them with a mortgage. They deserve the same service, care and protection from any lender. The "shadow bank system," where bank or bank-like products are offered by nonbanks using different standards, should be subject to as rigorous supervision as banks. Closing this gap would support the goals cited in the GAO report.

Another structural problem relates to unregulated financial products and the confluence of market factors that exposed the true risk of credit default swaps (CDS) and other derivative products. CDS are unregulated financial products that lack a prudential derivatives regulator or standard market regulation, and pose serious challenges for risk management. Shortcomings in data and in modeling certain derivative products camouflaged some of those risks. There frequently is heavy reliance on rating agencies and in-house models to assess the risks associated with these extremely complicated and unregulated products. In hindsight, the banking industry, the rating agencies and prudential supervisors, including OTS, relied too heavily on stress parameters that were based on insufficient historical data. This led to an underestimation of the economic shock that hit the financial sector, misjudgment of stress test parameters and an overly optimistic view of model output.

We have also learned there is a need for consistency and transparency in over-the-counter (OTC) CDS contracts. The complexity of CDS contracts masked risks and weaknesses. The OTS believes standardization and simplification of these products would provide more transparency to market participants and regulators. We believe many of these OTC contracts should be subject to exchange-traded oversight, with daily margining required. This kind of standardization and exchange-traded oversight can be accomplished when a single regulator is evaluating these products. Congress should consider legislation to bring such OTC derivative products under appropriate regulatory oversight.

One final issue on the structural side relates to the problem of regulating institutions that are considered to be too big and interconnected to fail, manage, resolve, or even formally deem as problem institutions when they encounter serious trouble. We will discuss the pressing need for a systemic risk regulator with the authority and resources adequate to the meet this enormous challenge later in this testimony.

The array of lessons learned from the crisis will be debated for years. One simple lesson is that all financial products and services should be regulated in the same manner regardless of the issuer. Another lesson is that some institutions have grown so large and become so essential to the economic well-being of the nation that they must be regulated in a new way.

Guiding Principles for Modernizing Bank Supervision and Regulation

The discussion on how to modernize bank supervision and regulation should begin with basic principles to apply to a bank supervision and consumer protection structure. Safety and soundness and consumer protection are fundamental elements of any regulatory regime. Here are recommendations for four other guiding principles:

1. *Dual banking system and federal insurance regulator*—The system should contain federal and state charters for banks, as well as the option of federal and state charters for insurance companies. The states have provided a charter option for banks and thrifts that have not wanted to have a national charter. A number of innovations have resulted from the kind of focused product development that can occur on a local level. Banks would be able to choose whether to hold a federal charter or state charter. For large insurance companies, a federal insurance regulator would be available to provide more comprehensive, coordinated and effective oversight than a collection of individual state insurance regulators.
2. *Choice of charter, not of regulator*—A depository institution should be able to choose between state or federal banking charters, but if it selects a federal charter, its charter type and regulator should be determined by its operating strategy and business model. In other words, there would be an option to choose a business plan and resulting charter, but that decision would then dictate which regulator would supervise the institution.
3. *Organizational and ownership options*—Financial institutions should be able to choose the organizational and ownership form that best suits their needs. Mutual, public or private stock and subchapter S options should continue to be available.
4. *Self-sustaining regulators*—Each regulator should be able to sustain itself financially through assessments. Funding the agencies differently could expose bank supervisory decisions to political pressures, or create conflicts of interest within the entity controlling the purse strings. An agency that supervises financial institutions must control its funding to make resources available quickly to respond to supervision and enforcement needs. For example, when the economy declines, the safety-and-soundness ratings of institutions generally drop and enforcement actions rise. These changes require additional resources and often an increase in hiring to handle the larger workload.
5. *Consistency*—Each federal regulator should have the same enforcement tools and the authority to use those tools in the same manner. Every entity offering financial products should also be subject to the same set of laws and regulations.

Federal Bank Regulation

The OTS proposes two federal bank regulators, one for banks predominately focused on consumer-and-community banking products, including lending, and the other for banks primarily focused on commercial products and services. The business models of a commercial bank and a consumer-and-community bank are fundamentally different enough to warrant these two distinct federal banking charters.

The consumer-and-community bank regulator would supervise depository institutions of all sizes and other companies that are predominately engaged in providing financial products and services to consumers and communities. Establishing such a regulator would address the gaps in regulatory oversight that led to a shadow banking system of unevenly regulated mortgage companies, brokers and consumer lenders that were significant causes of the current crisis.

The consumer-and-community bank regulator would also be the primary federal regulator of all state-chartered banks with a consumer-and-community business model. The regulator would work with state regulators to collaborate on examinations of state-chartered banks, perhaps on an alternating cycle for annual state and federal examinations. State-chartered banks would pay a prorated federal assessment to cover the costs of this oversight.

In addition to safety and soundness oversight, the consumer-and-community bank regulator would be responsible for developing and implementing all consumer protection requirements and regulations. These regulations and requirements would be applicable to all entities that offer lending products and services to consumers and communities. The same standards would apply for all of these entities, whether a state-licensed mortgage company, a state bank or a federally insured depository institution. Noncompliance would be addressed through uniform enforcement applied to all appropriate entities.

The current crisis has highlighted consumer protection as an area where reform is needed. Mortgage brokers and others who interact with consumers should meet eligibility requirements that reinforce the importance of their jobs and the level of trust consumers place in them. Although the recently enacted licensing requirements are a good first step, limitations on who may have a license are also necessary.

Historically, federal consumer protection policy has been based on the premise that if consumers are provided with enough information, they will be able to choose products and services that meet their needs. Although timely and effective disclosure remains necessary, disclosure alone may not be sufficient to protect consumers against abuses. This is particularly true as products and services, including mortgages, have become more complex.

The second federal bank regulator—the commercial bank regulator—would charter and supervise banks and other entities that primarily provide products and services to corporations and companies. The commercial bank regulator would have the expertise to supervise banks and other entities predominately involved in commercial transactions and offering complex products. This regulator would develop and implement the regulations necessary to supervise these entities. The commercial bank regulator would supervise issuers of derivative products. Nonbank providers of the same products and services would be subject to the same rules and regulations.

The commercial bank regulator would not only have the tools necessary to understand and supervise the complex products already mentioned, but would also possess the expertise to evaluate the safety and soundness of loans that are based on suchthings as income streams and occupancy rates, which are typical of loans for projects such as shopping centers and commercial buildings.

The commercial bank regulator would also be the primary federal supervisor of state-chartered banks with a commercial business model, coordinating with the states on supervision and imposing federal assessments just as the consumer-and-communityregulator would.

Because most depositories today are engaged in some of each of these business lines, the predominant business focus of the institution would govern which regulator would be the primary federal regulator. In determining the federal supervisor, a percentage of assets test could apply. If the operations of the institution or entity changed for a significant period of time, the primary federal regulator would change. More discussion and analysis would be needed to determine where to draw the line between institutions qualifying as commercial banks and institutions qualifying as consumer and community banks.

Holding Company Regulation

The functional regulator of the largest entity within a diversified financial company would be the holding company regulator. The holding company regulator would have authority to monitor the activities of all affiliates, to exercise enforcement authority and to impose information-sharing arrangements between entities in the holding company structure and their functional regulators. To the extent necessary for the safety and soundness of the depository subsidiary or the holding company, the regulator would have the authority to impose capital requirements, restrict activities, issue source-of support requirements and otherwise regulate the operations of the holding company and the affiliates.

Systemic Risk Regulation

The establishment of a systemic risk regulator is an essential outcome of any initiative to modernize bank supervision and regulation. OTS endorses the establishment of a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose a risk to financial stability. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including but not limited to companies involved inbanking, securities and insurance.

For systemically important institutions, the systemic risk regulator would supplement, not supplant, the holding company regulator and the primary federal bank supervisor.

A systemic regulator would have the authority and resources to supervise institutions and companies during a crisis situation. The regulator should have ready access to funding sources that would provide the capability to resolve problems at these institutions, including providing liquidity when needed.

Given the events of the past year, it is essential that such a regulator have the ability to act as a receiver and to provide an orderly resolution to companies. Efficiently resolving a systemically important institution in a measured, well-managed

manner is an important element in restructuring the regulatory framework. 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.

The continued ability of banks and other entities in the United States to compete in today's global financial services marketplace is critical. The systemic risk regulator would be charged with coordinating the supervision of conglomerates that have international operations. Safety and soundness standards, including capital adequacy and other factors, should be as comparable as possible for entities that have multinational businesses.

Although the systemic risk regulator would not have supervisory authority over nonsystemically important banks, the systemic regulator would need access to data regarding the health and activities of these institutions for purposes of monitoring trendsand other matters.

Conclusion

Thank you again, Mr. Chairman, Ranking Member Shelby, and Members of the Committee, for the opportunity to testify on behalf of the OTS on Modernizing Bank Supervision and Regulation.

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 the necessary clarity and stability for this nation's economy.

PREPARED STATEMENT OF JOSEPH A. SMITH, JR.

NORTH CAROLINA COMMISSIONER OF BANKS, AND
CHAIR-ELECT OF THE CONFERENCE OF STATE BANK SUPERVISORS

MARCH 19, 2009

Introduction

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Joe Smith, and I am the North Carolina Commissioner of Banks. I also serve as incoming Chairman of the Conference of State Bank Supervisors (CSBS) and a member of the CSBS Task Force on Regulatory Restructuring. I am pleased to be here today to offer a state perspective on our nation's financial regulatory structure—its strengths and its deficiencies, and suggestions for reform.

As we work through a federal response to this financial crisis, we need to carry forward a renewed understanding that the concentration of financial power and a lack of transparency are not in the long-term interests of our financial system, our economic system or our democracy. This lesson is one our country has had to learn in almost every generation, and I hope that the current lesson will benefit future generations. While our largest and most complex institutions are no doubt central to a resolution of the current crisis, my colleagues and I urge you to remember that the health and effectiveness of our nation's financial system also depends on a diverse and competitive marketplace that includes community and regional institutions.

While changing our regulatory system will be far from simple, some fairly simple concepts should guide these reforms. In evaluating any governmental reform, we must ask if our financial regulatory system:

- Ushers in a new era of cooperative federalism, recognizing the rights of states to protect consumers and reaffirming the state role in chartering and supervising financial institutions;
- Fosters supervision tailored to the size, scope and complexity of an institution and the risk it poses to the financial system;
- Assures the promulgation and enforcement of consumer protection standards that are applicable to both state and federally chartered institutions and are enforceable by state officials;
- Encourages a diverse universe of financial institutions as a method of reducing risk to the system, encouraging competition, furthering innovation, insuring access to financial markets, and promoting efficient allocation of credit;
- Supports community and regional banks, which provide relationship lending and fuel local economic development; and

- Requires financial institutions that are recipients of governmental assistance or pose systemic risk to be subject to safety and soundness and consumer protection oversight.

We have often heard the consolidation of financial regulation at the federal level is the "modern" answer to the challenges our financial system. We need to challenge this assumption. For reasons more fully discussed below, my colleagues and I would suggest to you that an appropriately coordinated system of state and federal supervision and regulation will promote a more effective system of financial regulation and a more diverse, stable and responsive financial system.

The Role of the States in Financial Services Supervision and Regulation

The states charter and supervise more than 70 percent of all U.S. banks (Exhibit A), in coordination with the FDIC and Federal Reserve. The rapid consolidation of the industry over the past decade, however, has created a system in which a handful of large national banks control the vast majority of assets in the system. The more than 6,000 banks supervised and regulated by the states now represent less than 30 percent of the assets of the banking system (Exhibit B). While these banks are smaller than the global institutions now making headlines, they are important to all of the markets they serve and are critical in the nonmetropolitan markets where they are often the major sources of credit for local households, small businesses and farms.

Since the enactment of nationwide banking in 1994, the states, working through CSBS, have developed a highly coordinated system of state-to-state and state-to-federal bank supervision. This is a model that has served this nation well, embodying our uniquely American dynamic of checks and balances—a dynamic that has been missing from certain areas of federal financial regulation, with devastating consequences.

The dynamic of state and federal coordinated supervision for state-chartered banks allows for new businesses to enter the market and grow to meet the needs of the markets they serve, while maintaining consistent nationwide standards. Community and regional banks are a vital part of America's economic fabric because of the state system.

As we continue to work through the current crisis, we need to do more to support community and regional banks. The severe economic recession and market distortions caused by bailing out the largest institutions have caused significant stress on these institutions. While some community and regional banks have had access to the TARP's capital purchase program, the processing and funding has grown cumbersome and slow. We need a more nimble and effective program for these institutions. This program must be administered by an entity with an understanding of community and regional banking. This capital will enhance stability and provide support for consumer and small business lending.

In addition to supervising banks, I and many of my colleagues regulate the residential mortgage industry. All 50 states and the District of Columbia now provide some regulatory oversight of the residential mortgage industry. The states currently manage over 88,000 mortgage company licenses, over 68,000 branch licenses, and approximately 357,000 loan officer licenses. In 2003, the states, acting through the CSBS and the American Association of Residential Mortgage Regulators, first proposed a nationwide mortgage licensing system and database to coordinate our efforts in regulating the residential mortgage market. The system launched on January 2, 2008, on time and on budget. The Nationwide Mortgage Licensing System (NMLS) was incorporated in the federal S.A.F.E. Act and, as a result, has established a new and important partnership with the United States Department of Housing and Urban Development, the federal banking agencies and the Farm Credit Administration. We are confident that this partnership will result in an efficient and effective combination of state and federal resources and a nimble, responsive and comprehensive system of regulation. This is an example of what we mean by "a new era of cooperative federalism."

Where Federalism Has Fallen Short

For the past decade it has been clear to the states that our system of mortgage finance and mortgage regulation was flawed and that a destructive and widening chasm had formed between the interests of borrowers and of lenders. Over that decade, through participation in GAO reports and through congressional testimony, one can observe an ever-increasing level of state concern over this growing chasm and its reflection in the state and federal regulatory relationship.

Currently, 35 states plus the District of Columbia have enacted predatory lending laws.[1] First adopted by North Carolina in 1999, these state laws supplement the federal protections of the Home Ownership and Equity Protection Act of 1994 (HOEPA). The innovative actions taken by state legislatures have prompted significant changes in industry practices, as the largest multi-state lenders have adjusted their practices to comply with the strongest state laws. All too often, however, we are frustrated in our efforts to protect consumers by the preemption of state consumer protection laws by federal regulations. Preemption must be narrowly targeted and balance the interest of commerce and consumers.

In addition to the extensive regulatory and legislative efforts, state attorneys general and state regulators have cooperatively pursued unfair and deceptive practices in the mortgage market. Through several settlements, state regulators have returned nearly one billion dollars to consumers. A settlement with Household resulted in $484 million paid in restitution, a settlement with Ameriquest resulted in $295 million paid in restitution, and a settlement with First Alliance Mortgage resulted in $60 million paid in restitution. These landmark settlements further contributed to changes in industry lending practices.

But successes are sometimes better measured by actions that never receive media attention. States regularly exercise their authority to investigate or examine mortgage companies for compliance not only with state law, but with federal law as well. These examinations are an integral part of a balanced regulatory system. Unheralded in their everyday routine, enforcement efforts and examinations identify weaknesses that, if undetected, might be devastating to the company and its customers. State examinations act as a check on financial problems, evasion of consumer protections and sales practices gone astray. Examinations can also serve as an early warning system of a financial institution conducting misleading, predatory or fraudulent practices. Attached as Exhibit C is a chart of enforcement actions taken by state regulatory agencies against mortgage providers. In 2007, states took nearly 6,000 enforcement actions against mortgage lenders and brokers.

These actions could have resulted in a dialog between state and federal authorities about the extent of the problems in the mortgage market and the best way to address the problem. That did not happen. The committee should consider how the world would look today if the ratings agencies and the OCC had not intervened and the assignee liability and predatory lending provisions of the Georgia Fair Lending Act had been applicable to all financial institutions. I would suggest we would have far fewer foreclosures and may have avoided the need to bailout our largest financial institutions. It is worth noting that the institutions whose names were attached to the OCC's mortgage preemption initiative—National City, First Franklin, and Wachovia—were all brought down by the mortgage crisis. That fact alone should indicate how out of balance the system has become.

From the state perspective, it has not been clear for many years exactly who was setting the risk boundaries for the market. What is clear is that the nation's largest and most influential financial institutions have been major contributing factors in our regulatory system's failure to respond to this crisis. At the state level, we sometimes perceived an environment at the federal level that is skewed toward facilitating the business models and viability of our largest financial institutions rather than promoting the strength of the consumer or our diverse economy.

It was the states that attempted to check the unhealthy evolution of the mortgage market and apply needed consumer protections to subprime lending. Regulatory reform must foster a system that incorporates the early warning signs that state laws and regulations provide, rather than thwarting or banning them.

Certainly, significant weaknesses exist in our current regulatory structure. As GAO has noted, incentives need to be better aligned to promote accountability, a fair and competitive market, and consumer protection.

Needed Regulatory Reforms: Mortgage Origination

I would like to thank this committee for including the Secure and Fair Enforcement for Mortgage Licensing Act (S.A.F.E.) in the Housing and Economic Recovery Act of 2008 (HERA). It has given us important tools that continue our efforts to reform mortgage regulation.

CSBS and the states are working to enhance the regulatory regime for the residential mortgage industry to ensure legitimate lending practices, provide adequate consumer protection, and to once again instill both consumer and investor confidence in the housing market and the economy as a whole. The various state initiatives are detailed in Exhibit D.

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[1] Source: National Conference of State Legislatures.

Needed Regulatory Reforms: Financial Services Industry

Many of the problems we are experiencing are both the result of "bad actors" and bad assumptions by the architects of our modern mortgage finance system. Enhanced supervision and improved industry practices can successfully weed out the bad actors and address the bad assumptions. If regulators and the industry do not address both causes of our current crisis, we will have only the veneer of reform and will eventually repeat our mistakes. Some lessons learned from this crisis must be to prevent the following: the over-leveraging that was allowed to occur in the nation's largest institutions; outsourcing of loan origination with no controls in place; and industry consolidation to allow institutions to become so large and complex that they become systemically vital and too big to effectively supervise or fail.

While much is being done to enhance supervision of the mortgage market, more progress must be made towards the development of a coordinated and cooperative system of state–federal supervision.

Preserve and Enhance Checks and Balances/Forge a New Era of Federalism

The state system of chartering and regulating has always been a key check on the concentration of financial power, as well as a mechanism to ensure that our banking system remains responsive to local economies' needs and accountable to the public. The state system has fostered a diversity of institutions that has been a source of stability and strength for our country, particularly locally owned and controlled community banks. To promote a strong and diverse system of banking-one that can survive the inevitable economic cycles and absorb failures-preservation of state-chartered banking should be a high priority for Congress. The United States boasts one of the most powerful and dynamic economies in the world because of those checks and balances, not despite them.

Consolidation of the industry and supervision and preemption of applicable state law does not address the cause of this crisis, and has in fact exacerbated the problem.

The flurry of state predatory lending laws and new state regulatory structures for lenders and mortgage brokers were indicators that conditions and practices were deteriorating in our mortgage lending industry. It would be incongruous to eliminate the early warning signs that the states provide. Just as checks and balances are a vital part of our democratic government, they serve an equally important role in our financial regulatory structure. Put simply, states have a lower threshold for crisis and will most likely act sooner. This is an essential systemic protection.

Most importantly, it serves the consumer interest that the states continue to have a role in financial regulation. While CSBS recognizes the financial services market is a nationwide industry that has international implications, local economies and individual consumers are most drastically affected by mortgage market fluctuations. State regulators must remain active participants in mortgage supervision because of our knowledge of local economies and our ability to react quickly and decisively to protect consumers.

Therefore, CSBS urges Congress to implement a recommendation made by the Congressional Oversight Panel in their "Special Report on Regulatory Reform" to eliminate federal preemption of the application of state consumer protection laws to national banks. In its report, the Panel recommends Congress "amend the National Banking Act to provide clearly that state consumer protection laws can apply to national banks and to reverse the holding that the usury laws of a national bank's state of incorporation govern that bank's operation through the nation."[2] We believe the same policy should apply to the Office of Thrift Supervision. To preserve a responsive system, states must be able to continue to produce innovative solutions and regulations to provide consumer protection.

The federal government would better serve our economy and our consumers by advancing a new era of cooperative federalism. The S.A.F.E. Act enacted by Congress requiring licensure and registration of mortgage loan originators through the Nationwide Mortgage Licensing System provides a model for achieving systemic goals of high regulatory standards and a nationwide regulatory roadmap and network, while preserving state authority for innovation and enforcement. The Act sets expectations for greater state-to-state and state-to-federal regulatory coordination.

Congress should complete this process by enacting a federal predatory lending standard. A federal standard should allow for further state refinements in lending standards and be enforceable by state and federal regulators. Additionally, a federal lending standard should clarify expectations of the obligations of securitizers.

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[2] The Congressional Oversight Panel's "Special Report on Regulatory Reform" can be viewed at *http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf*

Consumer Protection/Enforcement

Consolidated regulation minimizes resources dedicated to supervision and enforcement. As FDIC Chairman Sheila Bair recently told the states' Attorneys General, "if ever there were a time for the states and the feds to work together, that time is right here, right now. The last thing we need is to preempt each other." Congress should establish a mechanism among the financial regulators for identifying and responding to emerging consumer issues. This mechanism, perhaps through the Federal Financial Institutions Examination Council (FFIEC), should include active state regulator and law enforcement participation and develop coordinated responses. The coordinating federal entity should report to Congress regularly. The states must retain the right to pursue independent enforcement actions against all financial institutions as an appropriate check on the system.

Systemic Supervision/Capital Requirements

As Congress evaluates our regulatory structure, I urge you to examine the linkages between the capital markets, the traditional banking sector, and other financial services providers. Our top priority for reform must be a better understanding of systemic risks. The federal government must facilitate the transparency of financial markets to create a financial system in which stakeholders can understand and manage their risks. Congress should establish clear expectations about which regulatory authority or authorities are responsible for assessing risk. The regulator must have the necessary tools to identify and mitigate risk, and resolve failures.

Congress, the administration, and federal regulators must also consider how the federal government itself may inadvertently contribute to systemic risk—either by promoting greater industry consolidation or through policies that increase risk to the system. Perhaps we should contemplate that there are some institutions whose size and complexity make their risks too large to effectively manage or regulate. Congress should aggressively address the sources of systemic risk to our financial system.

While this crisis has demanded a dramatic response from the federal government, the short-term result of many of these programs, including the Troubled Asset Relief Program (TARP), has been to create even larger and more complex institutions and greater systemic risk. These responses have created extreme disparity in the treatment of financial institutions, with the government protecting those deemed to be too big or too complex to fail, perhaps at the expense of smaller institutions and the diversity of our financial system.

At the federal level, our state-chartered banks may be too-small-to-care but in our cities and communities, they are too important to ignore. It is exactly the same dynamic that told us that the plight of the individual homeowner trapped in a predatory loan was less important than the needs of an equity market hungry for new mortgage-backed securities.

There is an unchallenged assumption that federal regulatory reforms can address the systemic risk posed by our largest and most complex institutions. If these institutions are too large or complex to fail, the government must give preferential treatment to prevent these failures, and that preferential treatment distorts and harms the marketplace, with potentially disastrous consequences.

Our experience with Fannie Mae and Freddie Mac exemplifies this problem. Large systemic institutions such as Fannie and Freddie inevitably garner advantages and political favor, and the lines between government and industry blur in ways that do not reflect American values of fair competition and merit-based success.

My fellow state supervisors and I have long believed capital and leverage ratios are essential tools for managing risk. For example, during the debate surrounding the advanced approach under Basel II, CSBS supported FDIC Chairman Sheila Bair in her call to institute a leverage ratio for participating institutions. Federal regulation needs to prevent capital arbitrage among institutions that pose systemic risks, and should require systemic risk institutions to hold more capital to offset the grave risks their collapse would pose to our financial system.

Perhaps most importantly, Congress must strive to prevent unintended consequences from doing irreparable harm to the community and regional banking system in the United States. Federal policy to prevent the collapse of those institutions considered too big to fail should ultimately strengthen our system, not exacerbate the weaknesses of the system. Throughout the current recession, community and regional banks have largely remained healthy and continued to provide much needed credit in the communities where they operate. The largest banks have received amazing sums of capital to remain solvent, while the community and regional banks have continued to lend in this difficult environment with the added challenge of having to compete with federally subsidized entities.

Congress should consider creating a bifurcated system of supervision that is tailored to the size, scope, and complexity of financial institutions. The largest, most systemically significant institutions should be subject to much more stringent oversight that is comprehensive enough to account for the complexity of the institution. Community and regional banks should be subject to regulations that are tailored to the size and sophistication of the institutions. In financial supervision, one size should no longer fit all.

Roadmap for Unwinding Federal Liquidity Assistance and Systemic Responses

The Treasury Department and the Federal Reserve should be required to provide a plan for how to unwind the various programs established to provide liquidity and prevent systemic failure. Unfortunately, the attempts to avert crisis through liquidity programs have focused predominantly upon the needs of the nation's largest institutions, without consideration for the unintended consequences for our diverse financial industry as a whole, particularly community and regional banks. Put simply, the government is now in the business of picking winners and losers. In the extreme, these decisions determine survival, but they also affect the overall competitive landscape and relative health and profitability of institutions. The federal government should develop a plan that promotes fair and equal competition, rather than sacrificing the diversity of our financial industry to save those deemed too big to fail.

Conclusion

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, the task before us is a daunting one. The current crisis is the result of well over a decade's worth of policies that promoted consolidation, uniformity, preemption and the needs of the global marketplace over those of the individual consumer.

If we have learned nothing else from this experience, we have learned that big organizations have big problems. As you consider your responses to this crisis, I ask that you consider reforms that promote diversity and create new incentives for the smaller, less troubled elements of our financial system, rather than rewarding the largest and most reckless.

At the state level, we are constantly pursuing methods of supervision and regulation that promote safety and soundness while making the broadest possible range of financial services available to all members of our communities. We appreciate your work toward this common goal, and thank you for inviting us to share our views today.

Exhibit A: Percentage of Charters by Regulator

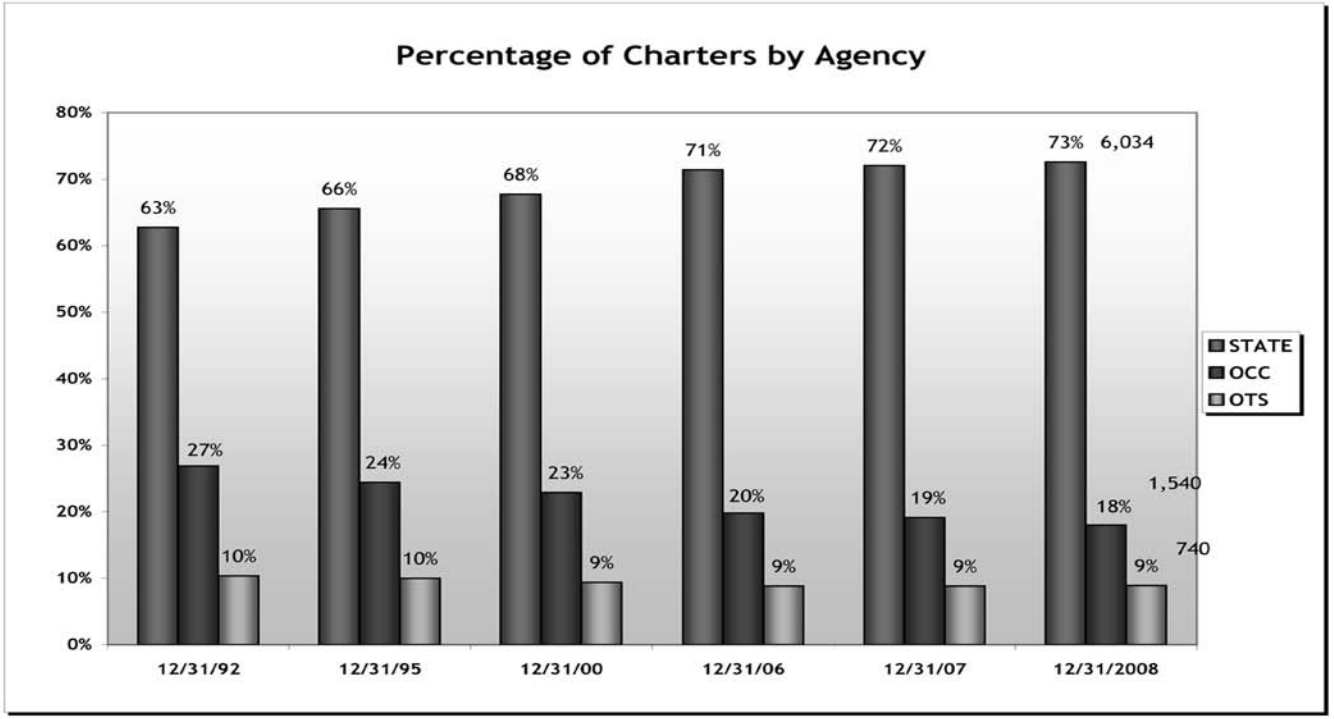


Exhibit B: Percentage of Assets by Regulator

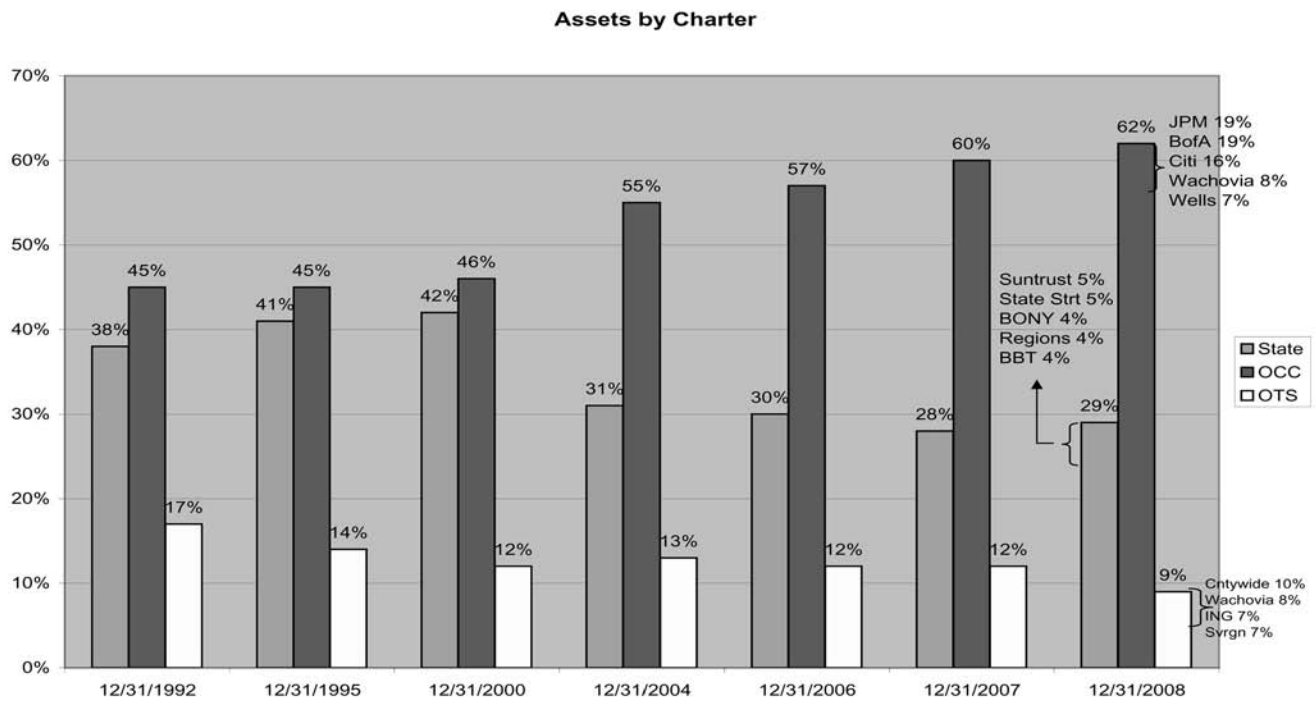
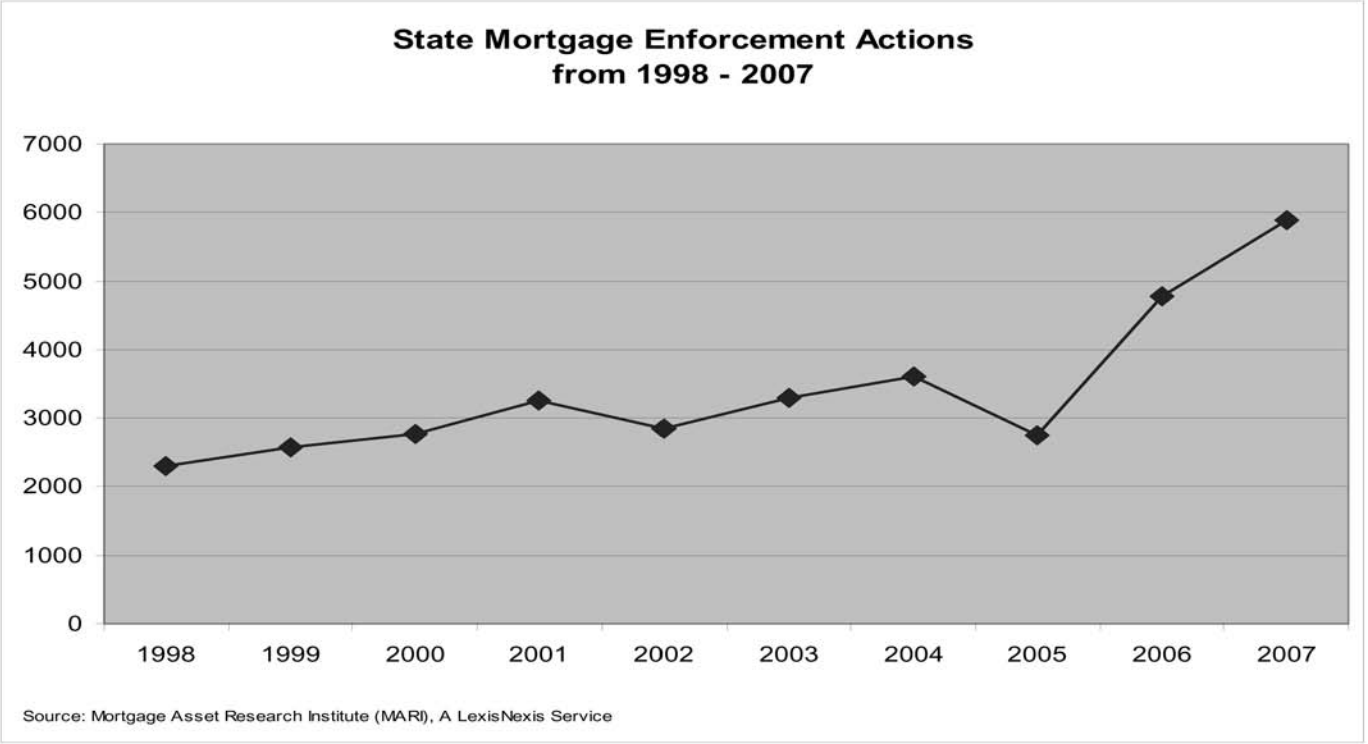


Exhibit C: State Enforcement Actions Against Mortgage Providers



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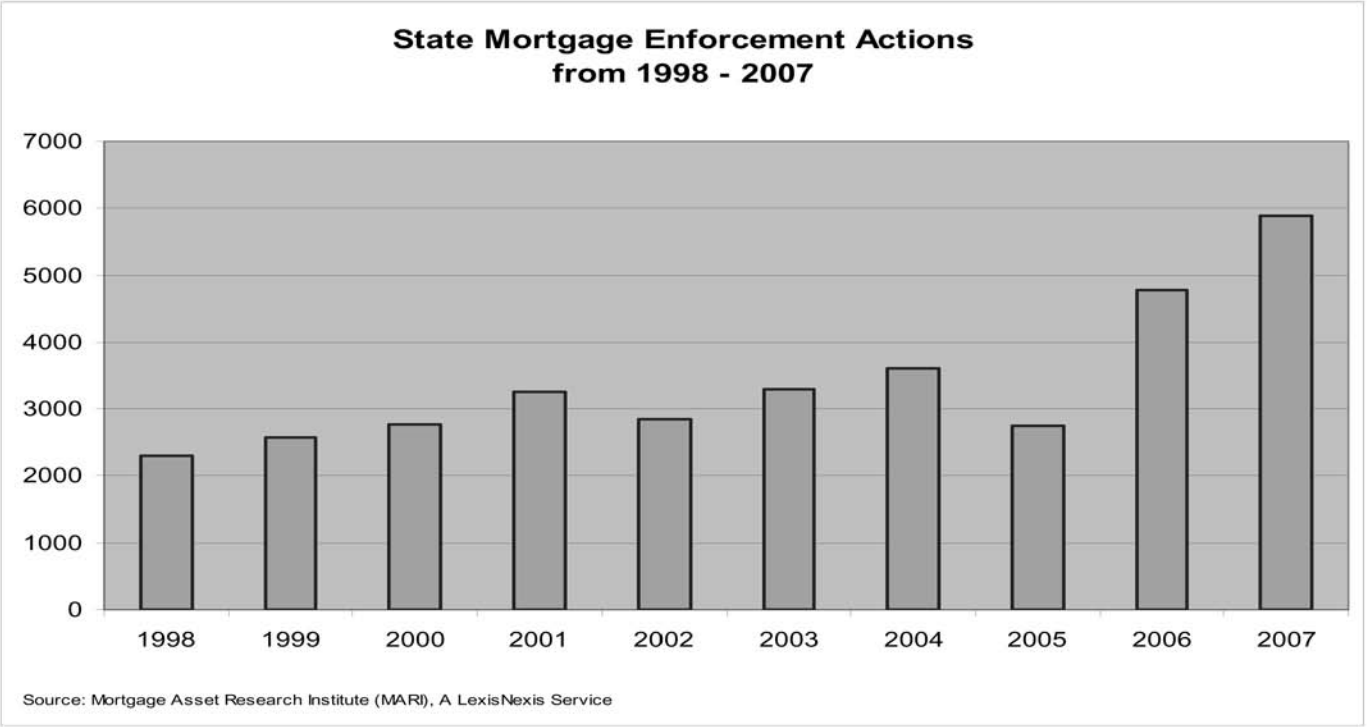
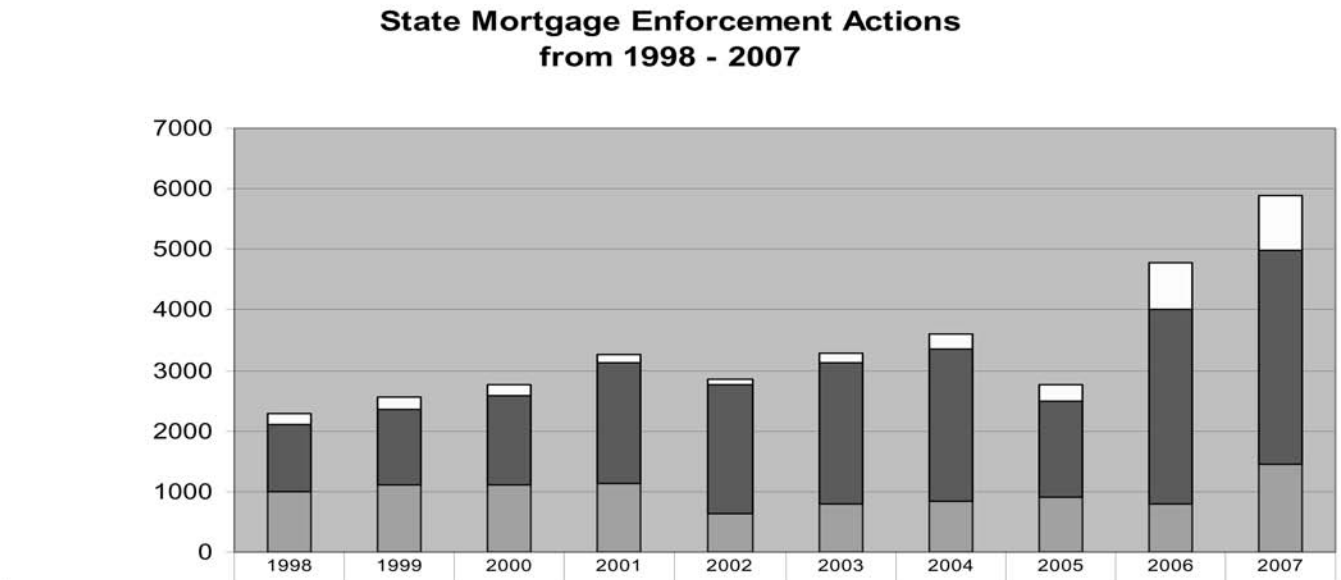


Exhibit C: State Enforcement Actions Against Mortgage Providers



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Disciplinary / Fines	185	212	180	133	93	171	249	260	761	912
Cease & Desist	1121	1242	1480	2002	2117	2343	2534	1595	3227	3527
Criminal / Revocation	992	1116	1106	1126	638	782	829	904	788	1457

Source: Mortgage Asset Research Institute (MARI), A LexisNexis Service

APPENDIX ITEMS

EXHIBIT D: STATE INITIATIVES TO ENHANCE SUPERVISION OF THE MORTGAGE INDUSTRY

CSBS–AARMR Nationwide Mortgage Licensing System

The states first recognized the need for a tool to license mortgage originators several years ago. Since then, states have dedicated tremendous monetary and staff resources to develop and enact the Nationwide Mortgage Licensing System (NMLS). First proposed among state regulators in late 2003, NMLS launched on time and on budget on January 2, 2008. The Nationwide Mortgage Licensing System is more than a database. It serves as the foundation of modern mortgage supervision by providing dramatically improved transparency for regulators, the industry, investors, and consumers. Seven inaugural participating states began using the system on January 2, 2008. Only 15 months later, 23 states are using NMLS and by January 2010—just 2 years after its launch—CSBS expects 40 states to be using NMLS.

NMLS currently maintains a single record for every state-licensed mortgage company, branch, and individual that is shared by all participating states. This single record allows companies and individuals to be definitively tracked across state lines and over time as entities migrate among companies, industries, and federal and state jurisdictions. Additionally, this year consumers and industry will be able to check on the license status and history of the companies and individuals with which they wish to do business.

NMLS provides profound benefits to consumers, state supervisory agencies, and the mortgage industry. Each state regulatory agency retains its authority to license and supervise, but NMLS shares information across state lines in real-time, eliminates any duplication and inconsistencies, and provides more robust information to state regulatory agencies. Consumers will have access to a central repository of licensing and publicly adjudicated enforcement actions. Honest mortgage lenders and brokers will benefit from the removal of fraudulent and incompetent operators, and from having one central point of contact for submitting and updating license applications.

The hard work and dedication of the states was ultimately recognized by Congress as they enacted the Housing and Economic Recovery Act of 2008 (HERA). The bill acknowledged and built upon the work that had been done in the states to protect consumers and restore the public trust in our mortgage finance and lending industries.

Title V of HERA, titled the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act), is designed to increase uniformity, reduce regulatory burden, enhance consumer protection, and reduce fraud by requiring all mortgage loan originators to be licensed or registered through NMLS.

In addition to loan originator licensing and mandatory use of NMLS, the S.A.F.E. Act requires the states to do the following:

1. Eliminate exemptions from mortgage loan originator licensing that currently exist in state law;
2. Screen and deny mortgage loan originator licenses for felonies of any kind within 7 years and certain financially related felonies permanently;
3. Screen and deny licenses to individuals who have ever had a loan originator license revoked;
4. Require loan originators to submit personal history information and authorize background checks to determine the applicant's financial responsibility, character, and general fitness;
5. Require mortgage loan originators to take 20 hours of pre-licensure education in order to enter the state system of licensure;
6. Require mortgage loan originators to pass a national mortgage loan originator test developed by NMLS;
7. Establish either a bonding or net worth requirement for companies employing mortgage loan originators or a recovery fund paid into by mortgage loan originators or their employing company in order to protect consumers;
8. Require companies licensed or registered through NMLS to submit a Mortgage Call Report on at least an annual basis;
9. Adopt specific confidentiality and information sharing provisions; and
10. Establish effective authority to investigate, examine, and conduct enforcement of licensees.

Taken together, these background checks, testing, and education requirements will promote a higher level of professionalism and encourage best practices and responsible behavior among all mortgage loan originators. Under the legislative guidance provided by Congress, the states drafted the Model State Law for uniform implementation of the S.A.F.E. Act. The Model State Law not only achieves the minimum licensing requirements under the federal law, but also accomplishes Congress' ten objectives addressing uniformity and consumer protection.

The Model State Law, as implementing legislation at the state level, assures Congress that a framework of localized regulatory controls are in place at least as stringent as those pre-dating the S.A.F.E. Act, while setting new uniform standards aimed at responsible behavior, compliance verification and protecting consumers. The Model State Law enhances the S.A.F.E. Act by providing significant examination and enforcement authorities and establishing prohibitions on specific types of harmful behavior and practices.

The Model State Law has been formally approved by the Secretary of the U.S. Department of Housing and Urban Development and endorsed by the National Conference of State Legislatures and the National Conference of Insurance Legislators. The Model State Law is well on its way to approval in almost all state legislatures, despite some unfortunate efforts by industry associations to frustrate, weaken or delay the passage of this important Congressional mandate.

Nationwide Cooperative Protocol and Agreement for Mortgage Supervision

In December 2007, CSBS and AARMR launched the Nationwide Cooperative Protocol and Agreement for Mortgage Supervision to assist state mortgage regulators by outlining a basic framework for the coordination and supervision of Multi-State Mortgage Entities (those institutions conducing business in two or more states). The goals of this initiative are to protect consumers; ensure the safety and soundness of institutions; identify and prevent mortgage fraud; supervise in a seamless, flexible, and risk-focused manner; minimize regulatory burden and expense; and foster consistency, coordination, and communication among state regulators. Currently, 48 states plus the District of Columbia and Puerto Rico have signed the Protocol and Agreement.

The states have established risk profiling procedures to determine which institutions are in the greatest need of a multi-state presence and we are scheduled to begin the first multi-state examinations next month. Perhaps the most exciting feature of this initiative is the planned use of robust software programs to screen the institutions portfolios for risk, compliance, and consumer protection issues. With this software, the examination team will be able to review 100 percent of the institution's loan portfolio, thereby replacing the "random sample" approach that left questions about just what may have been missed during traditional examinations.

CSBS–AARMR Reverse Mortgage Initiatives

In early 2007, the states identified reverse mortgage lending as one of the emerging threats facing consumers, financial institutions, and supervisory oversight. In response, the states, through CSBS and AARMR, formed the Reverse Mortgage Regulatory Council and began work on several initiatives:

- *Reverse Mortgage Examination Guidelines (RMEGs).* In December 2008, CSBS and AARMR released the RMEGs to establish uniform standards for regulators in the examination of institutions originating and funding reverse mortgage loans. The states also encourage industry participants to adopt these standards as part of an institution's ongoing internal review process.
- *Education materials.* The Reverse Mortgage Regulatory Council is also developing outreach and education materials to assist consumers in understanding these complex products before the loan is made.

CSBS–AARMR Guidance on Nontraditional Mortgage Product Risks

In October 2006, the federal financial agencies issued the Interagency Guidance on Nontraditional Mortgage Product Risks which applies to insured depository institutions. Recognizing that the interagency guidance does not apply to those mortgage providers not affiliated with a bank holding company or an insured financial institution, CSBS and AARMR developed parallel guidance in November 2006 to apply to state-supervised residential mortgage brokers and lenders, thereby ensuring all residential mortgage originators were subject to the guidance.

CSBS–AARMR–NACCA Statement on Subprime Mortgage Lending

The federal financial agencies also issued the Interagency Statement on Subprime Mortgage Lending. Like the Interagency Guidance on Nontraditional Mortgage Product Risks, the Subprime Statement applies only to mortgage providers associ-

ated with an insured depository institution. Therefore, CSBS, AARMR, and the National Association of Consumer Credit Administrators (NACCA) again developed a parallel statement that is applicable to all mortgage providers. The Nontraditional Mortgage Guidance and the Subprime Statement strike a fair balance between encouraging growth and free market innovation and draconian restrictions that will protect consumers and foster fair transactions.

AARMR–CSBS Model Examination Guidelines

Further, to promote consistency, CSBS and AARMR developed state Model Examination Guidelines (MEGs) for field implementation of the Guidance on Nontraditional Mortgage Product Risks and the Statement on Subprime Mortgage Lending.

Released on July 31, 2007, the MEGs enhance consumer protection by providing state regulators with a uniform set of examination tools for conducting examinations of subprime lenders and mortgage brokers. Also, the MEGs were designed to provide consistent and uniform guidelines for use by lender and broker compliance and audit departments to enable market participants to conduct their own review of their subprime lending practices. These enhanced regulatory guidelines represent a new and evolving approach to mortgage supervision.

Mortgage Examinations With Federal Regulatory Agencies

Late in 2007, CSBS, the Federal Reserve System (Fed), the Federal Trade Commission (FTC), and the Office of Thrift Supervision (OTS) engaged in a pilot program to examine the mortgage industry. Under this program, state examiners worked with examiners from the Fed and OTS to examine mortgage businesses over which both state and federal agencies had regulatory jurisdiction. The FTC also participated in its capacity as a law enforcement agency. In addition, the states separately examined a mortgage business over which only the states had jurisdiction. This pilot is truly the model for coordinated state–federal supervision.

PREPARED STATEMENT OF GEORGE REYNOLDS

CHAIRMAN,
NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS, AND
SENIOR DEPUTY COMMISSIONER,
GEORGIA DEPARTMENT OF BANKING AND FINANCE

MARCH 19, 2009

NASCUS History and Purpose

Good morning, Chairman Dodd, and distinguished Members of the Senate Committee on Banking, Housing, and Urban Affairs. I am George Reynolds, Senior Deputy Commissioner of Georgia Department of Banking and Finance and chairman of the National Association of State Credit Union Supervisors (NASCUS).[1] I appear today on behalf of NASCUS, the professional association of state credit union regulators.

The mission of NASCUS is to enhance state credit union supervision and advocate for a safe and sound state credit union system. We achieve our mission by serving as an advocate for the dual chartering system, a system that recognizes the traditional and essential role of state governments in the national system of depository financial institutions.

Thank you for holding this important hearing today to explore modernizing financial institution supervision and regulation. The regulatory structure in this country has been a topic of discussion for many years. The debate began when our country's founders held healthy dialogue about how to protect the power of the states. More recently, commissions have been created to study the issue and several administrations have devoted further time to examine the financial regulatory system. Most would agree that if the regulatory system were created by design, the current system may not have been deliberately engineered; however, one cannot overlook the benefits offered by the current system. It has provided innovation, competition and diversity to our nation's financial institutions and consumers.

In light of our country's economic distress, many suggest that regulatory reform efforts should focus, in part, on improving the structure of the regulatory framework. However, I suggest that it is not the structure of our regulatory system that

[1] NASCUS is the professional association of the 47 state credit union regulatory agencies that charter and supervise the nation's 3,300 state-chartered credit unions.

has failed our country, but rather the functionality and accountability within the regulatory system.

A financial regulatory system, regardless of its structure, must delineate clear lines of responsibility and provide the necessary authority to take action. Accountability and transparency must also be inherent in our financial system. This system must meet these requirements while remaining sufficiently competitive and responsive to the evolving financial service needs of American consumers and our economy. Credit union members and the American taxpayer are demanding each of these qualities be present in the nation's business operations and they must be present in a modernized financial regulatory system.

These regulatory principles must exist in a revised regulatory system. This is accomplished by an active system of federalism, a system in which the power to govern is shared between national and state governments allowing for clear communication and coordination between state and federal regulators. Further, this system provides checks and balances and the necessary accountability for a strong regulatory system. I detail more about this system in my comments.

NASCUS Priorities for Regulatory Restructuring

NASCUS' priorities for regulatory restructuring focus on reforms that strengthen the state system of credit union supervision and enhance the capabilities of state-chartered credit unions. The ultimate goal is to meet the financial needs of consumer members while assuring that the state system is operating in a safe and sound manner. This provides consumer confidence and contributes to a sound national and global financial system.

In this testimony, I discuss the following philosophies that we believe Congress must address in developing a revised financial regulatory system. These philosophies are vital to the future growth and safety and soundness of state-chartered credit unions.

- Preserve Charter Choice and Dual Chartering
- Preserve States' Role in Financial Regulation
- Modernize the Capital System for Credit Unions
- Maintain Strong Consumer Protections, which often Originate at the State Level

My comments today will focus solely on the credit union regulatory system; I will highlight successful aspects and areas Congress should carefully consider for refinement.

Preserving Charter Choice and Dual Chartering

The goal of prudential regulation is to ensure safety and soundness of depositors' funds, creating both consumer confidence and stability within the financial regulatory system.

Today's regulatory system is structured so that states and the federal government act independently to charter and supervise financial institutions. The dual chartering system for financial institutions has successfully functioned for more than 140 years, since the National Bank Act was passed in 1863, allowing the option of chartering banks nationally. It is important that Congress continue to recognize the distinct roles played by state and federal regulatory agencies.

Dual chartering remains viable in the financial marketplace because of the distinct benefits provided by charter choice and due to the interaction between state and federal regulatory agencies. This structure works effectively and creates the confidence and stability needed for the national credit union system.

Importance of Dual Chartering

The first credit union in the United States was chartered in New Hampshire in 1909. State chartering remained the sole means for establishing credit unions for the next 25 years, until Congress passed the Federal Credit Union Act (FCUA) in 1934.

Dual chartering allows an institution to select its primary regulator. For credit unions, it is either the state agency that regulates state-chartered credit unions in a particular state or the National Credit Union Administration (NCUA) that regulates federal credit unions. Forty-seven states have laws that permit state-chartered credit unions, as does the U.S. territory of Puerto Rico.

Any modernized regulatory restructuring must recognize charter choice. The fact that laws differ for governing state and federal credit unions is positive for credit unions and consumers. A key feature of the dual chartering system is that individual institutions can select the charter that will benefit their members or consumers the most. Credit union boards of directors and CEOs have the ability to ex-

amine the advantages of each charter and determine which charter matches the goals of the institution and its members.

Congress intended state and federal credit union regulators to work closely together, as delineated in the FCUA. Section 201 of the FCUA states, " . . . examinations conducted by State regulatory agencies shall be utilized by the Board for such purposes to the maximum extent feasible."[2] NCUA accepts examinations conducted by state regulatory agencies, demonstrating the symbiotic relationship between state and federal regulators.

Congress must continue to recognize and to affirm the distinct roles played by state and federal regulatory agencies. The U.S. regulatory structure must enable state credit union regulators to retain regulatory authority over state-chartered credit unions. This system is tried and it has worked for the state credit union system for 100 years. It has been successful because dual chartering for credit unions provides a system of "consultation and cooperation" between state and federal regulators.[3] This system creates the appropriate balance of power between state and federal credit union regulators.

A recent example of state and federal credit union examiners working together and sharing information is the bimonthly teleconferences held since October of 2008 to discuss liquidity in the credit union system. Further, state regulators and the NCUA meet in-person several times a year to discuss national policy issues. The intent of Congress was that these regulators share information and work together and in practice, we do work together.

Another exclusive aspect of the credit union system is that both state and federal credit unions have access to the National Credit Union Share Insurance Fund (NCUSIF). Federally insured credit unions capitalize this fund by depositing one percent of their shares into the fund. This concept is unique to credit unions and it minimizes taxpayer exposure. Any modernized regulatory system should recognize the NCUSIF. The deposit insurance system has been funded by the credit union industry and has worked well for credit unions. We believe that credit unions should have access to this separate and distinct deposit insurance fund. A separate federal regulator for credit unions has also worked well and effectively since the FCUA was passed in 1934. NASCUS and others are concerned about any proposal to consolidate regulators and state and federal credit union charters.

Charter choice also creates healthy competition and provides an incentive for regulators (both state and federal) to maximize efficiency in their examinations and reduce costs. It allows regulators to take innovative approaches to regulation while maintaining high standards for safety and soundness.

The dual chartering system is threatened by the preemption of state laws and the push for a more uniform regulatory system. As new challenges arise, it is critical that the benefits of each charter are recognized. As Congress discusses regulatory modernization, it is important that new policies do not squelch the innovation and enhanced regulatory structure provided by the dual chartering system. As I stated previously, dual chartering benefits consumers, provides enhanced regulation and allows for innovation in our nation's credit unions.

Ideally, the best of each charter should be recognized and enhanced to allow competition in the marketplace. NASCUS believes dual chartering is an essential component to the balance of power and authority in the regulatory structure. The strength and health of the credit union system, both state and federal, rely on the preservation of the principles of the dual chartering system.

Strengths of the State System

State-chartered credit unions make many contributions to the economic vitality of consumers in individual states. Our current regulatory system benefits citizens and provides consumer confidence.

To begin, one of the strengths of the state system is that states operate as the "laboratories" of financial innovation. Many consumer protection programs were designed by state legislators and state regulators to recognize choice and innovation. The successes of state programs have been recognized at the federal level, when like programs are introduced to benefit consumers at the federal level. It is crucial that state legislatures maintain the primary authority to enact consumer protection statutes for residents in their states and to promulgate and enforce state consumer protection regulations, without the threat of federal preemption.

We caution Congress about putting too much power in the hands of the federal regulatory structure. Dual chartering allows power to be distributed throughout the

[2] 12 U.S. Code §1781(b)(1).

[3] The Consultation and Cooperation With State Credit Union Supervisors provision contained in The Federal Credit Union Act, 12 U.S. Code §1757a(e) and 12 U.S. Code §1790d(l).

system and it provides a system of checks and balances between state and federal authorities. A system where the primary regulatory authority is given to the federal government may not provide what is in the best interest of consumers.

Preserve States' Role in Financial Regulation

The dual chartering system is predicated on the rights of states to authorize varying powers for their credit unions. NASCUS supports state authority to empower credit unions to engage in activities under state-specific rules, deemed beneficial in a particular state. States should continue to have the authority to create and to maintain appropriate credit union powers in any new regulatory reform structure debated by Congress.

However, we are cognizant that our state systems are continuously challenged by modernization, globalization and new technologies. We believe that any regulatory structure considered by Congress should not limit state regulatory authority and innovation. Preemption of state laws and the push for more uniform regulatory systems will negatively impact our nation's financial services industry, and ultimately consumers.

Congress should ensure that states have the authority to supervise state credit unions and that supervision is tailored to the size, scope and complexity of the credit union and the risk they may pose to their members. Further, Congress should reaffirm state legislatures' role as the primary authority to enact consumer protection statutes in their states.

Added consumer protections at the state level can better serve and better protect the consumer and provide greater influence on public policy than they can at the federal level. This has proved true with data security and mortgage lending laws, to name a few. It is crucial that states maintain authority to pursue enforcement actions for state-chartered credit unions. Congress' regulatory restructuring efforts should expand the states' high standards of consumer protection.

Recently, Chairman Barney Frank (D, Mass.) of the House Financial Services Committee, said, "States do a better job," when referring to consumer protection. NASCUS firmly believes this, too.

Comprehensive Capital Reform for Credit Unions

The third principle I want to highlight is modernizing the capital system for credit unions. Congress should recognize capital reform as part of regulatory modernization. Capital sustains the viability of financial institutions. It is necessary for their survival.

NASCUS has long supported comprehensive capital reform for credit unions. Credit unions need access to supplemental credit union capital and risk-based capital requirements; these related but distinctly different concepts are not mutually exclusive. The current economic environment necessitates that now is the time for capital reform for credit unions.

Access to Supplemental Capital

State credit union regulators are committed to protecting credit union safety and soundness. Allowing credit unions access to supplemental capital would protect the safety and soundness of the credit union system and provide a tool to use if a credit union faces declining net worth or liquidity needs.

A simple fix to the FCUA would authorize state and federal regulators the discretion, when appropriate, to allow credit unions to use supplemental capital.

NASCUS follows several guiding principles in our quest for supplemental capital for credit unions. First, a capital instrument must preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions. Next, it must preserve credit unions' tax-exempt status.[4] Finally, regulatory approval would be required before a credit union could access supplemental capital. We realize that supplemental capital will not be allowed for every credit union, nor would every credit union need access to supplemental capital.

Access to supplemental capital will enhance the safety and soundness of credit unions and provide further stability in this unpredictable market. Further, supplemental capital will provide an additional layer of protection to the NCUSIF thereby maintaining credit unions' independence from the federal government and taxpayers.

Allowing credit unions access to supplemental capital with regulatory approval and oversight will enhance their ability to react to market conditions, grow safely

[4] State-chartered credit unions are exempt from federal income taxes under Section 501(c)(14) of the Internal Revenue Code, which requires that (a) credit union cannot access capital stock; (b) they are organized/operated for mutual purposes; and without profit. The NASCUS white paper, "Alternative Capital for Credit Unions . . . Why Not?" addresses Section 501(c)(14).

into the future, serve their nearly 87 million members and provide further stability for the credit union system. We feel strongly that now is the time to permit this important change. Unlike other financial institutions, credit union access to capital is limited to reserves and retained earnings from net income. Since net income is not easily increased in a fast-changing environment, state regulators recommend additional capital-raising capabilities for credit unions. Access to supplemental capital will enable credit unions to respond proactively to changing market conditions, enhancing their future viability and strengthening their safety and soundness.

Supplemental capital is not new to the credit union system; several models are already in use. Low-income credit unions are authorized to raise uninsured secondary capital. Corporate credit unions have access, too; they have both membership capital shares and permanent capital accounts, known as paid-in capital. These models work and could be adjusted for natural-person credit unions.

Risk-Based Capital for Credit Unions

Today, every insured depository institution, with the exception of credit unions, uses risk-based capital requirements to build and to monitor capital levels. Risk-based capital requirements enable financial institutions to better measure capital adequacy and to avoid excessive risk on their balance sheets. A risk-based capital system acknowledges the diversity and complexity between financial institutions. It requires increased capital levels for financial institutions that choose to maintain a more complex balance sheet, while reducing the burden of capital requirements for institutions holding assets with lower levels or risk. This system recognizes that a one-size-fits-all capital system does not work.

The financial community continues to refine risk-based capital measures as a logical and an important part of evaluating and quantifying capital adequacy. Credit unions are the only insured depository institutions not allowed to use risk-based capital measures as presented in the Basel Accord of 1988 in determining required levels or regulatory capital. A risk-based capital regime would require credit unions to more effectively monitor risks in their balance sheets. It makes sense that credit unions should have access to risk-based capital; it is a practical and necessary step in addressing capital reform for credit unions.

Systemic Risk Regulation

The Committee asked for comment regarding the need for systemic risk regulation. Certainly, the evolution of the financial services industry and the expansion of risk outside of the more regulated depository financial institutions into the secondary market, investment banks and hedge funds reflect that further consideration needs to be given to having expanded systemic risk supervision. Many suggest that the Federal Reserve System due to its structural role in the financial services industry might be well suited to be assigned an expanded role in this area.

The Role of Proper Risk Management

During this period of economic disruption, Congress should consider regulatory restructuring and also areas where risk management procedures might need to be strengthened or revised to enhance systemic, concentration and credit risk in the financial services industry.

Congress needs to address the reliance on credit rating agencies and credit enhancement features in the securitization of mortgage-backed securities in the secondary market.

These features were used to enhance the marketability of securities backed by subprime mortgages. Reliance on more comprehensive structural analysis of such securities and expanded stress testing would have provided more accurate and transparent information to market analysts and investors.

Further, there is a debate occurring about the impact of "mark-to-market" accounting on the financial services industry as the secondary market for certain investment products has been adversely impacted by market forces. While this area deserves further consideration, we urge Congress to approach this issue carefully in order to maintain appropriate transparency and loss recognition in the financial services industry.

Finally, consideration needs to be given to compensation practices that occurred in the financial services industry, particularly in the secondary market for mortgage-backed securities. Georgia requires depository financial institutions that are in Denovo status or subject to supervisory actions that use bonus features in their management compensation structure not to simply pay bonuses based on production or sales, but also to include an asset quality component. Such a feature will "claw back" bonuses if production or sales result in excessive volumes of problematic or nonperforming assets. If such a feature were used in the compensation structure for the marketing of asset-backed securities, perhaps this would have been a deterrent

to the excessive risk taking that occurred in this industry and resulted in greater market discipline.

Conclusion

Modernizing our financial regulatory system is a continuous process, one that will need to be fine-tuned over time. It will take careful study and foresight to ensure a safe and sound regulatory structure that allows enhanced products and services while ensuring consumer protections. NASCUS recognizes this is not an easy process.

To protect state-chartered credit unions in a modernized regulatory system, we encourage Congress to consider the following points:

- Enhancing consumer choice provides a stronger financial regulatory system; therefore charter choice and dual chartering must be preserved.
- Preserve states' role in financial regulation.
- Modernize the capital system for credit unions to protect safety and soundness.
- Maintain strong consumer protections, which often originate at the state level.

It is important that Congress take the needed time to scrutinize proposed financial regulatory systems.

NASCUS appreciates the opportunity to testify today and share our priorities for a modernized credit union regulatory framework. We urge this Committee to be watchful of federal preemption and to remember the importance of dual chartering and charter choice in regulatory modernization. We welcome questions from Committee Members.

Thank you.

Alternative Capital for U.S. Credit Unions? A Review and Extension of Evidence Regarding Public Policy Reform

Robert F. Hoel, PhD
Professor Emeritus of Business,
Colorado State University,
and Filene Fellow in Residence,
Filene Research Institute

Filene Research Institute

Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process.

The Filene Research Institute is a 501(c)(3) not-for-profit research organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance. Through independent research and innovation programs the Institute examines issues vital to the future of credit unions.

Progress is the constant replacing of the best there is with something still better!

— Edward A. Filene

Ideas grow through thoughtful and scientific analysis of top-priority consumer, public policy, and credit union competitive issues. Researchers are given considerable latitude in their exploration and studies of these high-priority issues.

The Institute is governed by an Administrative Board made up of the credit union industry's top leaders. Research topics and priorities are set by the Research Council, a select group of credit union CEOs, and the Filene Research Fellows, a blue ribbon panel of academic experts. Innovation programs are developed in part by Filene i^3, an assembly of credit union executives screened for entrepreneurial competencies.

The name of the Institute honors Edward A. Filene, the "father of the U.S. credit union movement." Filene was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

Since its founding in 1989, the Institute has worked with over one hundred academic institutions and published hundreds of research studies. The entire research library is available online at www.filene.org.

Acknowledgments

This research was inspired by the National Association of State Credit Union Supervisors, which urged the Filene Research Institute to synthesize existing research about alternative capital and to fill in informational and analytical gaps. This project was funded in part by a generous grant from the Corporate Credit Union Network.

The author thanks the many researchers who have examined alternative capital issues in recent years and whose findings are cited in this report. Also, appreciation is extended to the dozens of experts in the credit union movement and the banking industry who generously shared their knowledge about alternative capital needs and mechanisms. Their organizations include Abbott Laboratories Employees Credit Union, American Airlines Federal Credit Union, American Share Insurance, Association of Corporate Credit Unions, California Credit Union League, Credit Union National Association, CUNA Mutual Group, National Association of Community Development Credit Unions, National Association of State Credit Union Supervisors, National Association of Federal Credit Unions, State Employees' Credit Union of North Carolina, and the World Council of Credit Unions.

My special thanks go to William E. Jackson III, professor of management and Smith Foundation Chair of Business Integrity at the University of Alabama, and to George Hofheimer, chief research officer at the Filene Research Institute, for their many insights during this research effort. Also, I wish to thank Josey Siegenthaler of the Filene Research Institute and Alissa Bazsali for their invaluable assistance in preparing this report.

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Executive Summary and Commentary

By George A. Hofheimer,
Chief Research Officer

Autumn is a lovely time of year where I live. The leaves are changing, mornings and evenings are brisk, all those darn mosquitoes are going into hibernation, and animals are preparing for winter. One of my most enjoyable things to observe during this time of year is the wily squirrel—in particular, squirrels that make their homes near oak trees. These squirrels fill their mouths with acorns to the point of overflow and then hide the tasty morsels for the lean months. The squirrels work hard going back and forth between their only food source and their secret lair so that they have enough food to last the season. I always think to myself, how many acorns do these tiny creatures really need? The answer came to me when Bob Hoel, the author of this study, handed me this report.

For some time I could not quite determine why credit unions needed alternative sources of capital. Academics, consultants, credit union executives, and economists will likely tell you credit unions are "overcapitalized."[1] So if credit unions have more than enough capital, why do they need to find alternative sources of capital? Then my mind zipped back to those kinetic squirrels. The reason those squirrels are collecting so many acorns is similar to why credit unions are collecting so much capital: Each group has only one source of sustenance. For squirrels it is the oak tree, and for credit unions it is retained earnings. Psychologists refer to this type of behavior as hoarding, and while it is not a common human behavior, hoarding is a common response to fear, whether fear of danger or the simple fear of *a shortage of some good*. Therefore, with alternative sources of capital, credit unions may be paradoxically more efficient with their precious capital.

With this added clarity it is now essential to turn our attention away from squirrels so that we may explore the three fundamental research questions of this report:

- Is it in the public interest to permit U.S credit unions greater access to alternative capital sources?
- Can credit unions use alternative capital to expand their capital bases in a way that will not dilute their cooperative ownership, values, and governance structure?
- If so, what alternative capital mechanisms would be most appropriate and feasible?

1 In late 2007, the Filene Research Institute released a study entitled *Is the U.S. Credit Union Industry Overcapitalized? An Empirical Examination*, by William E. Jackson III.

What Did the Researcher Discover?

Hoel reviews existing literature in the fields of credit unions, capital formation, and public policy and provides the following eight key research conclusions:

- It is in the public interest to permit credit unions greater access to alternative capital sources.
- Federal and state laws and regulations should be amended to permit credit unions to obtain alternative capital.
- Credit unions can expand their capital bases by using alternative capital in ways that will not dilute their cooperative ownership, values, and governance structure.
- Several different mechanisms for raising alternative capital are appropriate and feasible. Some of the most promising involve obtaining alternative capital from outside investors, and others involve acquiring special long-term deposits from credit union members.
- A broad menu of alternative capital options would best serve credit unions, their members, and the general public. There is no single method that is best for all credit unions seeking alternative capital.
- It would be appropriate for credit union regulators to review and approve a credit union's alternative capital plan and mechanisms prior to its issuance of alternative capital instruments.
- Though many credit unions may not wish to seek alternative capital now, having the power to do so would benefit them by allowing them to conduct their business with the confidence that, if necessary, they could build capital in a variety of ways beyond the slow retained-earnings approach.
- Steps should be taken promptly to repeal or reform statutes and regulations that prohibit credit unions from obtaining alternative capital. No compelling reasons to delay were uncovered during the course of this research.

Practical Implications

One of the most extraordinary issues related to this topic is the dearth of capital formation tools at the disposal of most U.S. credit unions. Cooperatives and credit unions around the world have figured out how to access alternative forms of capital without diluting the core ownership structure of their organization. Additionally, investor-owned financial services firms have seemingly unlimited options and access to capital. This puts U.S. credit unions at a potential disadvantage because they operate in an environment where financial services consumers are demanding more delivery channels, higher levels of service, and more product choices.

Since most credit unions reading this report do not have access to alternative sources of capital, one of the most practical things you can do with this document is educate yourself and policymakers about the how, why, when, and what of alternative capital issues. This report certainly covers these issues in great detail.

Finally, as I write this executive summary, autumn is setting in, and the squirrels, like most credit unions, are starting their planning season. This study, therefore, may be a nice springboard to discuss issues related to credit union capital at your institution. Every so often a report is released that presents a comprehensive look at an issue that is critical to the future of your institution. I therefore urge you to share (not hoard) this report with your credit union colleagues.

About the Author

Robert F. Hoel, PhD

Robert F. Hoel, PhD, is the Filene Fellow in Residence at the Filene Research Institute. He frequently speaks about credit union challenges and opportunities at meetings for credit union leaders, regulators, and auditors, among others. He has spoken at conferences and conventions in all 50 states as well as in Canada, Europe, Africa, Asia, Australia, and South America.

Prior to joining Filene, Dr. Hoel was a professor of business and the chairman of the department of marketing at Colorado State University. He received Colorado State University's Outstanding Business Professor Award on three separate occasions.

His primary research interests are in the areas of financial institutions, marketing strategy, and consumer analysis. His research has been reported extensively in academic and industry journals, and he has served as a consultant to a wide range of private-sector and government organizations. He received his PhD from the University of Minnesota, an MBA from Indiana University, and a BA from Hamline University. Currently, he is a member of the national examining committee for the Certified Credit Union Executive program, the capitalization program committee of the National Federation of Community Development Credit Unions, and the credit policies committee at Great Wisconsin Credit Union.

CHAPTER 1
A Capital Formation Anomaly

Limitations on U.S. credit union capital formation powers raise questions about why these financial institutions are so restricted, and whether credit union members and the general public would be better served if U.S. credit unions had access to more capital formation options.

Financial institutions need adequate capital to serve their patrons and continue operating in a safe and sound manner. Because capital needs increase as financial institutions grow and enhance their product and service offerings, new avenues for capital formation have opened for them during the past 50 years. Enlightened government policies on capital alternatives have emerged worldwide. New capital instruments have been developed and deployed.

Legislation and regulations regarding capital for U.S. credit unions, however, have not been updated to allow these credit unions access to modern capital options. Their capital structures remind analysts of balance sheets of the 1950s. Laws and regulations require most of these member-owned, not-for-profit cooperatives to grow capital almost exclusively via retained earnings.

Banks and thrifts in the United States and abroad enjoy much broader authority than U.S. credit unions to pursue alternative sources of capital. Similarly, non-U.S. credit unions and domestic and foreign financial cooperatives have many capital-raising options. Production, consumer, and other types of cooperatives throughout the developed world can access capital markets in a wide variety of ways.

The unusual limitations on U.S. credit union capital formation powers raise questions about why these financial institutions are so restricted, and whether credit union members and the general public would be better served if U.S. credit unions had access to more capital formation options.

Capital: What Is It?

The term "capital" is frequently misunderstood. Capital is not something that is locked in a large blue fireproof box and placed in a black vault. It is not a physical entity. Rather, it is an economic and financial construct. In its simplest form, capital is a firm's assets that remain after subtracting its liabilities. In the event of financial difficulties, the claims of owners of capital are subordinated to other claims.

Paletta illustrates a classic function of capital in a financial institution:

> *A bank's capital, essentially calculated by subtracting liabilities from assets, is its last line of defense against collapse. A bank might have $100 million in loans, financed by $90 million in deposits, which are liabilities. In this case, capital would equal 10% of assets, sufficient to absorb losses up to $10 million without endangering the bank's ability to repay deposits.* (Paletta 2006, C3)

Of course, today's financial institutions are more complex. Liabilities include more than deposits. External deposit insurers typically have claims in the case of collapse. Also, by contract, the claims associated with some liabilities and equity-like instruments may be deeply subordinated to other claims. Deeply subordinated claims are called "alternative capital" and protect the claims of depositors and others, much like owner equity does.

Again, it is important to remember that capital in most cases is not physically segregated from other funds. If a financial institution receives infusions of capital, those new funds are commingled with other funds and used to make loans, acquire assets, and conduct the affairs of the institution.

Capital: An Evolving Concept

History shows that capital in financial institutions plays a critical role in stabilizing a nation's economy and protecting taxpayers, who may be required to bail out failing financial institutions. The problems of U.S. banks and thrifts during the 1980s and early 1990s are recent examples. A present-day example is the subprime mortgage difficulties encountered by financial intermediaries. Because an increasingly global economy is destined to adversely affect many employers and local economies, the adequate capitalization of financial institutions has rarely been more important.

It is important to remember that capital in most cases is not physically segregated from other funds.

Not surprisingly, definitions of capital have evolved as economies and financial markets have matured and evolved themselves. Historically, capital was narrowly defined as owner equity, which is subordinated to the claims of almost all creditors and government authorities. Now, however, capital typically includes long-term debt and other financial instruments and funds that are subordinated to almost all claims other than those of equity owners. Terms like "alternative capital," "Tier 2 capital," "supplementary capital," and "secondary capital" all refer to these other capital sources. For U.S. credit unions, secondary capital and alternative capital are broadly

defined as "capital generated from sources other than retained earnings" (Kwon and Lee 2006, 7–8).

Because banks, cooperatives, and credit unions outside the United States can expand their capital bases through a wide variety of means, it is not surprising that they often express amazement at the comparatively primitive capital structures of U.S. credit unions. Many financial institutions that compete with U.S. credit unions are no doubt pleased by the capital acquisition restrictions placed on credit unions. Less credit union capital means less competition.

Capital: A Filene Research Priority

Capital formation and credit union safety and soundness issues have long been research priorities at the Filene Research Institute. Scholars at leading universities and other experts have contributed original research to six Filene publications on capital. Other Filene reports have dealt with a wide variety of related safety and soundness concerns.

The subsequent chapters of this report reference these studies and summarize many of their key findings. Readers are encouraged to review these reports for full details on methodology and findings.

Research Purpose, Questions, and General Methodology

This report examines alternative capital options for U.S. credit unions and proposes methods for expanding their capital acquisition alternatives. It synthesizes findings from previous Filene Research Institute reports and other sources and fills informational and analytic gaps. It seeks credit union capital alternatives that serve the public interest and the best interests of credit union members.

More specifically, this report explores three questions regarding the issue of alternative capital in U.S. credit unions:

- Is it in the public interest to permit U.S. credit unions greater access to alternative capital sources?
- Can credit unions use alternative capital to expand their capital bases in a way that will not dilute their cooperative ownership, values, and governance structure?
- If so, what alternative capital mechanisms would be most appropriate and feasible?

CHAPTER 2
The Vital Role of Credit Union Capital

Capital serves as a cushion for credit unions. Because of standards set by the Credit Union Membership Access Act and the National Credit Union Administration, credit unions are now required to have more capital than banks do to qualify as "well-capitalized."

Capital serves as a cushion for credit unions and other financial institutions, allowing them to absorb operating, credit, and other losses. It also protects deposit insurance funds, which assure depositors that all or portions of their savings will not be lost if the institution experiences major financial difficulties. Deposit insurance funds reimburse depositors only after the financial institution's capital has been depleted.

Deposit Insurance

In the case of most credit unions, the National Credit Union Share Insurance Fund (NCUSIF) insures total deposits (shares) of up to $100,000 for each member of a federally chartered credit union. In addition, retirement accounts (individual retirement accounts and Keogh accounts) are separately insured up to $250,000 per member.

Though most state-chartered credit unions are similarly insured by the NCUSIF, some states permit state-chartered credit unions to carry private deposit insurance in lieu of NCUSIF coverage. Sometimes NCUSIF- and privately insured credit unions purchase additional nonfederal insurance to cover deposits exceeding standard deposit insurance limits.

Credit union members, deposit insurers, and regulators share a strong interest in building and maintaining adequate levels of institutional capital: Members want their credit union to survive so they can continue to receive credit union benefits, and regulators and insurers want to insulate insurance funds from major losses.

Clearly, it is in the national interest for banks and credit unions to be adequately capitalized. Too many failures of financial institutions would destabilize the U.S. financial system. Furthermore, the federal government promises to support seriously depleted federal deposit insurance funds with the full faith and credit of the United States.

Evolution of Credit Union Capital Levels[2]

Until the 1970s, most credit unions operated with minimal capital. The belief was that, as member-owned cooperatives, credit unions should limit capital accumulation and instead emphasize the provision of attractive prices and quality services to members. Excess retained earnings were considered by many as contrary to the credit union's purpose, democratic nature, and philosophy of member control, the idea being that credit unions should return as much capital to members as possible.

In the early 1980s, the credit union movement established the National Credit Union Capitalization Commission to study capital issues facing credit unions and corporate credit unions. One key output was a philosophical document declaring that raising capital levels at natural-person credit unions[3] is a legitimate undertaking that can enhance long-term benefits for members. The document helped establish the movement's view that it is not anti-cooperative to build net worth in credit unions.

In the mid-1980s, the National Credit Union Administration (NCUA) reinforced perceptions of a need to grow capital when it introduced the CAMEL approach in its regulatory processes. (CAMEL was already being used by some state credit union regulators.) The basic idea is to evaluate credit unions in five general areas, the first letters of which spell "CAMEL." The letter "C" stands for "capital." The NCUA set targets in the CAMEL matrix that exceeded capital levels possessed by credit unions at the time.

The belief was that, as member-owned cooperatives, credit unions should limit capital accumulation and instead emphasize the provision of attractive prices and quality services to members.

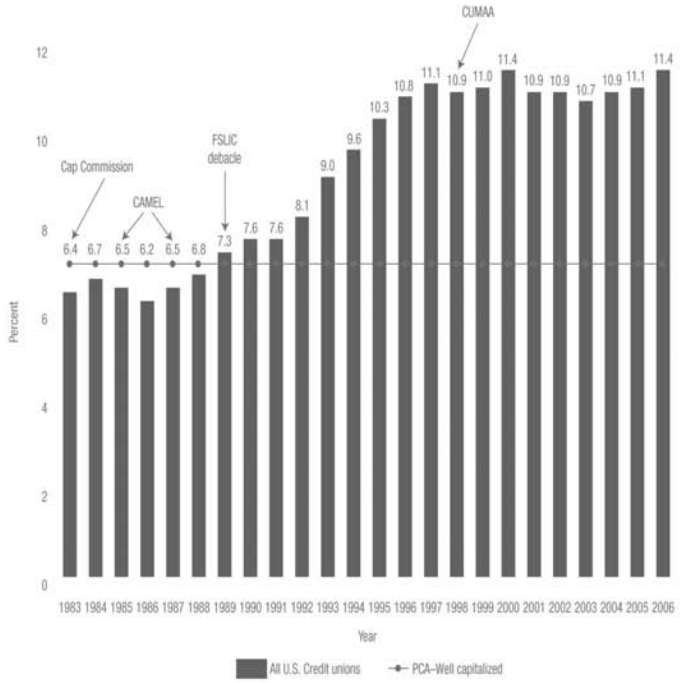
The Federal Savings and Loan Insurance Corporation (FSLIC) crisis in the late 1980s, coupled with the troubles at the Federal Deposit Insurance Corporation (FDIC), sent warning signals to federal and state regulators about capital adequacy at all financial institutions. Though credit unions experienced less financial difficulty than the bank and thrift industries, regulators became more zealous in their examination and supervision of credit unions, and they increased their pressure on credit unions to build capital (Wilcox 2005b, 2007).

2 This section draws heavily from Bill Hampel, "The Prospect of Alternative Capital," in *Managing Credit Union Capital: Subordinated Debt, Uninsured Deposits, and Other Secondary Sources* (Madison, WI: Filene Research Institute, 2004), 21–34.

3 A natural-person credit union serves individuals and families directly, while a corporate credit union serves other credit unions and credit union organizations.

Figure 1 shows credit union net worth ratios from 1983 to 2006. When the National Credit Union Capitalization Commission completed its work in 1983, the net worth ratio in credit unions was 6.4%, compared to previously typical ratios equal to or below 6%. The introduction of CAMEL helped keep capital levels above 6% for the remainder of the decade, even though credit unions were growing rapidly. Capital soared after the FSLIC debacle for a variety of reasons, including greater regulatory vigilance. Interestingly, the run-up in net worth ratios preceded the passage in 1998 of the Credit Union Membership Access Act (CUMAA), which explicitly defines capital adequacy levels. Since 1989, net worth ratios have exceeded the act's 7% requirement for a well-capitalized credit union, and since 1995 they have exceeded 10%.

Figure 1: Credit Union Net Capital to Assets—1983–2006



Source: CUNA Economics and Statistics.

CUMAA[4]

CUMAA imposed explicit net worth requirements on federally insured credit unions. Also, prompt corrective action (PCA) rules for credit unions failing to meet minimum standards were mandated. The act defines net worth, and it does so very narrowly. It forbids the use of alternative capital with few exceptions.

Unlike banks, credit unions now face *statutorily* defined capital levels. Bank regulators can adjust bank capital level requirements based on their knowledge of the banking industry. Credit union regulators cannot, because of CUMAA. Credit unions, with a few statutorily defined exceptions, are required by law to maintain 7% capital to qualify as well capitalized, while banks are required by their regulators to maintain 5%. Credit unions need 6% capital to qualify as adequately capitalized, while banks need 4%. Credit unions with less than 6% net worth are subject to PCAs that become increasingly severe as their net worth ratio falls.

Since 1989, net worth ratios have exceeded the act's 7% requirement for a well-capitalized credit union, and since 1995 they have exceeded 10%.

CUMAA divides credit unions into five categories: (1) standard, (2) complex, (3) low-income, (4) new, and (5) under a net worth restoration plan. Standard credit unions are by far the most prevalent. Based on their net worth ratios, CUMAA further classifies credit unions as (1) well capitalized, (2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, and (5) critically undercapitalized.

CUMAA directs the NCUA to develop separate risk-based net worth requirements (RBNWRs) for "complex" credit unions. As a result, credit unions holding long-term real estate loans, business loans, long-term investments, loans sold with recourse, and high allowances for loan losses may be subject to additional net worth requirements.

Credit unions classified as serving large numbers of low-income households are permitted to use secondary capital accounts to meet their net worth requirements. These accounts are structured so that their claims are subordinate to other creditors and the NCUSIF. These instruments are discussed further in Chapter 5.

4 This section draws extensively from James A. Wilcox, *Subordinated Debt for Credit Unions* (Madison, WI: Filene Research Institute, 2002), 11–16.

New credit unions are defined as those that have been in operation for less than 10 years and have less than $10 million (M) in assets. NCUA rules, which are discussed in Chapter 5, make some allowance for their challenges in ramping up to adequate capital levels.

Under CUMAA, credit unions that are less than adequately capitalized may be placed under net worth restoration plans to bring them into compliance with net worth requirements. The NCUA has discretionary power to temporarily classify special deposits as regulatory capital if it believes it will help the credit union eventually reach adequate net worth levels.

Differences in Bank and Credit Union Risk Profiles and Capital Requirements

The substantial differences between capital standards for banks and credit unions cannot be justified on the basis of comparative risk profiles. The less risky institutions (credit unions) are required to have higher capital levels than the more risky institutions (banks). As previously mentioned, CUMAA requires credit unions to maintain a 7% capital ratio to qualify as well capitalized, but bank regulators say banks are well capitalized if they have only a 5% ratio. Stated another way, credit unions need 40% more capital than banks do in order to be considered well capitalized. Economic theory suggests that credit unions take fewer risks than banks (Smith 1984). Because they take fewer risks, credit unions need not hold as much capital. Supporting theoretical predictions that credit unions have lower risk profiles than banks are many studies, including Kane and Hendershott (1996), Smith and Woodbury (2001), Wilcox (2005b), and Wilcox (2007). The economics and finance literature has long recognized that the combination of the

Credit unions classified as serving large numbers of low-income households are permitted to use secondary capital accounts to meet their net worth requirements.

WHAT IS NET WORTH?

As mentioned previously, federal law dictates that net worth for most credit unions can be created only through retaining earnings. According to the NCUA, net worth includes "undivided earnings, regular reserves, appropriation for non-conforming assets (state chartered credit unions only), and other reserves (appropriations of undivided earnings)" (2005, 12).

profit-maximizing orientation of banks and insured deposit funding encourages more risk taking (Kane 1989).

The U.S. Department of the Treasury defends higher required capital standards for credit unions. It claims that Congress determined that a higher capital ratio was appropriate because credit unions cannot quickly issue capital stock to raise their net worth should a financial need arise. Instead, credit unions must rely on retained earnings to build net worth, which necessarily takes time (U.S. Department of the Treasury 2001, 11).

Lifting the ban on alternative capital would lessen credit unions' dependence on retained earnings, thus eliminating the need for higher capital standards.

The U.S. Government Accountability Office (GAO) also argues for maintaining higher capital standards for credit unions because of their dependence on retained earnings as a source of capital. At the same time, the GAO does not support proposals to allow credit unions access to alternative capital (U.S. Government Accountability Office 2004, 36). This is ironic, since lifting the ban on alternative capital would lessen credit unions' dependence on retained earnings, thus eliminating the need for higher capital standards.

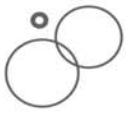
The U.S. Department of the Treasury says Congress established a capital level two percentage points higher for credit unions than banks—a level recommended by Treasury—because 1% of a credit union's assets is dedicated to the NCUSIF and another 1% is dedicated to its corporate credit union (U.S. Department of the Treasury 2001, 11).

The NCUA disagrees with Treasury's position on capital levels. It states that according to generally accepted accounting principles (GAAP), which Congress mandated credit unions follow, the NCUSIF deposit is considered an asset on credit unions' financial statements. The NCUA points out that the NCUSIF deposit is not related to a credit union's net worth from either an accounting or a financial risk standpoint. The GAO, however, argues that NCUSIF deposits are not liquid and therefore are not immediately accessible for credit unions to use as a capital buffer (U.S. Government Accountability Office 2004, 36). The GAO's argument is difficult to reconcile with conventional notions of capital, which do not require immediate liquidity. Priority of claims, not liquidity, is the essence of capital.

The NCUA also says that because not all credit unions have investments in corporate credit unions, using a one-size-fits-all approach to trigger PCA supervisory actions based on the corporate-investment assumption is inherently unfair (U.S. Government Accountability Office 2004, 36).

CHAPTER 3
Consequences of Prohibiting Alternative Capital in Credit Unions

There are many negative consequences to prohibiting alternative capital by credit unions. Credit unions could face slower recovery from financial setbacks, limitations on growth, and overcapitalization.



There are at least six negative consequences of prohibiting the acquisition of alternative capital by U.S. credit unions:

- Slower recovery from financial setbacks.
- Fewer new credit unions.
- Limitations on growth and the addition of new services.
- Difficulty in achieving economies of scale.
- Conversion of credit unions to bank and thrift charters.
- Overcapitalization.

Slower Recovery from Financial Setbacks

All financial institutions face some threat of potential losses. Sometimes losses are caused by uncontrollable external factors such as natural disasters, workforce reductions at sponsor companies, and sudden declines in local economies. Losses may also be caused by internal failures in loan underwriting or operating systems.

Losses, of course, reduce capital. Infusions of alternative capital can prevent institutional failure, shorten recovery periods, and protect deposit insurance funds. Without alternative capital options, credit unions that have suffered capital losses must restore their capital levels through the relatively slow process of retaining earnings. While rebuilding capital to adequate levels, their capital levels are substandard, and they often pose greater risk to the deposit insurer than well-capitalized credit unions do.

Infusions of alternative capital can also accelerate the recovery process and lessen harm to credit union members and their communities. Without alternative capital, credit unions often find it necessary to shrink assets to achieve satisfactory capital-to-asset ratios. In addition, capital-deficient credit unions may need to boost earnings during recovery periods by reducing deposit rates, raising loan rates,

increasing fees, and cutting operating expenses, all of which have negative member and community consequences.

Fewer New Credit Unions

Because net worth requirements can be satisfied only through retained earnings, launching and growing a credit union in the United States is extraordinarily difficult. In many ways, people contemplating starting a credit union face a classic conundrum: It takes capital to build assets, but it takes assets to build capital.

New banks are required to start with a minimum amount of capital, which they obtain by issuing stock and using other capital instruments. In contrast, credit unions cannot issue stock, and they begin their existence with no capital. As mentioned previously, the NCUA does have special rules for new credit unions.

From 1996 to 2005, new commercial bank charters averaged 156 per year, while new credit union charters averaged 11 per year—a 14:1 ratio.

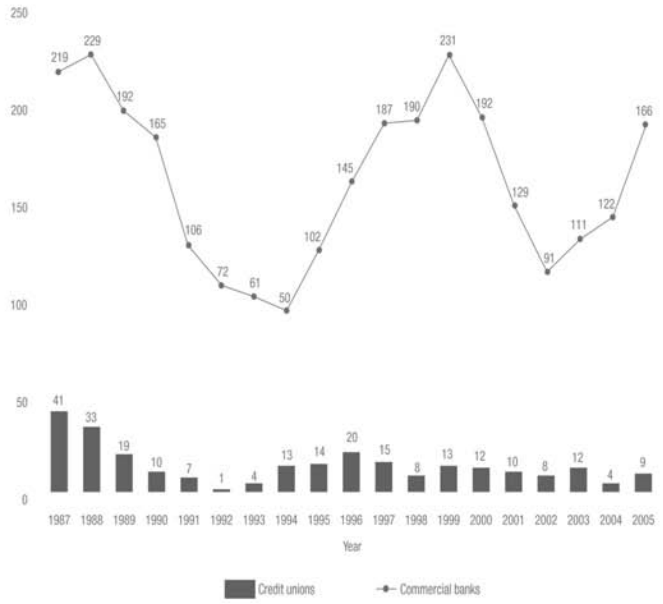
New credit unions have up to five years to accumulate a net worth of 2% of assets, and they must be adequately capitalized at a minimum of 6% in 10 years. This is a higher hurdle than it may appear. A new credit union typically needs to grow assets quickly to reach an economically viable size. Rapid asset growth, in turn, necessitates extraordinarily high capital growth rates if the credit union is to meet the 2% and 6% standards.

Limitations on credit union capital creation options are barriers to entry. Given the differences in capital accessibility, it's not surprising to find that very few new credit unions are formed compared with banks. From 1996 to 2005, new commercial bank charters averaged 156 per year, while new credit union charters averaged 11 per year—a 14:1 ratio. Furthermore, the majority of credit unions launched during that period were low-income community development credit unions, a special category of credit unions empowered to use subordinated debt and other instruments to satisfy capital requirements.

Limitations on Growth and the Addition of New Services

The growth rate of a U.S. credit union is constrained by its ability to add capital through retained earnings. If assets grow at a rate faster than capital grows internally, the net worth ratio declines. In practice, regulators view declining capital ratios as adverse trends, even if a credit union's net ratio remains over the 6% defined by statute as adequate capitalization. Federal and state regulators often issue oral and written warnings to credit unions with falling capital levels, and they may take strong steps to ensure capital levels they perceive as appropriate are achieved.

Figure 2: New Charters



Sources: FDIC, NCUA, and CUNA.

Without access to external sources of capital, a credit union may be unable to meet the growing and evolving needs of its existing membership. It may not be able to expand to fill the needs of the low-income and underserved segments of its community. Capital constraints make it more difficult to add new members and respond to promising marketing opportunities.

Difficulty in Achieving Economies of Scale

An inability to add capital adversely affects a credit union's expense ratio by making it more difficult to achieve economies associated with a larger scale of operations. Several studies reveal an inverse relationship between a credit union's size and its operating expense ratio. For example, Wilcox's research for the Federal Reserve Bank of San Francisco finds that "credit unions of all sizes likely will face growing pressures to improve efficiency by increasing the scale of their operations, either by internal growth or by acquiring other credit unions" (Wilcox 2005a, 3).

Doyle and Kelly (2005) found that a credit union's expense ratio is best predicted using a model that incorporates five factors: (1) deposits per member, (2) credit union size, (3) loan-to-assets ratio, (4) average loan size, and (5) real estate loans. A lack of capital-raising capabilities adversely affects performance in each of these areas: Without capital, a credit union cannot expand its deposits per member and total asset base (1 and 2), increase the number and size of loans (3 and 4), and assist its members in obtaining loans or purchasing homes (5).

Conversion of Credit Unions to Bank and Thrift Charters

Credit unions needing more capital than they can raise through retained earnings may be tempted to convert to bank or thrift charters. If there were widespread conversions of credit unions to other charters, consumer choice would be reduced. Large numbers of consumers would no longer have nonprofit, member-owned, one-member–one-vote options in the financial services marketplace.

Capital constraints make it more difficult to add new members and respond to promising marketing opportunities.

Most analysts believe that meaningful consumer choice is good for consumers in most product and service categories, including financial services. The evidence is also clear that credit unions typically behave differently than banks in the marketplace, largely because of their unique ownership and governance structure.

Thirty-one credit unions have converted to thrift and bank charters since 1998, and six are in the process of converting as of May 15, 2007 ("Conversion Update" 2007). Many more are actively considering a charter change.

The capital advantages of thrift and bank charters are frequently cited reasons for many charter conversions. As noted previously, credit unions must maintain a 7% capital ratio to be well capitalized, while banks need only maintain a 5% ratio. Also, banks and thrifts can raise large amounts of capital more quickly through the issuance of stock and alternative capital instruments.

Given the capital-formation limitations of credit unions, it is not surprising that organizations specializing in converting credit union charters regularly tout the capital advantages of thrifts and banks to potential clients. The following is an example of a conversion specialist's core marketing message regarding capital:

> *In addition to retaining earnings, banks have many ways to increase regulatory capital empowering them to expand services to members and the community, including loans, branches, employment and deposit products. For example, Pacific Trust Federal, a former credit*

union, raised almost $65 million in regulatory capital in a member approved IPO. The additional capital allows it to grow from $300 million to $2 billion, thus seeding a significant boost to the local community. As a credit union—even if other impediments were lifted—growing to this level of service would require over a decade of retained earnings. ("Solid Benefits & CU Handcuffs" 2003, 2)

Overcapitalization

From a macroeconomic perspective, excess capital is largely nonproductive and not in the public interest. From the perspective of credit union members, the process of building excess capital often deprives them of such benefits as lower loan rates, higher rates on savings, and more or higher-quality services in the short and medium term, and possibly in the long run as well.

Prohibiting capital creation alternatives creates incentives for credit unions to seek higher capital levels than they would if alternative capital options were open to them. The following example illustrates the rational component of the tendency to overcapitalize when options are restricted:

- Two identical credit unions in similar economic environments need about the same amount of base capital to operate in a safe and sound manner. In addition, both need safety capital to cover unplanned events. Some of these unplanned events—like unanticipated membership and asset growth spurts—are likely to be beneficial in the long run. Some events—like unanticipated operating losses—will be detrimental. Whether these events are positive or negative, they will reduce the credit unions' capital ratios, possibly below legally required levels.
- If both credit unions operate rationally, have the same knowledge, and have equal access to capital, they will carry identical amounts of safety capital. However, if one credit union can obtain new capital only through retained earnings and the other has many faster alternatives, the former should carry more safety capital than the latter.

Given the capital-formation limitations of credit unions, it is not surprising that organizations specializing in converting credit union charters regularly tout the capital advantages of thrifts and banks to potential clients.

Growing retained earnings is a relatively slow method of replenishing basic and safety capital compared to alternatives used by banks and cooperatives. Carrying more safety capital in credit unions is rational, but only up to a certain level of capital.

Behavioral Distortions

Rational behavior, however, does not fully explain the overcapitalization tendencies of credit unions lacking access to alternative

capital sources. Credit unions often seek an additional amount of excess capital.

The fields of behavioral economics and organizational psychology provide insights into this tendency to increase safety capital beyond rationally defensible levels. Researchers find that decision makers place more importance on potential losses than they do on gains: "In general, we tend to feel worse about a loss than we feel good about a win. The disutility of a loss is stronger than the utility of a win" (Holt and Charness 2005, 23). Consequently, we expect U.S. credit unions to hold even more safety capital than is necessary after adjusting for their highly constrained capital access options.

In addition, incentive systems shape behavior. Credit union regulators, boards of directors, and executives operate in systems with penalties and rewards that discourage risk taking (including, in many instances, carefully calculated, rational risk taking) and contribute to the overcapitalization problem:

- *Regulators.* Their internal accountability and reward systems incent them to emphasize risk minimization over fully rational risk management. Examiners are not promoted or otherwise rewarded if credit unions under their watch fail or flounder. Therefore, it is not surprising that they tend to be overly vigilant, even in the best of times. They predictably encourage credit union actions that result in higher capital levels than are rationally necessary.
- *Boards of directors.* These unpaid volunteers are not rewarded for taking chances, and they risk criticism from members, regulators, and the community if the credit union falters. Consequently, they favor organizational stability over maximizing member benefits, a pursuit involving greater organizational risk. Excess capital is perceived as stability enhancing. Economic theory's prediction that credit unions take on less risk than banks is primarily based on their governance structures, the primary difference between credit unions and banks (Jackson 2003, 105).
- *Managers.* Their job tenure depends on their ability to satisfy risk-averse regulators and boards. Because unemployment is undesirable, most managers enjoy the reassurance that comes from the high capital levels coveted by regulators and boards. Also, excess capital makes managers' jobs easier. They do not pay explicit interest on retained earnings to members. Overall, there are few job-related penalties to offset managers' incentives to hold excess capital.

In addition, incentive systems shape behavior. Credit union regulators, boards of directors, and executives operate in systems with penalties and rewards that discourage risk taking (including, in many instances, carefully calculated, rational risk taking) and contribute to the overcapitalization problem.

In summary, the lack of capital formation options makes risk-averse regulators, boards, and managers even more cautious and more willing to pursue irrationally high capital levels. Furthermore, behavioral incentives preclude fully rational behavior. The general result is excessively high capital levels in credit unions.

The Dangers of Overcapitalization

Excessively high capital levels reduce the value of credit union membership, and accumulation of excessive capital by the credit union is worth less to a member than higher savings rates, lower loan rates, and low service fees.

Excess capital also threatens the overall stability of the U.S. credit union system. It is a key factor underlying recent credit union conversions to bank and thrift charters. In addition, credit unions with excessive capital are vulnerable to friendly and hostile takeovers by banks and other credit unions. A recent example involves Wings Financial Federal Credit Union and Continental Federal Credit Union.

In 2007, Wings Financial FCU attempted to merge with Continental FCU. Both credit unions primarily serve airline workers. After Continental's management and board of directors turned down the merger idea, Wings appealed directly to Continental members, showing them the benefits of a merger, offering them a special $200 bonus dividend if the proposed merger took place, and asking them to persuade the Continental board to approve the merger. Continental's leadership strongly resisted and labeled the Wings proposal a hostile takeover attempt.

Overcapitalization makes Continental FCU a tempting merger target. At the end of 2006, it had a net worth ratio of 16.8%, compared to 11% at its peers. But Continental is "loaded with even more capital than the net worth ratio suggests: its loans are only 33% of total assets, and its net worth to loans ratio is an incredible 50%. That's like painting a takeover bulls eye on your chest," argues Hoel (Rubenstein 2007, 9). The excess capital at Continental FCU made it economically possible for Wings to promise to pay each former Continental member a special $200 bonus dividend.[5]

Are U.S. Credit Unions Overcapitalized?

Given alternative capital restrictions and behavioral theory and research, one would expect U.S. credit union capital to exceed necessary levels. Credit union data support this expectation. At the

5 After the bonus offer was made, the NCUA ruled that such a promise was illegal. Wings later abandoned its efforts to persuade Continental members to lobby for the merger.

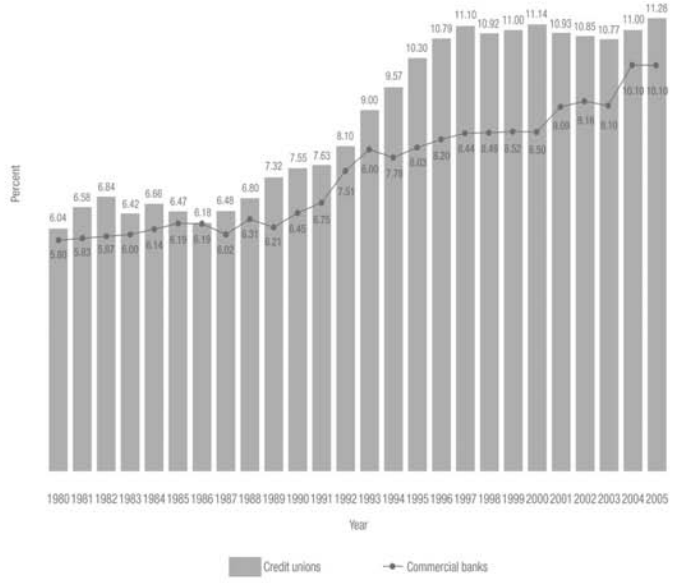
end of 2006, the net capital ratio excluding loan loss allowances was 11.4% of total assets, though federal law states that a credit union is adequately capitalized at 6%. Loan delinquencies were a mere 0.68% of total loans. Over the past 15 years, annual loan loss provisions have been only 0.28%–0.42% of total assets. Even at the highest annual charge-off rate of 0.42%, it would take the average credit union more than 27 years to deplete capital if it did not have positive earnings or change size. Capital per credit union member was a more-than-adequate $950 at the end of 2006.

Data support the general expectation of higher credit union capital levels, even though banks have riskier asset portfolios and higher delinquency rates than credit unions.

Because banks can increase capital in a wide variety of ways, one would expect banks to have lower capital ratios than credit unions. As shown in Figure 3, data support the general expectation of higher credit union capital levels, even though banks have riskier asset portfolios and higher delinquency rates than credit unions.

In a forthcoming Filene report, Jackson examines credit, interest-rate, liquidity, and operational risks and the industry composition

Figure 3: Equity Capital as a Percentage of Total Assets



Sources: FDIC, NCUA, and CUNA E&S.

characteristics of credit unions and banks in 1990 and 2006. His analysis leads to the same conclusion reached by Sollenberger (2005): The credit union industry not only has much more capital in 2006 than it did in 1990, but it also has a lower risk profile. Jackson concludes that U.S. credit unions are overcapitalized. He recommends major adjustments in capital requirements:

> The evidence strongly suggests that credit unions are indeed overcapitalized.

> *To achieve comparability, the PCA leverage requirement for credit unions should be lower than the leverage requirement for banks and thrifts. Based on the articles by Kane and Hendershott (1996) and Smith and Woodbury (2001), which compare credit union risk taking to that of banks and thrifts, I would recommend a net worth ratio for Well-Capitalized credit unions of three-quarters to four-fifths of that for banks and thrifts.* (Jackson, forthcoming)

In summary, the evidence strongly suggests that credit unions are indeed overcapitalized. Allowing access to additional capital sources would lower credit union capital to more appropriate levels.

TAXATION

U.S. credit unions are exempt from taxation of earnings. Because credit unions are prone to building excess capital given their alternative capital limitations, they are likely to limit or postpone member dividends, which are taxed at the individual member level and rate. As a result, U.S. and state treasuries receive smaller and delayed tax revenues from individual credit union members.

On the other hand, exempting credit union earnings from taxation mitigates to some degree the negative results of denying credit unions access to alternative capital. When a troubled credit union encounters financial difficulty, it is able to replenish capital more quickly because future earnings destined for retention are not diminished by taxation. Taxing credit union earnings would likely exacerbate problems created by prohibiting alternative capital formation methods.

CHAPTER 4
Capital Options in Other Financial Institutions and Cooperatives

Cooperatives and financial institutions in the United States and abroad enjoy a wide array of options for obtaining alternative capital. There are several options that may be of interest to policymakers and others considering altering U.S. policies that prohibit credit unions from accessing alternative capital.

U.S. Banks[6]

The widespread problems in the U.S. banking and thrift industries during the 1980s and early 1990s prompted many reforms in required capitalization levels. Understandably, Congress and regulators wish to prevent future financial institution catastrophes that would adversely affect the U.S. economic system, federal deposit insurance agencies, and local communities.

Today's bank capital requirements are not only complex, but constantly evolving, and they are likely to be influenced by future Basel Accord standards and other capital standards established by international bank regulators. The following material describes the general pattern of U.S. bank capital requirements.

A bank must meet three minimum capital requirements to avoid remedial actions, including possible closure, by regulators. Unlike with U.S. credit unions, several asset classes are assigned weights of less than 100% when calculating capital ratios. The three capital requirements are:

- A leverage ratio based on the total assets of the bank.
- A core capital (Tier 1) ratio.
- A total capital (Tier 1 plus Tier 2) ratio.

The Leverage Ratio

To qualify as adequately capitalized, a bank must hold a minimum of 3% of Tier 1 capital relative to (unweighted) total assets. Tier 1 capital includes common equity plus retained earnings, noncumulative perpetual preferred stock, limited amounts of cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

6 This section draws heavily from James A. Wilcox, *Subordinated Debt for Credit Unions* (Madison, WI: Filene Research Institute, 2002).

The Core Capital (Tier 1) Ratio

To qualify as adequately capitalized, a bank must hold a minimum of 4% of Tier 1 capital relative to risk-weighted assets. As of this writing, the asset risk-weighting system assigns each class of assets a weight of 0%, 20%, 50%, or 100%. Cash and securities issued by governments of most developed countries have a weight of 0%. Claims on banks and securities issued by the U.S. government or agencies that do not have the backing of the full faith and credit of the United States receive a weight of 20%. Some mortgage loans, certain asset-backed securities, and most derivative transactions receive a weight of 50%. Typically, commercial loans receive the standard weight of 100%. Some off-balance-sheet items may be included in the four risk categories.

The Total Capital (Tier 1 plus Tier 2) Ratio

To qualify as adequately capitalized, a bank must hold a minimum of 8% of total capital (Tier 1 and Tier 2) relative to risk-weighted assets. Tier 2 capital (also known as supplementary capital) may consist of intermediate-term and/or cumulative preferred stock, allowances for loan losses, hybrid instruments that combine equity and debt characteristics, unrealized gains on equity securities, and subordinated debt. The total amount of these components that may be counted toward Tier 2 capital cannot exceed the amount of Tier 1 capital. Additional amounts of the components of Tier 2 capital may be held, but they do not count toward the capital requirement. There are other restrictions on the maximum qualifying amounts of the different components.

Subordinated debt is of special interest in this report because it shows substantial promise as a potential alternative capital vehicle for credit unions.

Subordinated Debt as Tier 2 Capital

Subordinated debt is of special interest in this report because it shows substantial promise as a potential alternative capital vehicle for credit unions. Subordinated debt is subordinated to the claims of depositors and other creditors. It helps insulate deposit insurance funds from losses. If a bank is unable to pay its depositors, the deposit insurance agency does not pay depositors until claims of subordinated debt holders have been exhausted.

In the case of U.S. banks, the amount of subordinated debt plus intermediate-term preferred stock that qualifies as Tier 2 capital cannot exceed 50% of Tier 1 capital. In order to qualify as Tier 2 capital at banks, subordinated debt must:

- Not contain provisions that permit holders to accelerate the payment of principal prior to maturity.

- Not be credit-sensitive (i.e., not make increased interest payments in near-default situations).
- Have an original weighted average maturity of no less than five years. Issues with a remaining maturity of between four and five years are weighted to be counted as capital at 80% of face value, between three and four years at 40%, and between one and two years at 20%. Issues with remaining maturity of less than one year receive a 0% weight.

Cooperatives in the United States and Abroad[7]

Non-credit-union cooperatives have discovered many ways to expand their capital bases without abandoning their essential cooperative nature. Like credit unions, they need to gather sufficient capital to serve their members well, extend services to new members, expand their menu of services, and achieve economies of scale. Also, they wish to operate in a safe and sound manner. Unlike their U.S. credit union siblings, they are not compelled to rely solely on retained earnings as a source of capital.

Non-credit-union cooperatives have discovered many ways to expand their capital bases without abandoning their essential cooperative nature.

U.S. Cooperatives

Founded mainly in the early part of the twentieth century in the United States, traditional cooperatives, often in the agricultural arena, were financed with modest stock purchases by their initial members. The purchase of a single voting share was typical. New members in traditional cooperatives made minimal contributions to capital as a condition of membership.

Traditional stock cooperatives can expand capital by retaining earnings from three sources:

- *Nonmember business.* These earnings are retained as permanent capital and are called unallocated equity capital, reserves, or surplus on cooperative balance sheets.
- *Member business (allocated).* Earnings from member business may be retained by the cooperatives and equity shares distributed to members. Legally for federal income tax purposes, at least 20% of earnings must be paid in cash, while the other 80% may be retained by the cooperative for working capital. These retained earnings are allocated to a specific member who has rights to

7 The material in this section draws heavily from Michael L. Cook and Fabio R. Chaddad, *Capital Acquisition in North American and European Cooperatives* (Madison, WI: Filene Research Institute, 2006).

their proceeds when the shares are redeemed at the discretion of the board of directors. Redemption practices vary greatly among cooperatives.

- *Member business (unallocated).* Earnings from member business may become part of permanent capital and not allocated or redeemable by individual members.

Nonstock cooperatives typically accumulate capital through a system of per-unit retained funds called "retains." Under these systems, a cooperative (e.g., an agricultural producer cooperative) retains a specified portion of the value of each member's deliveries with the expectation that the retained funds will be returned to the member within a few years. Thus, the retains become a form of capital.

"New generation cooperatives" represent a major change in how cooperatives create capital. These cooperatives conduct capital drives that often generate sufficient equity capital to justify bank loans for multimillion-dollar facilities. The typical goal is to pay high cash returns to members on their investments in the cooperative. Capital investments in new generation cooperatives are redeemed rapidly compared to those in traditional stock cooperatives.

The equity shares in stock cooperatives and the per-unit retains (often described as debt) in nonstock organizations are rightfully considered to be capital. First, they are usually subordinated to all other financial obligations of the cooperative. Second, they are relatively permanent and cannot flee quickly in times of economic crisis. Though they may be partially redeemable, bylaws typically allow redemptions only with the approval of the board of directors.

Democratic control continues even though capital structures have evolved. Most cooperatives still operate on a one-member–one-vote basis.

Democratic control continues even though capital structures have evolved. Most cooperatives still operate on a one-member–one-vote basis. Proportional voting arrangements, however, are used by some. Proportional voting schemes are increasingly tied to patronage or weighted combinations of patronage and equity holdings. Cooperatives using proportional voting typically limit the percentage of total votes that can be cast by a single member.

European Cooperatives

As in the United States, the European cooperative is a local cooperative founded on principles of member ownership, member benefit, and member control. Important sources of funding, historically, were nonallocated patronage equity and bank debt, often obtained from cooperative lending institutions.

Over time, it proved advantageous for local European cooperatives to form regional associations and ultimately national federations, generally along a single crop or service line. These larger organizations permitted gains from economies of scale, and they provided greater access to capital. The frequent result is an interlinked, multitiered (local, district, regional, and national) cooperative structure.

An important capital development tool has been the introduction of PLCs, limited liability companies that are wholly or partially owned by individual cooperatives or groups of cooperatives. PLCs become operational arms of the cooperatives. While the PLC may be called a cooperative by the general public, it is really an investor-based entity owned by a cooperative.

The ownership by cooperative associations of these investor-owned holding companies creates a range of possibilities for equity investment in cooperatively owned operations. Because a PLC is an investor-owned entity, nonmembers can invest in and receive investment returns from the PLC without violating the cooperative character of the association.

Some differences exist between the other financial instruments used by European cooperatives and those used in the United States. However, most European instruments would be readily recognized by accounting specialists from U.S. cooperatives.

Trends in Capital Formation Tools for Cooperatives

In general, cooperatives in developed nations are expanding their options for capital formation. Sometimes these expansions require new laws, and sometimes they do not. Following are some examples of recent trends in capital formation.

- *Strategic alliances.* In this nontraditional financial model, the cooperative has the option of forming strategic alliances with partners to acquire permanent equity capital from nonmember sources. For example, Dairy Farmers of America (DFA), the largest U.S. dairy cooperative, established a holding company structure to govern strategic alliances in downstream businesses in the milk supply chain. As much as 30% of the milk volume handled by DFA is marked and processed by strategic alliances.
- *Trust companies.* In this model, the cooperative establishes a separate nonoperating trust company solely for the purpose of acquiring risk capital from nonmember sources, particularly institutional investors. Diamond of California is a marketing cooperative owned by 2,000 walnut growers. It recently acquired capital through its Diamond Walnut Capital Trust. The actual financing instrument is a 12-year, fixed-dividend, nonvoting preferred stock of the trust.

- *Preferred stock.* CoBank, a Denver-based cooperative bank, completed the private placement of $300M of its cumulative preferred stock. The preferred stock does not carry voting rights in the cooperative. It is a fixed-dividend, nonredeemable instrument.
- *Nonvoting common stock and investor participation shares.* In many countries, including Canada, France, the United Kingdom, and Australia, nonmembers are allowed to invest in cooperative associations and receive nonfixed dividends. However, these models do not grant nonmembers voting rights.

Non-U.S. Credit Unions and Cooperative Credit Associations

Credit cooperatives, including credit unions, in most developed nations enjoy a broader array of capital formation options than U.S. credit unions do. Typically they must satisfy Basel Accord requirements. Many operate subsidiaries that bring capital to support the cooperative's mission and do so without impacting the cooperative's capital position stated on its balance sheet.

Basel Accords

The Basel I and Basel II agreements, reached in 1988 and 2004 by central bankers, establish minimum capital standards for financial institutions. They have been endorsed and fully or partially implemented by G10 countries and more than 100 other nations.

The Basel agreements generally define Tier 1 and Tier 2 capital, and they recommend appropriate amounts of capital in relation to risk-weighted assets. Because of variations in the legal frameworks across nations, each country's regulator has some discretion regarding how differing financial instruments may count in the capital adequacy calculation.

Credit cooperatives, including credit unions, in most developed nations enjoy a broader array of capital formation options than U.S. credit unions do.

Most central banks and regulators follow the Bank of International Settlements' guidelines in setting asset risk weights. Assets like cash and coins usually have zero risk weightings, unsecured loans have a risk weight of 100%, and most types of secured loans are weighted somewhere in between.

Tier 1 capital is the core measure of a financial institution's financial strength because it is relatively permanent and reliable. Examples of Tier 1 capital are common stock, retained earnings, and preferred stock that is irredeemable and noncumulative.

Tier 2 capital is less permanent and reliable than Tier 1 capital. However, it cannot be withdrawn quickly if the financial institution

experiences financial setbacks or fails. Furthermore, it is subordinated to almost all other claims on assets and earnings. Subordinated debt is a popular form of Tier 2 capital. It is debt that is not redeemable over a usually lengthy set term, and it can be repaid only after other claims, including those of ordinary depositors, are paid in full. Other examples of Tier 2 capital are hybrid financial instruments combining some characteristics of both shareholder equity and debt.

Membership Restrictions and Capital Opportunities[8]

Unlike U.S. credit unions, most credit cooperatives are not constrained by requirements limiting membership to people who share a common bond of geography, employment, or association. European credit cooperatives, for example, are permitted to attract capital and deposits from members outside their target market, thus enabling wealthy urban dwellers to sometimes invest funds in less affluent rural areas.

Retention of Earnings

As in U.S credit unions, retention of earnings is the primary way to build capital. Foreign credit cooperatives obtain capital initially from individuals who deposit money in a share account and become cooperative members. Because funds on deposit can be withdrawn upon the demand of the member, cooperatives seek to build capital through retained earnings, which are more permanent.

Trust-Preferred Securities

Trust-preferred securities have become a popular method of securing additional capital from nonmembers. Rabobank, a large credit cooperative based in the Netherlands, has issued Class B Preferred stock since 1999 to trusts that then issue trust-preferred securities to outside, nonmember investors. Outside investors obtain a fixed rate of return indexed to government bond rates. They are not allowed to convert their securities into regular Rabobank shares. Only the trust—which Rabobank controls—can convert its preferred stock shares into regular shares. Rabobank sells trust-preferred securities to U.S. investors through a trust it formed in Delaware.

PLCs

PLCs, which were described previously in the context of all cooperatives, have become another key method for building capital at credit cooperatives. PLCs are limited liability companies that are wholly or partially owned by individual cooperatives or groups of cooperatives. PLCs owned by credit cooperatives may provide services such

8 The remaining parts of this section draw heavily from Cook and Chaddad (2006).

Australian credit unions provide a recent example of how credit cooperatives can attract Tier 1 and Tier 2 capital from investors. In 2006, 21 Australian credit unions collaborated to obtain a total of A$100 million (US$85M) in capital from outside investors. Half the total raised was for Tier 1 capital at 20 credit unions, and half was for Tier 2 capital at 21 credit unions. Funds obtained through this effort qualify as Tier 1 and Tier 2 capital under the guidelines of the Australian Prudential Regulation Authority.

By working together, marketing and overall funding costs were more favorable. CUNA Mutual, the leading credit union insurer in the United States with extensive Australian credit union business, and ABN-AMRO, a global financial conglomerate based in the Netherlands, played key roles in coordinating, structuring, and placing the offering.

The transaction involved creating two special-purpose vehicles: a Tier 1 trust and a Tier 2 special-purpose issuer (SPI). The Tier 1 instruments sold to investors are perpetual, noncumulative, and subordinate to almost all other claims including those of depositors, thereby satisfying key Tier 1 Basel requirements. The Tier 1 instruments have a floating dividend rate. Credit unions can call the instruments after 10 years. If they choose not to, there is a 100 basis point step-up in the rate paid to investors.

The Tier 2 instruments provide capital that is less permanent than the Tier 1 instruments. They are subordinated debt notes with a 10-year term and floating rates. They are not callable by the credit union for at least five years.

To facilitate placement of these Tier 2 subordinated debt instruments at favorable rates, the SPI issued notes in three classes (tranches) that were rated by Standard and Poors: $33.5M (AAA) senior notes, $10M (BBB) mezzanine notes, and $6.5M (BB) junior notes.

Each credit union received Tier 1 and Tier 2 capital as an individual entity. Each is separately responsible for meeting its obligations to the investors. There is no cross default among the Tier 1 instruments issued by the different credit unions. Similarly, there is no cross default among the Tier 2 instruments issued by different credit unions.[9]

9 Based on information obtained from Standard and Poors (2006), ABN-AMRO, the CUNA Mutual Group, and Australian credit unions.

as aggregated investing and clearing services to the cooperative, members, or outside customers. Sometimes they invest in activities beyond the traditional scope of the credit cooperative. For example, Rabobank has expanded internationally to acquire organizations in the United States and other countries well beyond the direct interests of their owners in Dutch communities.

The Irish Model

The so-called Irish model refers to a general method developed by Irish credit cooperatives to expand their capital bases. In this approach, assets of the cooperative are transferred to an investor-owned firm in exchange for the cooperative receiving all stock, a minority portion of which is then sold on the Dublin and London stock exchanges to outside investors. Through this model, the cooperative retains control over the assets by holding the majority of stock outstanding, but it can access capital from outside, nonmember investors.

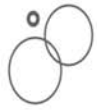
Credit cooperatives outside the United States also issue subordinated debt to obtain capital from external investors without diluting the share ownership rights of members.

Subordinated Debt

Credit cooperatives outside the United States also issue subordinated debt to obtain capital from external investors without diluting the share ownership rights of members. Subordinated debt programs vary widely. In some cases, investors in these debt instruments receive returns based on a percentage of the cooperative's earnings. In other cases, investors receive a defined return. In both general cases the claims of the securities holders are subordinated to virtually all claims by other creditors and depositors.

CHAPTER 5
Special Situations Where Alternative Capital Is Permitted for U.S. Credit Unions

Though laws and regulations do not permit most U.S. credit unions to use alternative capital, there are three significant exceptions: low-income credit unions, some state-chartered credit unions with private deposit insurance, and corporate credit unions that were created to serve other credit unions.



Low-Income Credit Unions

As Congress has repeatedly recognized, access to capital is essential but exceptionally difficult for credit unions that primarily serve low-income households. These credit unions tend to have low deposit and loan balances, relatively high operating costs, and above-average vulnerability to loan losses (National Federation of Community Development Credit Unions 2007, 5).

In 1970, Congress granted federally insured low-income credit unions (LICUs) the right to accept nonmember uninsured deposits. Later regulations began to permit these deposits to be considered a form of capital.

CUMAA explicitly allows secondary (alternative) capital to be included in net worth calculations at federally insured LICUs. It states that for LICUs, net worth "includes secondary capital accounts that are—(i) uninsured and (ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the [National Credit Union Share Insurance] Fund" (National Credit Union Administration 2007, Section 1790d).

A secondary capital account at a LICU is deeply subordinated debt. It fully counts as net worth when its maturity exceeds five years.

A secondary capital account at a LICU is deeply subordinated debt. It fully counts as net worth when its maturity exceeds five years. Each year after its maturity drops below five years, 20% becomes general debt for the credit union and is no longer counted as net worth capital.

Usage and Defaults

In March 2007, only 47 of the 1,061 credit unions officially designated as LICUs had outstanding secondary capital. Total secondary capital reported was $27.6M, with secondary capital at individual credit unions ranging from $5,000 to $9M.

Since 1997, the National Federation of Community Development Credit Unions (NFCDCU) has helped its member credit unions obtain $9M of secondary capital, largely from philanthropic organizations. Secondary capital losses occurred in seven credit unions, with total losses approximating $1M. Six of the defaulting credit unions are no longer in business. Given the challenges of serving low-income areas, it is not surprising that secondary capital losses are high (NFCDCU 2007).

The NFCDCU finds secondary capital especially valuable for fast-growing, high-performing LICUs that otherwise could not grow without running afoul of regulators and prompting PCA. Secondary capital has also proved important for other LICUs, including some long-established minority church-based credit unions that had below-par capital ratios (NFCDCU 2007, 6).

Alternative Capital Caps

The NCUA generally restricts nonmember deposits in a LICU to a maximum of 20% of total deposits. This so-called 20% rule is controversial. The NFCDCU argues that the restrictions are no longer necessary and burdensome:

> *As in the past, LICUs are obliged to prepare business plans and request special permission to accept non-member deposits in excess of their (20%) quota, even if these funds are low-cost or interest free. Some examiners continue to pressure LICUs to return to investors deposits that they already hold, and that could be used to earn incom for the credit unions. In any case, those credit unions that are most successful in raising philanthropic, CRA, or other social investments must still incur unnecessary paperwork burdens, petitioning NCUA regional directors for relief.* (NFCDCU 2007, 6)

State-Chartered Credit Unions

Federal law restricting capital exclusively to net worth applies to all federally insured, natural person credit unions. All federal credit unions must have federal insurance on deposits. In addition, most state-chartered credit unions are federally insured. If they wish, state may permit their non-federally-insured credit unions to use alternative capital. Some states now count membership shares as capital.

Though the number of state-chartered credit unions is large, the number of privately insured credit unions is small. As of March 2007, 3,146 state-chartered credit unions make up 37% of the total credit union population of 8,592 credit unions, and they account fo $326 billion (B), or 43%, of the movement's $751B in assets.

Twenty-nine states, according to the Credit Union National Association (CUNA), make some provision allowing private deposit insurance. In addition, regulator approval is often required, and

some regulators have been reluctant to approve private insurance. Sometimes the credit union's membership must also vote to approve private deposit insurance.

CUNA reports that as of March 2007, there are 174 non-federally-insured credit unions with total assets just under $17B. Relative to the size of the U.S. credit union movement, the number of non-LICUs eligible for secondary capital is small.

If the number of state-chartered credit unions eligible for alternative capital is to increase, federal laws prohibiting alternative capital at federally insured credit unions need to be repealed or modified.

State Calls for Alternative Capital Reform

The National Association of State Credit Union Supervisors (NASCUS) is the professional association for state credit union supervisors (regulators). Its past chairman, Jerrie J. Lattimore, who also serves as North Carolina's chief credit union regulator, testified before Congress on March 27, 2003, about the value of permitting alternative capital. The following is from her testimony:

> *As a regulator, it makes no business sense to deny credit unions the use of other forms of capital that improve their safety and soundness. We should take every financially feasible step to strengthen the capital base of this nation's credit union system.*

Lattimore pointed out that denying access to alternative capital (1) constricts credit union membership service and growth, and (2) encourages and sometimes forces credit unions to convert to non-credit-union charters (Lattimore 2003).

A NASCUS task force reexamined the alternative capital issue and various models for structuring capital in 2005. Its conclusion was unequivocal:

Figure 4: Privately Insured Credit Unions, March 2007

State	Number of privately insured credit unions	Assets (in millions)
Alabama	3	$599
California	18	$7,113
Idaho	19	$160
Illinois	35	$3,086
Indiana	17	$1,340
Maryland	3	$98
Nevada	8	$2,479
New Hampshire	1	<$1
Ohio	70	$1,878
Total	**174**	**$16,753**

Source: CUNA.

> *NASCUS firmly believes that credit unions should have access to alternative capital and that it can be done in a safe and sound manner.* (Alternative Capital for Credit Unions 2005, 10)

It continues to be a priority for NASCUS to study and advocate capital reform for credit unions with the ultimate goal of expanding the definition of net worth for credit unions to include alternative capital.

EXAMPLES: TWO START-UP, STATE-CHARTERED CREDIT UNIONS

ABBOTT LABORATORIES EMPLOYEES CREDIT UNION

Abbott Laboratories Employees Credit Union (ALEC), a state-chartered, privately insured credit union based in Illinois, was founded in 1989 with the assistance of the Abbott Laboratories company. The firm wanted its employees to have the "fringe benefit" of credit union access. Abbott provided initial capitalization by making an uninsured "redeemable capital contribution" of $6M. The agreement between Abbott and ALEC did not specify a maturity date, though Abbott expected to be repaid eventually. The contribution was interest-free to the credit union. It was fully at risk and subordinate to claims of depositors and other creditors.

State of Illinois regulators approved the capital contribution plan and chartered the credit union. American Share Insurance (ASI), a nongovernment credit union deposit insurer, also approved the redeemable capital contribution arrangement. Both treated Abbott's contribution as capital, though all parties were aware that the contribution was not intended to be permanent.

ALEC is thriving. Three years after its founding, it elected to repay the $6M in full. Today ALEC has $430M in assets and more than $300M in loans. It regularly receives a CAMEL 1 rating by regulators.

A SECOND CREDIT UNION

About the same time ALEC was founded, another credit union was launched, but its fate was far different. A sponsoring employer provided uninsured capital and also covered the credit union's operating expenses during the start-up period. The credit union suffered large loan losses and failed after a couple of years. The sponsor lost its $250,000 capital contribution plus the operating expenses.

The credit union may have failed, but alternative capital properly played its loss-mitigating role, as it must when credit unions and other financial institutions experience financial difficulties. Claims on alternative capital were subordinate to claims by depositors, the deposit insurer, and other claimants. The deposit insurer was protected from substantial loss by the credit union's alternative capital. (The name of the credit union has been withheld at the request of the interviewees.)

Exemption from Federal Income Taxes

Not surprisingly, credit unions wish to maintain their exemption from federal income taxes. The U.S. Code exempts "credit unions without capital stock organized and operated for mutual purposes and without profit." Federally chartered credit unions are exempt from income taxation under U.S. Internal Revenue Code, Section 501 because they are federal instrumentalities. State-chartered credit unions are exempted from federal income tax under the Code's Section 501(c)(14)(A).

If state law permits, a state-chartered credit union that is not federally insured can have capital options that are not afforded to federally chartered or insured credit unions while continuing to be exempt from federal income taxes. It may issue subordinated debt or similar instruments if the instrument is not deemed to be "capital stock" and the credit union continues to operate "for mutual purposes without profit."

Following the Code's requirement, the Internal Revenue Service (IRS) often uses a three-pronged test for determining tax exemption. Under one of those prongs, a credit union is barred from issuing capital stock if it wishes to be tax exempt. However, neither the

EXAMPLE: ALTERNATIVE CAPITAL AT AN ESTABLISHED CREDIT UNION

STATE EMPLOYEES' CREDIT UNION OF NORTH CAROLINA

State Employees' Credit Union of North Carolina, a state-chartered, federally insured credit union, entered into an "equity shares investment agreement" on June 30, 2001, and received a $1M infusion of alternative capital. The investment is not insured by the NCUSIF or any other deposit-insuring entity. The agreement calls for the credit union to pay to the investor a premium rate equivalent to Federal Home Loan Bank of Atlanta's quarterly dividend. In exchange, the investor agrees that it cannot redeem its shares without at least five years' notice, and then only if the redemption would not cause State Employees' Credit Union to fail to comply with government capital standards.

Holders of the equity shares have no voting rights, and the dividend is not guaranteed. Furthermore, the shares are subordinate to all other claims, including those of the NCUSIF.

The credit union received an outside audit opinion stating that the equity shares satisfy GAAP capital standards. The state regulator is comfortable with the arrangement and with the conclusion that the shares qualify as capital. However, CUMAA does not allow the equity shares to satisfy minimum capital standards applicable to federally insured credit unions.

Internal Revenue Code nor IRS regulations define capital stock for the purpose of judging a credit union's tax exemption status. The relatively few published court opinions on the subject suggest that the absence of some features make an instrument less like stock and more like debt. Typical stock features are voting rights, distributions at the discretion of the issuer, appreciation in the instrument's value in accordance with the issuer's profitability, and participation in the residual interests of the issuer at the time of liquidation. Debt instruments, in contrast, usually include repayment of the face amount at a certain maturity date and a fixed or variable return not tied to issuer profitability (*Alternative Capital for Credit Unions* 2005, 4).

In the case of State Employees' Credit Union of North Carolina, discussed in the sidebar, the IRS issued a private letter ruling that the equity shares did not disqualify the credit union from its federal income tax exemption (*Alternative Capital for Credit Unions* 2005, 7).

Corporate Credit Unions

Corporate credit unions are special credit unions that serve other credit unions rather than natural persons. Corporate credit unions enjoy a broader definition of capital and are specifically exempted from the Federal Credit Union Act's requirement that only retained earnings can count as net worth. As stated in NCUA's Rule 704.2, capital is the "sum of a corporate credit union's retained earnings, paid-in capital, and membership capital." A minimum capital ratio of 4% is required.

Rule 704.3 further clarifies paid-in capital and membership capital:

- *Member paid-in capital.* Paid-in capital accounts are callable at the option of the corporate credit union and only if the corporate credit union meets its minimum level of required capital and other requirements. In the event of liquidation of the credit

DO THESE ALTERNATIVE CAPITAL PROGRAMS WORK?

Alternative capital has enabled low-income, state-chartered with private insurance, and corporate credit unions to serve more members, expand their operations, and offer additional services. It has increased their capacity to weather economic fluctuations. It has enhanced their capital bases, which protect depositors and deposit insurance funds from losses. All available literature reviewed and personal interviews conducted during the course of this research indicate that alternative capital, when permitted in credit unions, has performed its primary economic functions well.

union, paid-in capital is payable only after satisfaction of all liabilities and claims including uninsured deposits and obligations to NCUSIF and membership capital holders.

- *Membership capital.* These funds may be in the form of a term certificate or an adjusted balance account. These funds can be withdrawn by depositors with a minimum notice of three years. In the event of liquidation of the corporate credit union, membership capital is payable only after satisfaction of all liabilities and claims excluding paid-in capital. (NCUA 2006)

Member paid-in capital and membership capital are forms of alternative capital in the context of this report. These instruments help ensure a healthy corporate credit union system and constitute 63% of total corporate credit union capital.

Figure 5: Sources of Capital—Corporate Credit Unions, March 31, 2007

	Capital	Percent of Total
Retained earnings	$2,876,517,851	37.02
Paid-in capital	$803,504,005	10.34
Membership capital	$4,089,790,461	52.64
Total capital	$7,769,810,317	100.00

Source: The Association of Corporate Credit Unions.

CHAPTER 6
Proposals for Expanding Alternative Capital Options

There are many potential sources of alternative capital for credit unions, including credit union members, outside investors, and other credit unions willing to loan their excess capital.

Uninsured Deposits by Credit Union Members

Like other cooperatives, credit unions could obtain alternative capital directly from their members in the form of uninsured deposits, sometimes called member investment shares. The deposits would have long maturities so the funds could not flee quickly if the credit union encountered financial difficulties. Being uninsured, these deposits would, of course, be subordinate to the claims of depositors in insured accounts and those of the deposit insurer. To compensate members for accepting greater risk, the credit union would offer higher interest rates on these uninsured accounts.

Member Knowledge and Interest in Uninsured Certificates of Deposit[10]

Credit union members vary greatly in their knowledge about deposit insurance. Lee and Kelly found that 77% of the credit union members participating in their study had heard about federal deposit insurance, but only a little more than half of those who had heard of it claimed they completely understood it. Among all respondents, 23% said they didn't understand it, 36% indicated limited knowledge, and 41% said they completely understood it.

To determine consumer interest in acquiring uninsured depository products, Lee and Kelly provided four groups of credit union members with information about a new uninsured certificate of deposit (CD). Each group received basic information about the product, and three of the four groups received additional information:

- Group A received only basic product information.
- Group B received basic product information plus the interest rate translated into dollar amounts.

10 This section reports findings from Jinkook Lee and William A. Kelly Jr., *Uninsured Accounts: An Assessment of Member Interest* (Madison, WI: Filene Research Institute, 2003).

- Group C received basic product information plus NCUA information about the rate of credit union failures causing a loss to the federal deposit insurance fund (0.0017%).
- Group D received basic information plus the additional information given to both Group B and Group C.

The addition of information boosted member interest in uninsured CDs. Members in Group A received only basic product information, and they were the least interested. Group D members received the most information, and they were the most interested.

Interest in uninsured deposit products soared when members were given a choice of what proportion of funds they would allocate to insured and uninsured accounts. The likelihood of purchasing an uninsured CD and the proportion of $10,000 that members wanted to place in this certificate were highest in Group D, whose members received the most information.

Members participating in the Lee-Kelly study who were generally more knowledgeable about savings and investment products were more likely to respond favorably to the uninsured CD than members who had less knowledge. Also, these members who were generally knowledgeable about savings and investment products were more likely to view the uninsured CD more favorably when they were given information about credit union failure rates and when the interest rate was translated into dollars.

The Design of Uninsured CDs[11]

Building on knowledge obtained in the Lee-Kelly study of member interest in uninsured accounts, Kwon and Lee conducted three

Figure 6: Indicators of Member Interest in an Uninsured CD

	Information given member	Percent likely to use product	Of $10,000 total deposit, percent depositing $1,000 or more in uninsured account	Of $10,000 total deposit, median uninsured deposit
Group A	Basic product info (BPI) only	13	63	$1,000
Group B	BPI plus interest rate translated into dollar amounts	40	87	$5,000
Group C	BPI plus info on credit union failure rates	47	93	$5,000
Group D	BPI plus info given to Groups B and C	87	93	$7,500

11 This section reports findings from Kyoung-Nan Kwon and Jinkook Lee, *Secondary Capital Products: An Assessment of Member Interest* (Madison, WI: Filene Research Institute, 2006).

experiments involving a total of 1,750 credit union members in five credit unions across the nation. The experiments examined possible CD design features, including:

- Bundling an uninsured product with an insured product. For example, a bundled CD could be 50% insured and 50% uninsured.
- Interest rates.
- Maturity length. Products tested were 5- to 10-year CDs with no early withdrawals.

The experiments also measured the characteristics of members most likely to purchase a fully or partially insured long-term CD.

A small but significant minority (12%–18%) of participants in each experiment indicated they were very likely (6 and 7 on a 7-point scale) to acquire a five-year CD without early withdrawal privileges. The member's willingness to acquire a long-term CD was greater when one or more of the following occurred:

- Federal deposit insurance was offered to cover all of the CD's value.
- The annual percentage was given for a bundled product rather than its separate components.
- The annual percentage was larger rather than smaller.
- Comparative product information was provided.
- The member's objective financial knowledge was low.
- The member's acceptable financial risk level was average or somewhat above average.
- The member's financial assets were less than $50,000, not including retirement savings.

Conclusions and Commentary: Uninsured CDs

A significant minority of credit union members would welcome the opportunity to purchase long-term uninsured CDs that would qualify as alternative and secondary credit union capital. Given the low failure rate of credit unions and an interest-rate premium to compensate for the lack of deposit insurance, uninsured credit union CDs would make excellent additions to many members' investment portfolios.

Most uninsured credit union CDs would likely be relatively safe investments, similar to quality uninsured corporate bonds. They would have an added benefit: The credit union issuing the CDs is regularly examined by government regulators, who take remedial actions when they observe financial weakness.

However, there are perils. Some uninsured CDs would be riskier investments than others. Furthermore, research shows that many

credit union members likely to be interested in purchasing uninsured CDs are unsophisticated investors who do not understand the role of deposit insurance and its overall value. Some have limited wealth and would be seriously harmed if the credit union defaulted. They might become confused about the major differences between insured and uninsured CDs. There is always a danger that some would misunderstand the risk–reward tradeoff, even if it was fully explained to them.

Most uninsured credit union CDs would likely be relatively safe investments, similar to quality uninsured corporate bonds.

In summary, uninsured CDs could benefit many of the members who purchase them, as well as the credit union membership as a whole. But if credit unions are allowed to issue uninsured CDs, special care should be taken to protect unsophisticated members who are not fully aware of the risk involved.

Membership Capital Shares

Many credit unions require their members to maintain a modest minimum amount in their accounts, typically less than $50. The minimum deposit amounts can be withdrawn only upon termination of membership. These deposits tend to be highly stable, and the annual interest cost is usually low or sometimes zero, similar to retained earnings. Furthermore, credit unions often have a legal right to refuse to pay out these minimum amounts if net worth levels are inadequate (Alternative Capital Task Force 2001, 1).

If these minimum deposits were uninsured and counted as net worth, a credit union would be able to increase capital by raising the minimum deposit amount required. Also, members might be encouraged to voluntarily make higher minimum deposits in exchange for special privileges or special rates on services.

Member Paid-in Capital

The member paid-in capital approach is based on the corporate credit union model, where qualifying member paid-in capital is perpetual and uninsured. Corporate credit union paid-in capital without stated maturity is considered equity for GAAP purposes and primary capital by the NCUA, and it satisfies several important capital requirements for corporate credit unions. The same approach could be used by natural person credit unions if federal law permitted (Alternative Capital Task Force 2001, 4).

Member paid-in capital appears to be an excellent net worth component for calculating capital adequacy.

Member paid-in capital appears to be an excellent net worth component for calculating capital adequacy. It is stable because it is

perpetual and cannot flee in times of financial crisis. In corporate credit unions, member paid-in capital is callable only at the option of the credit union and only if the credit union meets its minimum level of required capital and other requirements. Though payments to capital holders may be higher than payments on insured accounts, dividends are noncumulative. In the event of the liquidation of the credit union, paid-in capital is payable only after the satisfaction of all liabilities and claims, including uninsured deposits and obligations to the NCUSIF and holders of membership capital shares.

Subordinated Debt Issued to Investors[12]

James A. Wilcox, a prominent authority on risk management at financial institutions, proposes that credit unions be permitted to issue subordinated debt to outside investors in much the same way that community banks are allowed to do so. Banks often issue long-term subordinated bonds with maturities of 10 to 20 years. The claims of the bond holders are explicitly subordinate to those of depositors, deposit insurers, and other claimants in the event of default.

If credit unions were permitted to issue similar instruments and regulators were able to count them as a form of capital, the pathway to alternative capital for credit unions would be open.

Bank regulators, as noted in Chapter 4, count subordinated debt as Tier 2 capital. If credit unions were permitted to issue similar instruments and regulators were able to count them as a form of capital, the pathway to alternative capital for credit unions would be open.

Subordinated Debt Instruments

Wilcox points out that credit union alternative capital instruments could be structured in a variety of ways, and legislation and regulations would influence their ultimate structures. However, subordinated debt in credit unions would probably be structured along the lines seen in banking.

The key features of credit union subordinated debt would likely be:

- Long maturities.
- A higher coupon rate than those paid on regular credit union shares and CDs.
- Junior standing in liquidations.
- No voting rights for bond holders.

12 The following sections draw heavily from two Filene Research Institute reports by James A. Wilcox—*Subordinated Debt for Credit Unions* (2002) and *Capital Instruments for Credit Unions: Precedents, Issuance and Implementation* (2003).

- No direct influence over management.
- The right of management to forgo payment in specified situations.

Benefits to Regulators

Subordinated debt enhances regulatory efforts because it:

- *Imposes direct market discipline on credit union decision making.* Credit unions wishing to issue subordinated debt would know that the cost of obtaining subordinated debt is directly related to investor perceptions of the risk of default. The prospect of higher funding costs provides an incentive for credit unions to refrain from taking excessive risk.
- *Imposes indirect market discipline.* Regulators are likely to interpret a rise in the interest rate an individual credit union must pay for subordinated debt as a signal of potentially increased risk at that credit union. After observing an upward rate change, the regulator may wish to investigate the credit union's financial condition further and possibly take corrective action.
- *Enhances transparency and disclosure.* Subordinated debt investors require full and complete information about the credit union's operations and financial condition.
- *Increases the size of the financial cushion provided to the deposit insurer.* Because holders of subordinated debt are compensated only after the deposit insurer has been compensated, the addition of subordinated debt provides the deposit insurance fund with additional safety.
- *Reduces the need for supervisory forbearance.* While PCA schedules empower and eventually require supervisors to place ever-greater restrictions on credit unions with deteriorating net worth ratios, there is likely to be some forbearance by supervisors. Subordinated debt may keep credit unions from dropping below PCA and potential forbearance trigger points. Also, holders of subordinated debt may encourage supervisors to take action earlier to prevent troubled institutions from accumulating larger losses and further depleting the value of outstanding subordinated debt.

Subordinated Debt and Net Worth Requirements

If Congress were to permit credit unions to use alternative capital, a key question is how alternative capital would satisfy net worth requirements. The interchangeability of subordinated debt and retained earnings could be set anywhere between zero and 100%. Zero percent represents the status quo, where subordinated debt is not counted at all as net worth. At the other end of the spectrum is an exchange rate of 100%, where a dollar of subordinated debt would count as a full dollar of net worth. An interchangeability ratio

of 50% means that each dollar of subordinated debt would count as 50 cents of net worth.

A subordinated debt instrument's length of time until maturity also raises net worth questions. The alternative capital counting scheme currently used by LICUs might be applied. As discussed in Chapter 5, subordinated debt in LICUs fully counts as net worth when its maturity exceeds five years. Each year after its maturity drops below five years, 20% becomes general debt for the credit union and is no longer counted as net worth capital.

Enhancing the Marketability of Subordinated Debt and Other Alternative Capital Securities

Financial institutions wishing to issue small amounts of securities have traditionally been thwarted by high interest and issuance costs. However, since 2000, pooling mechanisms have provided access to capital markets to large numbers of financial institutions that had previously been considered too small to issue securities into public markets. These pools are extremely flexible. They can simultaneously include trust-preferred securities and subordinated debt and fixed- and floating-rate issues. They are sufficiently elastic to include several types of securities that might be issued by credit unions.

Wilcox's interviews with investment bankers revealed their interest in further expanding pooling mechanisms to include capital securities issued by credit unions.

Wilcox points out the possibility of developing pooling mechanisms that purchase only securities issued by credit unions. However, if the volume of capital securities issued by credit unions did not justify the development of separate credit-union-only pools, credit unions would probably be welcomed into mixed pools along with banks and thrifts.

Wilcox's interviews with investment bankers revealed their interest in further expanding pooling mechanisms to include capital securities issued by credit unions. His 2003 report analyzes bank capital securities and pooling mechanisms and also possible comparable credit union securities and mechanisms providing alternative capital.

A Credit Union Distribution System for Alternative Capital Emerges[13]

Many potential marketers, distributors, and purchasers of credit union subordinated debt and other alternative capital instruments are service and product supply organizations specializing in meeting

13 The next two sections are based on Thomas J. Merfeld, "New Strategies to Obtain Secondary Capital," in *Managing Credit Union Capital: Subordinated Debt, Uninsured Deposits, and Other Secondary Sources* (Madison, WI: Filene Research Institute, 2004) and also on documents supplied by the CUNA Mutual Group.

the needs of credit unions. Some are owned by credit unions and their members.

In 2003 the CUNA Mutual Group, a diversified, mutually owned financial organization founded in 1935 to serve credit unions, introduced Capital Notes, a secondary capital product. Phase 1 of CUNA Mutual's program is designed for LICUs. Phase 2 will adapt the program to all credit unions if Congress acts to permit alternative capital in mainstream credit unions.

Under the program, CUNA Mutual purchases an alternative capital instrument that is a nonvoting, medium-to-long-term (more than five-year) subordinated note. The investment contract explicitly states that the note holder will not become involved in the governance of the credit union. The note may have a fixed or floating rate, at the option of the credit union. There is a risk adjustment on the issuance yield, charging more for a credit union that has lower capital or more risky assets. This yield adjustment applies market discipline to the program. The note is prepayable at the option of the credit union. In extraordinary circumstances a credit union can defer a coupon payment without triggering default. The initial plan is to limit secondary capital to a maximum of 25% of total capital (retained earnings plus secondary capital).

In phase 2, when the program would be made available to credit unions not designated by the NCUA as low-income, there might be more credit union demand for subordinated debt capital than CUNA Mutual could retain on its own balance sheet. If this occurred, CUNA Mutual would create trusts to fund its purchases of the subordinated notes. The trusts would sell rights to certain cash flows, or tranches, to be paid by the trusts. The trusts would work with a rating agency to define and rate bundles of cash flows as AAA, AA, A, and unrated. CUNA Mutual is confident that there would be sufficient investor demand for these bundles.

Alternative capital is not inexpensive. Investors demand a significant premium because of risk and length of time to maturity.

The Cost of Subordinated Debt

Alternative capital is not inexpensive. Investors demand a significant premium because of risk and length of time to maturity. Bank costs for floating-rate subordinated notes may be 250–300 basis points over LIBOR (London Interbank Offered Rate), and for fixed-rate notes, costs may be 275–325 basis points over 10-year treasury notes. However, credit unions generally have lower risk profiles than banks, so the issuance spreads might be lower. On the other hand, the liquidity premium might have to be somewhat higher for credit unions.

In a narrow sense, subordinated debt is too expensive to use for making individual loans to credit union members. The net interest spread is too small. But looking at individual loans is inappropriate. It overlooks the point that secondary capital allows the credit union to expand and is intended to support the credit union's overall business. Also, it is important to remember that alternative or secondary capital may be used for relatively short periods of time compared to primary capital. These are conceptual hurdles that both credit union CEOs and regulators need to overcome.

Other Capital Options

Leased Capital

Another proposal is to permit credit unions with excess capital to loan or lease that capital to credit unions in need of additional capital. The capital-borrowing credit union could pay a fee to the capital-providing credit union, or it might share the monetary benefits of greater growth. Under this proposal, a credit union faced with growth opportunities could accept increased deposits and make additional loans while using leased capital to cover the associated decrease in its net worth ratio. The capital-providing credit union would receive above-market rates, or its goal might be more philosophically motivated.

Nonmember Paid-in Capital

In the so-called nonmember paid-in capital approach, a limited liability company (LLC) is created. Initial LLC capital is contributed by a small group of credit union members who receive senior voting rights in the LLC. Most capital (e.g., 97%) is contributed by other investors who receive junior voting rights. The LLC then becomes a member of the credit union and purchases a special uninsured share certificate with most alternative capital features. The certificate is perpetual and callable only by the credit union. The certificate's interest rate is higher than rates paid on insured certificates. As a credit union member, the LLC has only one vote (*Alternative Capital for Credit Unions* 2005, 8–9).

Alternative Capital and Complex Credit Unions

The NCUA can immediately allow complex credit unions to use some alternative capital, with no need for legislative change to make this possible, according to Wilcox.

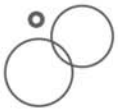
Complex credit unions are now subject to additional capital requirements associated with an RBNWR calculation. All federally insured credit unions can use only retained earnings to meet net worth requirements of 6% or 7% to be adequately or well capitalized. However, federal law does not explicitly mandate that incremental

capital required for additional credit union complexity be in the form of retained earnings. Therefore, the NCUA, if it wishes, could permit alternative capital to fulfill the need for additional RBNWR capital (Wilcox 2002).

Permitting alternative capital to satisfy incremental RBNWR requirements would provide the NCUA and the credit union movement a testing ground for subordinated debt procedures and instruments. Two regulatory issues that would need to be addressed are the interchangeability ratio of alternative capital and retained earnings, and how to count subordinated debt when the maturity date of the instrument is less than a trigger period of, say, five years.

CHAPTER 7
Public Policy, Managerial Implications, and Recommendations

Is it in the public interest to permit credit unions greater access to alternative capital sources? Alternative capital could be used to promote growth and stability among credit unions. Prohibiting alternative capital reduces competition and narrows consumer choice.



This chapter further addresses the three general questions posed at the beginning of this report:

- Is it in the public interest to permit U.S. credit unions greater access to alternative capital sources?
- Can credit unions use alternative capital to expand their capital bases in a way that will not dilute cooperative ownership, values, and governance structure?
- What alternative capital mechanisms would be most appropriate and feasible?

In addition, this chapter examines the question of when alternative capital reforms should be made.

Prohibiting Alternative Capital vs. Regulating It

Automobiles and alternative capital have much in common in the area of public policy: Automobiles generate a wide range of consumer benefits, but if driven improperly, they can be dangerous and destructive. If they wish to reduce or eliminate the dangers of automobiles, policymakers have three choices:

- Ban automobiles (or prohibit automobile driving).
- Regulate automobiles (e.g., speed limits, equipment standards, and vigilant police enforcement).
- Educate drivers.

It's widely agreed that the first alternative—banning all autos or prohibiting driving—thwarts rather than advances the public interest. Most policymakers also believe that a partial ban—one arbitrarily prohibiting certain classifications of people (e.g., women and people less than six feet tall) from driving—is unfair, inappropriate, and discriminatory. Instead of implementing unreasonable bans on automo-

biles or driving, policymakers opt for some combination of the other two choices—regulation and education.

Like autos used by individuals, alternative capital used by financial institutions generates individual and societal benefits, but it can be used improperly. Should alternative capital be totally banned because of the potential for misuse? Should a partial ban be implemented so that one class of financial institutions (e.g., U.S. credit unions) is arbitrarily prohibited from using it? Can alternative capital be intelligently and effectively regulated instead? Is there a place for educating and coaching institutions that are contemplating its use?

Like autos used by individuals, alternative capital used by financial institutions generates individual and societal benefits, but it can be used improperly.

Benefits of Regulation and Education

Banks, thrifts, and cooperatives worldwide have found alternative capital highly useful in serving their patrons and their communities. Public policy makers and regulators have developed effective ways to regulate its use, and the present research has been unable to uncover compelling arguments for banning the use of alternative capital by financial institutions. There is no public outcry for its prohibition.

As discussed in previous chapters, the use of alternative capital in credit unions would generate many benefits for 90 million U.S. credit union members and other consumers of financial services. Alternative capital can:

- Make more credit union start-ups possible.
- Permit credit unions to grow and expand services.
- Lower credit unions' operating costs through economies of scale.
- Help credit unions recover from financial setbacks.
- Prevent unnecessary conversions to bank charters.
- Reduce the squandering of capital through overcapitalization.

All these outcomes are in the public interest because they expand consumer choice and enhance the efficiency of financial institutions and the financial system.

To be sure, alternative capital can be misused by any class of financial institution, including credit unions. The instruments can be poorly structured. Issuers can agree to imprudently high rates and attempt to attract too much alternative capital. But solving the potential problem by arbitrarily banning alternative capital is unnecessary and not in the public interest.

For inexplicable reasons, credit unions are the only U.S. depositories prohibited from using alternative capital. U.S. thrifts and banks can use a variety of alternative capital instruments. Government agencies, however, vigilantly monitor and regulate usage. These regulators educate and sometimes cajole those they regulate. For example, the Office of Thrift Supervision (OTS) became concerned about thrifts potentially misusing trust-preferred securities pools being used to raise alternative capital. Various OTS leaders and spokespeople said:

Credit unions are the only U.S. depositories prohibited from using alternative capital.

- "[Trust-preferred securities] are like any bank product—if it's used wisely, it's a good product."
- "We've seen instances where [thrifts] have been marketed to and told that there is a pooling vehicle in place and it's going to market, and so they've jumped on board without a real plan about how to use it."
- "We always talk to [thrifts] about use of proceeds and we generally try to work with them to make sure the amount they are using is right."
- "Part of our job here [at OTS] is to take the punch bowl away mid-party." (Mandaro 2002)

Regulatory and educational approaches to dealing with valuable alternative capital products appear far superior to outright prohibitions. Credit union regulators—just like their counterparts regulating banks and thrifts—are likely capable of crafting guidelines and procedures that will minimize potential misuse.

Serving the Public Interest

Optimal Public Policy

U.S. financial institutions operate under a patchwork of federal and state laws and regulations developed in response to financial crises, political pressures, and historical events. No single central agency is assigned the task of developing an overall system of regulation. Regulation evolves to serve numerous goals, many of which change over time and are in conflict with one another. In addition, the economy evolves, and consumer financial needs and preferences change. All of these dynamic factors contribute to the need to frequently reassess the appropriateness of laws and regulations affecting credit unions and other financial institutions.

Economist William E. Jackson III, reflecting the views of many experts, provides guidance for evaluating public policy issues relating to financial institutions:

> *It is important to remember the fundamental goal of regulation is to allow financial markets and institutions to work efficiently for the consumer, while maintaining the fundamental integrity, or safety and soundness, of the system.* (Jackson 2003, 38)

> *The end goal of optimal regulatory policy is a marketplace with many choices for consumers, businesses, and other users of financial services. A financial system composed of homogeneous financial institutions is not ideal. Consumer choice, not restriction, should be the primary driver of change in the marketplace.* (Jackson 2003, 43)

Jackson finds that deregulation of credit unions—through removing secondary capital prohibitions and other unneeded restrictions—would have a positive overall economic effect. He sees two basic economic benefits of removing barriers to greater efficiency and innovation: (1) credit unions will better serve their members, and (2) they will increase financial market competition, which will lead to a more efficient overall marketplace for nonmembers as well as members.

Jackson finds that deregulation of credit unions—through removing secondary capital prohibitions and other unneeded restrictions—would have a positive overall economic effect.

High Capital Requirements vs. Ability to Obtain Alternative Capital

With passage of CUMAA in 1998, credit unions became subject to PCA regulations somewhat similar to those of banks. However, the capital requirements for credit unions were set much higher than bank requirements, even though credit unions have lower risk profiles than banks, as shown in Chapter 2. One possible rationale for setting a higher capital requirement for credit unions might be their inability to quickly raise capital by issuing securities, as banks are able to do.

Allowing credit unions to obtain alternative capital from investors or members would remove the need to set excessively high capital requirements.

Allowing credit unions to obtain alternative capital from investors or members would remove the need to set excessively high capital requirements. Jackson finds that allowing alternative capital would be the more efficient approach because excessive capital requirements restrict the ability of the financial system to provide the optimal amount of credit to potential borrowers (2003, 80).

Prohibiting Alternative Capital—Other Undesirable Consequences

Previous chapters examined several undesirable consequences of prohibiting alternative capital options for credit unions. All have

adverse public policy implications. The largest set of undesirable consequences involves reducing competition and narrowing consumer choice:

- Fewer new credit unions.
- Unnecessarily low limits on membership and asset growth potential.
- Barriers to adding new services.
- Barriers to achieving economies of scale.
- Incentives for credit unions to convert to bank and thrift charters, thus limiting the variety of consumer choices in the marketplace.

The second set of consequences involves internal inefficiencies that ultimately affect communities and capital markets:

- Slower recoveries from economic setbacks.
- Overcapitalization of credit unions.

Public Policy Arguments for Prohibiting Alternative Capital

Though the negatives of prohibiting alternative capital are considerable, making public policy involves trade-offs. Do the advantages of prohibiting alternative capital outweigh the disadvantages?

It might be argued that credit unions are relatively unsophisticated and uninformed financial institutions that will irrationally acquire too much or too costly alternative capital. This would unduly raise chances for institutional failure. For this scenario to play out, it must be assumed that credit union regulators are also unsophisticated and would approve all credit union requests to issue alternative capital instruments.

Credit unions have demonstrated the ability to assimilate a wide variety of sophisticated new products and services into their operations.

The proposition that credit unions and their regulators are generally unsophisticated and uninformed is not supported by convincing evidence. Credit union failures have been rare under all national economic conditions. Credit unions have demonstrated the ability to assimilate a wide variety of sophisticated new products and services into their operations.

Another possible reason for prohibiting alternative capital might be a fear that credit unions would grow so quickly that they would destabilize the financial services system by reducing bank profits and putting banks out of business. This view grossly underestimates the ability of banks to attract and retain customers in a competitive marketplace. There is no credible evidence supporting this doomsday scenario.

Dilution of Credit Union Uniqueness

Credit unions take considerable pride in their uniqueness. They are member-owned financial cooperatives in which each member has a single vote regardless of the size of his or her account balance. Their boards of directors are composed of members (not investors) who are elected by their fellow members. In federal credit unions and almost all state-chartered credit unions, these board members serve without pay. Their mottos are "Not for profit, not for charity, but for service," "People helping people," and "Where people are more important than money."

As demonstrated by other cooperatives and foreign credit unions and financial cooperatives, alternative capital instruments can be crafted to avoid compromising unique ownership characteristics. None of the alternative capital proposals for U.S. credit unions that were discussed in the previous chapter alter the cooperative structure or dilute the one-vote-per-member principle. Boards of directors would continue to be elected by the membership, outsiders would continue to be banned from serving on the boards, and the volunteer leadership tradition would go on.

As demonstrated by other cooperatives and foreign credit unions and financial cooperatives, alternative capital instruments can be crafted to avoid compromising unique ownership characteristics.

However, some leaders within the credit union movement express concern about credit unions seeking alternative capital and bank-like capital structures. John M. Tippets, a highly respected credit union leader and CEO of American Airlines Federal Credit Union, is an outspoken critic of alternative capital. In correspondence with the author, Tippets stated the following:

> *What the authors of two Filene Research Institute reports on secondary capital seem to be missing are the philosophical and political benefits of not having access to bank-like capital structures. As cooperative financial institutions, our retained earnings source of capital gives members a critical sense of power and ownership. It is also a source of some strategy/growth/pricing discipline on management. And, that unique structure is certainly one of the justifications for a unique tax treatment.*

Tippets believes that funding capital through retention of earnings is one of several characteristics contributing to credit unions' uniqueness. Together, these characteristics (member ownership, not-for-profit economic model, etc.) make credit unions special. The erosion of any of these distinctions (which are advantages in his view) diminishes the whole credit union strategy. He believes the "cost" of alternative capital for credit unions is much higher than the interest rate paid to providers of that capital.

Jim Blaine, another highly respected credit union leader and CEO of State Employees' Credit Union of North Carolina, disagrees with Tippets. He sees alternative capital as central to the long-run viability of credit unions. He endorses the idea of obtaining alternative capital from members and sees it as a positive way to reward members for longer-term savings. Blaine also suggests that credit unions be permitted to count up to 2% alternative capital in PCA calculations, with the remainder being generated from retained earnings. He adds, "If we pursue secondary capital, credit unions must define it, limit it, and use it on credit union terms" ("Two Sides of Secondary Capital" 2002, 14).

Credit unions are highly democratic organizations, and it is not unusual to see differences of opinion on major issues like alternative capital.

Credit unions are highly democratic organizations, and it is not unusual to see differences of opinion on major issues like alternative capital. Evidence supporting claims that permitting alternative capital would diminish the uniqueness of credit unions is not strong in the eyes of this researcher. It is more plausible that access to alternative capital would strengthen credit unions, enabling them to better pursue their unique purpose and goals.

What Alternative Capital Mechanisms Are Most Appropriate?

Chapter 6 discussed several potential methods for obtaining alternative capital. They all require changes in federal law if they are to be implemented by non-LICU, federally insured credit unions. The primary potential sources of alternative capital are credit union members, outside investors, and other credit unions:

- Credit union members
  - Uninsured CDs
  - Membership capital shares
  - Member paid-in capital
- Outside investors
  - Subordinated debt
  - Nonmember paid-in capital
- Other credit unions
  - Leased capital
  - Subordinated debt

Obtaining alternative capital from members is closest to the credit union tradition of mutual assistance. Of the credit union member alternatives, uninsured CDs appear to have the strongest potential to raise large amounts of money. As previously discussed, research

indicates that a significant minority of members would consider purchasing them. On the negative side of the issue, many members who show interest in uninsured certificates are relatively unsophisticated and have modest savings. There is a danger that some members would become confused about which credit union offerings are insured and which are not.

The most attractive investor-based source of alternative capital is subordinated debt. Investors have considerable experience with these types of products, and pooling mechanisms are available to lower the interest rate and the cost of issuance. Also, one movement-related organization has already taken steps to purchase and distribute alternative capital instruments issued by credit unions. Subordinated debt types of alternative capital bring market discipline to credit union activities. On the negative side, subordinated debt is relatively expensive.

Though subordinated debt issued to investors and uninsured member deposits show the greatest promise, the alternatives previously discussed should not be discarded.

Though subordinated debt issued to investors and uninsured member deposits show the greatest promise, the alternatives previously discussed should not be discarded. U.S. credit unions are a heterogeneous lot, and a limited menu of alternatives is not ideal.

Lack of Credit Union Consensus on Proposals

The U.S. credit union movement generally supports calls for alternative capital for credit unions. It has not rallied around a specific proposal, and there is no consensus on the best source for alternative capital. Instead, the industry has endorsed general guidelines.

CUNA's formal policy statement is as follows:

> *CUNA supports the authority of credit unions to build additional capital either from members or nonmembers in a way that does not dilute the cooperative ownership and governance structure of credit unions. This additional capital should be subordinated to credit unions' share insurance funds so that credit unions have the financial base to offer member services and adjust to fluctuating economic conditions.* (CUNA 2005)

The National Association of Federal Credit Unions board endorses seven principles for evaluating alternative capital models and instruments:

- Preserve the not-for-profit, mutual, member-owned, and cooperative structure of credit unions and ensure that ownership interest (including influence) remains with the members.

- Ensure that the capital structure of credit unions is not fundamentally changed and that the safety and soundness of the credit union community as a whole is preserved.
- Provide for a degree of permanence such that a sudden outflow of capital will not occur.
- Allow for a feasible means to augment capital.
- Provide a solution with market viability.
- Ensure that any proposed solution applies for PCA purposes (to include risk-based capital as appropriate) or changes the definition of net worth to include other equity capital balances.
- Ensure that any proposed solution qualifies as equity capital balances under GAAP and qualifies as an amendment redefining net worth.

The Current Need for Alternative Capital

On average, U.S. credit unions are well capitalized, and their balance sheets are strong. Capital is greater than 11% and charge-offs and delinquencies are low. More than 98% of all credit unions have net worth exceeding 7%, thereby meeting the CUMAA standard for being well capitalized.

The GAO Study on Alternative Capital

The U.S. Government Accountability Office, in its report *Credit Unions: Available Information Indicates No Compelling Need for Secondary Capital* (2004), states that credit unions are well capitalized. It says that the credit union industry's interest in making changes to the current capital requirements for credit unions appears to be driven by three primary concerns: (1) restricting the definition of net worth solely to retained earnings could trigger PCA actions due to conditions beyond credit unions' control, (2) PCA in its present form acts

Figure 7: Financial Strength—U.S. Credit Unions, End of 2006

		Asset size			
	All credit unions	Less than $5M	$5M–$20M	$20M–$100M	More than $100M
Net worth/assets	11.5	17.2	15.0	12.8	11.1
Credit unions with net worth exceeding 7% of assets	98.5	97.3	98.9	99.1	99.0
Delinquencies/loans	0.68	2.78	1.49	1.02	0.58
Net chargeoffs/average loans	0.47	0.77	0.55	0.49	0.46

Source: CUNA.

as a restraint on credit union growth, and (3) PCA trip wires for corrective action are too high given the conservative risk profile of most credit unions.

The GAO:

- Did not find evidence that the inflow of member share deposits resulted in widespread net worth problems for federally insured credit unions since PCA had been put in place.
- Found that credit unions grew faster than banks during the three years after PCA was put in place.
- Defended the high PCA trip wires established by Congress.
- Found that the credit union industry was not unified in its calls for reform and that proposals were not specific enough for assessment.
- Said that the potential use of a risk-based capital system for all credit unions appears less controversial than alternative capital.

One major reason for their interest in converting to a thrift or bank charter is the lack of capital-building options they have as credit unions.

A major omission in the GAO report is meaningful discussion of why credit unions should be subjected to competitive inequality as compared to banks in the area of alternative capital. Similarities and differences between banks and credit unions are not seriously explored. The report advocates economic discrimination without providing reasons.

The Fallacy of the Mean and the Case for Moving Forward Now

Averages are measures of central tendency, and they do not reveal the characteristics and needs of those who are not average. Credit unions are far from homogeneous. In fact, given their diversity, the term "average credit union" is usually misleading.

While an average credit union does not need or want alternative capital today, there are some that do. Those unaverage credit unions may face extraordinary growth opportunities, see how they can expand their product lines, wish to achieve economies of scale, or need to recover from economic setbacks.

Also, some credit unions are now contemplating abandonment of their credit union charters to become banks. One major reason for their interest in converting to a thrift or bank charter is the lack of capital-building options they have as credit unions. A significant subset of those contemplating charter changes would prefer to remain credit unions. Lifting alternative capital prohibitions now would allow them to abandon their plans to switch charters.

If it is in the public's and credit union movement's long-term interest to allow credit unions to use alternative capital, steps to remove alternative capital prohibitions should be taken as soon as possible, even if few credit unions will use it in the short term. The few innovators will provide learning experiences for other credit unions and their regulators. Investor markets can be developed slowly and intelligently. Later, if credit union demand for alternative capital soars, the insights gained from a slower-paced introductory period will prove useful.

The Case for Deregulation

Over the past 27 years, Congress has relaxed or eliminated many of the regulations imposed on depository institutions. These actions are responses to the impact of significant technological competitive and other market changes encountered by those institutions. Former Federal Reserve Board Chairman Alan Greenspan recognized the positive effect deregulation offers consumers when he said that deregulation provides financial services at lower prices, increased access, and higher-quality services. These benefits accompany the increased competition associated with permitting depository institutions to expand their activities (Greenspan 1993).

Former Federal Reserve Board Chairman Alan Greenspan recognized the positive effect deregulation offers consumers when he said that deregulation provides financial services at lower prices, increased access, and higher-quality services.

The process of deregulation produced positive results. It intensified competition among depository institutions, inducing them to expand product offerings, increase efficiency to align prices with production costs, and improve service to consumers.

Credit unions benefited far less from deregulation than commercial banks and thrifts. While the same factors that supported the deregulation of commercial banks and thrifts also support the deregulation of credit unions, credit union powers have gone largely unchanged over the past 20 years (Jackson 2003).

Lifting laws and regulations prohibiting the use of alternative capital by credit unions would be a big step forward in the deregulatory process. The benefits are substantial. Two other capital reforms also deserve review with an eye toward revision: lowering the capital levels required to meet PCA standards, and introducing risk-weighted capital standards.

Conclusions

Eight general research findings emerged during the course of this study:

- It is in the public interest to permit credit unions greater access to alternative capital sources.
- Federal and state laws and regulations should be amended to permit credit unions to obtain alternative capital.
- Credit unions can expand their capital bases using alternative capital in ways that will not dilute their cooperative ownership, values, and governance structure.
- Several different mechanisms for raising alternative capital are appropriate and feasible. Some of the most promising involve obtaining alternative capital from outside investors, and others involve acquiring special long-term deposits from credit union members.
- A broad menu of alternative capital options would best serve credit unions, their members, and the general public. There is no single method that is best for all credit unions seeking alternative capital.
- It would be appropriate for credit union regulators to review and approve a credit union's alternative capital plan and mechanisms prior to its issuance of alternative capital instruments.
- Though many credit unions may not wish to seek alternative capital now, having the power to do so would benefit them by allowing them to conduct their business with the confidence that, if necessary, they could build capital in a variety of ways beyond the slow retained-earnings approach.
- Steps should be taken promptly to repeal or reform statutes and regulations that prohibit credit unions from obtaining alternative capital. No compelling reasons to delay were uncovered during the course of this research.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOHN C. DUGAN

Q.1. *Consumer Protection Regulation*—Some have advocated that consumer protection and prudential supervision should be divorced, and that a separate consumer protection regulation regime should be created. They state that one source of the financial crisis emanated from the lack of consumer protection in the underwriting of loans in the originate-to-distribute space.

What are the merits of maintaining it in the same agency? Alternatively, what is the best argument each of you can make for a new consumer protection agency?

A.1. Effective protection for consumers of financial products and services is a vital part of financial services regulation. The attractiveness of the single financial product protection agency model is that it would presumably centralize authority and functions in this area in a single agency, which could write and apply rules that would apply uniformly to all financial services providers, whether or not they are depository institutions. Because the agency would focus exclusively on consumer protection, proponents of the concept also argue that such a model eliminates the concerns sometimes expressed that prudential supervisors neglect consumer protection in favor of safety and soundness supervision. These asserted attributes need to be closely evaluated, however. In the case of federally regulated depository institutions, the benefits could well be outweighed by the costs of diminishing the real consumer protections that flow from the Federal banking agencies' comprehensive supervision and oversight of depository institutions.

In the OCC's experience, and as the mortgage crisis illustrates, safe and sound lending practices are integral to consumer protection. Indeed, I believe that the best way to implement consumer protection regulation of banks—and the best way to protect their customers—is to do so through comprehensive prudential supervision.

Effective consumer protection of financial institutions includes three vital components: (1) strong regulatory standards; (2) consistent and thorough oversight of compliance with these standards; and (3) an effective corrective/enforcement response when it is determined that those standards are not met.

The appropriate structure for the rulemaking function can be debated. With respect to federally supervised banks that are subject to regular, ongoing supervision by the Federal banking agencies, there are good reasons why these agencies, by virtue of their familiarity with the issues these institutions present, should have a role in the rulemaking process. They bring expertise regarding potentially complex issues, and they are in a position to warn against potential unintended consequences of rulemaking initiatives under consideration. At the very least, if rulemaking for financial product consumer protection is vested in any single agency, there should be a requirement to consult with the Federal banking agencies with respect to the impact of proposed rules on federally regulated depository institutions.

Next is the question of consistent and thorough oversight of applicable consumer protection standards. Here, significant differences exist in the manner in which federally regulated deposi-

tory institutions are examined and supervised, and the oversight schemes applicable to the "shadow banking system"—nonbank firms that provide products and services comparable to those offered by depository institutions. I think it would be a mistake to displace the extensive role of the Federal banking agencies in examination and supervision of the operations of depository institutions—including their compliance with consumer protection standards.

The Federal banking agencies' regular and continual presence in institutions through the process of examination and supervision puts them in the best position to ensure compliance with applicable consumer protection laws and regulations. Examiners are trained to detect weaknesses in institutions' policies, systems, and procedures for implementing consumer protection mandates, as well as substantive violations of laws and regulations. Their regular communication with institutions occurs through examinations at least once every 18 months for smaller institutions, supplemented by quarterly contacts, and for the largest banks, the consumer compliance examination function is conducted continuously, by examiners on site at large banks every day. The extensive examination and supervisory presence creates especially effective incentives for achieving consumer protection compliance, and allows examiners to detect compliance weaknesses much earlier than would otherwise be the case.

Moreover, in many respects, for purposes of examination and supervision by the Federal banking agencies, safety and soundness and consumer protection issues are inextricably linked. Take, for example, mortgage lending. Safe and sound credit underwriting for a mortgage loan requires sound credit judgments about a borrower's ability to repay a loan, while the same sound underwriting practices help protect a borrower from an abusive loan with terms that the borrower does not understand and cannot repay. Bank examiners see both perspectives and require corrections that respond to both aspects of the problem. This system did not fail in the current mortgage crisis. It is well recognized the overwhelming source of toxic mortgages precipitating the mortgage crisis were originated by lenders that were not federally supervised banks.

To shift the responsibility for examining for and reacting to the consumer protection issues to an entirely separate agency is less efficient than the integrated approach bank examiners apply today. Shifting the examination and supervision role to a new and separate agency also would seem to require the establishment of a very substantial new workforce, with a major budget, to carry out those responsibilities.

Where substantial enhancement of examination and supervision is warranted, however, is for nonbank firms that are not subject to federal examination and supervision. Again, it is important to remember that these nondepository institutions were the predominant source of the toxic subprime mortgages that fueled the current mortgage crisis. The providers of these mortgages—part of the "shadow banking system"—are not subject to examination and supervision comparable to that received by federally supervised depository institutions. Rather than displace the extensive consumer protection examination and supervisory functions of the federal

banking agencies, any new financial product protection agency should focus on ensuring that the "shadow banking system" is subject to the same robust consumer protection standards as are applicable to depository institutions, and that those standards are in fact effectively applied and enforced.

Finally, in the area of enforcement, the Federal banking agencies have strong enforcement powers and exceptional leverage over depository institutions to achieve correction actions. As already mentioned, depository institutions are among the most extensively supervised firms in any type of industry, and bankers understand very well the range of negative consequences that can ensue from failing to be response to their regulator. As a result, when examiners detect consumer compliance weaknesses or failures, they have a broad range of tools to achieve corrective action, and banks have strong incentives to achieve compliance as promptly as possible. It is in the interests of consumers that this authority not be undermined by the role and responsibilities of any new consumer protection agency.

Q.2. *Regulatory Gaps or Omissions*—During a recent hearing, the Committee has heard about massive regulatory gaps in the system. These gaps allowed unscrupulous actors like AIG to exploit the lack of regulatory oversight. Some of the counterparties that AIG did business with were institutions under your supervision.

Why didn't your risk management oversight of the AIG counterparties trigger further regulatory scrutiny? Was there flawed assumption that AIG was adequately regulated, and therefore no further scrutiny was necessary?

A.2. A critical focus of our examination of trading activities at our large national banks is to assess how well the bank manages its counterparty exposures. We regularly review large counterparty exposures at our large national banks; however, the counterparty exposure to AIG did not trigger heightened regulatory scrutiny by the OCC because it was a AAA-rated company, was generally well-respected in the financial services industry, and was not a meaningful risk concentration to any of the banks under our supervision. Because AIG had such a strong credit rating, many counterparties, including national banks, did not require AIG to post collateral on its exposures. A key lesson learned for bankers and supervisors is the need to carefully manage all counterparty exposures, especially those that may have sizable unsecured exposures, regardless of the counterparty's rating. In particular, regulators need to revisit the issue of the extent to which collateral should be required in counterparty relationships, merely due to AAA ratings.

Q.3. Was there dialogue between the banking regulators and the state insurance regulators? What about the SEC?

A.3. We did not have any meaningful dialogue with state insurance regulators or the SEC about AIG since we had no compelling reason to do so, given the lack of supervisory concerns at the time with regard to the exposure to AIG.

Q.4. If the credit default swap contracts at the heart of this problem had been traded on an exchange or cleared through a clearinghouse, with requirement for collateral and margin payments, what

additional in formation would have been available? How would you have used it?

A.4. Because the transactions between AIG and its counterparties were highly customized to specific CDOs, it is unlikely that they would have been eligible for trading on an exchange or clearing through a clearinghouse. Transactions that use exchanges or clearinghouses generally require a fairly high degree of standardization. In addition, for a contract to trade on an exchange, the exchange/clearinghouse needs to be able to determine prices for the underlying reference entities, in this case super-senior ABS CDOs, yet, even the most sophisticated market participants had great difficulty valuing these securities. If the transactions could have been traded on an exchange, then AIG would have been forced to post initial and variation margin. These margin requirements would likely have limited the volume of trades that AIG could have done, or forced them to exit the transactions prior to the losses becoming so significant that they threatened the firm's solvency. In addition, because an exchange or clearinghouse provides for more price transparency, if these transactions had been cleared through a clearinghouse, market participants may have had greater knowledge of the pricing of the underlying CDO assets.

Q.5. *Over-Reliance on Credit Rating Agencies*—While many national banks did not engage in substandard underwriting for the loans they originated, many of these institutions bought and held these assets in the form of triple-A rated mortgage-backed securities.

Why was it inappropriate for these institutions to originate these loans, but it was acceptable for them to hold the securities collateralized by them?

A.5. National banks are allowed to purchase and hold as investments various highly rated securities that are supported by a variety of asset types. Examples of such asset types include mortgages, autos, credit cards, equipment leases, and commercial and student loans. National banks are expected to conduct sufficient due diligence to understand and control the risks associated with such investment securities and the collateral that underlies those securities. In recent years, many national banks increased their holdings of highly rated senior ABS CDO securitization exposures. These senior positions were typically supported by subordinated or mezzanine tranches and equity or first-loss positions, as well as other forms of credit enhancement such as over-collateralization and, in certain instances, credit default swaps provided by highly rated counterparties. In hindsight, bankers, regulators, and the rating agencies put too much reliance on these credit enhancements and failed to recognize the leverage and underlying credit exposures embedded in these securities, especially with respect to a systematic decline in value of the underlying loans based on a nationwide decline in house prices. Our supervisory approach going forward will emphasize an increased need for banks to consider the underwriting on the underlying loans in a securitization and understand the potential effect of those underlying exposures on the performance of the securitized asset.

In addition, as previously noted, another key lesson learned from the recent financial turmoil is the need for firms to enhance their ability to identify and aggregate risk exposures across business, product lines, and legal entities. With regard to subprime mortgage exposures, many national banks thought they had avoided subprime risk exposures by deliberately choosing to not originate such loans in the bank, only to find out after the fact that their investment bank affiliates had purchased subprime loans elsewhere to structure them into collateralized debt obligations.

Q.6. What changes are you capable of making absent statutory changes, and have you made those changes yet?

A.6. As noted above, while we expect bankers to conduct sufficient due diligence on their investment holdings, in recent years both bankers and regulators became too complacent in relying on NSRO ratings and various forms of credit enhancements for complex structured products, which often were based on various modeled scenarios.

The market disruptions have made bankers and regulators much more aware of the risk within models, including over-reliance on historical information and inappropriate correlation assumptions. Because of our heightened appreciation of the limitation of models and the NSRO ratings that were produced from those models, we are better incorporating quantitative and qualitative factors to adjust for these weaknesses. We are also emphasizing the need for bankers to place less reliance on models and NSRO ratings and to better stress-test internal model results. We also have told banks that they need a better understanding of the characteristics of the assets underlying these securities.

Finally, enhancements to the Basel II capital framework that were announced by the Basel Committee on Banking Supervision in January 2009 will require banks to hold additional capital for re-securitizations, such as collateralized debt obligations comprised of asset-back securities. In addition to the higher capital that banks will be required to hold, these enhancements will also require banks that use credit ratings in their measurement of required regulatory capital for securitization exposures to have:

- A comprehensive understanding on an ongoing basis of the risk characteristics of their individual securitization exposures.
- Access to performance information on the underlying pools on an ongoing basis in a timely manner. For re-securitizations, banks should have information not only on the underlying securitization tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitization tranches.
- A thorough understanding of all structural features of a securitization transaction that would materially impact the performance of the bank's exposures to the transaction, such as the contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default.

The comment period for the proposed enhancements has ended, and the Basel Committee is expected to adopt the final changes be-

fore year-end 2009. The U.S. federal banking agencies will consider whether to propose adding these or similar standards to their Basel II risk-based capital requirements.

Q.7. *Liquidity Management*—A problem confronting many financial institutions currently experiencing distress is the need to roll-over short-term sources of funding. Essentially these banks are facing a shortage of liquidity. I believe this difficulty is inherent in any system that funds long-term assets, such as mortgages, with short-term funds. Basically the harm from a decline in liquidity is amplified by a bank's level of "maturity-mismatch."

I would like to ask each of the witnesses, should regulators try to minimize the level of a bank's maturity-mismatch? And if so, what tools would a bank regulator use to do so?

A.7. There are a myriad of a factors that influence a bank's liquidity risk profile and that need to be effectively managed. Some of these factors include the stability and level of a bank's core deposits versus its dependence on more volatile wholesale and retail funds; the diversification of the bank's overall funding base in terms of instrument types, nature of funds providers, repricing, and maturity characteristics; and the level of readily available liquid assets that could be quickly converted to cash. We do use a number of metrics, such as net short-term liabilities to total assets, to identify banks that may have significant liquidity risk. However, we believe that it has been difficult to distill all of the factors that influence a bank's liquidity risk into a single regulatory metric that is applicable to all types and sizes of financial institutions. As a result, we direct banks to develop a robust process for measuring and controlling their liquidity risk. A key component of an effective liquidity risk management process are cash flow projections that include discrete and cumulative cash flow mismatches or gaps over specified future time horizons under both expected and adverse business conditions. We expect bankers to have effective strategies in place to address any material mismatches under both normal and adverse operating scenarios.

The Basel Working Group on Liquidity (WGL) issued revised principles last year that emphasized the importance of cash flow projections, diversified funding sources, comprehensive stress testing, a cushion of liquid assets, and a well-developed contingency funding plan. Financial institutions are in the process of implementing these additional principles into their existing risk management practices. The WGL is currently reviewing proposals for enhanced supervisory metrics to monitor a financial institution's liquidity position and the OCC is actively involved in those efforts.

Q.8. *What Is Really Off-Balance Sheet*—Chairman Bair noted that structured investment vehicles (SIVs) played an important role in funding credit risk that are at the core of our current crisis. While the banks used the SIVs to get assets off their balance sheet and avoid capital requirements, they ultimately wound up reabsorbing assets from these SIV's.

Why did the institutions bring these assets back on their balance sheet? Was there a discussion between the OCC and those with these off-balance sheet assets about forcing the investor to take the loss?

A.8. For much of the past two decades, SIVs provided a cost effective way for financial companies to use the short-term commercial paper and medium term note (MTN) markets to fund various types of loans and credit receivables. Beginning in August 2007, as investor concerns about subprime mortgage exposures spilled over into the general asset-backed commercial paper (ABCP) and MTN markets, banks were facing increased difficulties in rolling over these funding sources for their SIVs. As a result, banks began purchasing their sponsored SIVs' ABCP as a short term solution to the market disruption. In some instances, banks had pre-approved liquidity facilities established for this purpose. Over time, it became apparent that market disruptions would continue for an extended period, making it impossible for SIVs to roll ABCP or MTNs as they matured. In order to avoid possible rating downgrades of senior SIV debt and to maintain investor relationships, banks supported their sponsored SIV structures by either purchasing SIV assets or maturing ABCP. As a result of these purchases, many banks were required to consolidate SIV assets under GAAP.

The OCC had ongoing discussions with banks on this topic, and OCC examiners emphasized the need for bank management to consider all potential ramifications of their actions, including liquidity and capital implications, as well as other strategic business objectives.

Q.9. How much of these assets are now being supported by the Treasury and the FDIC?

A.9. Treasury's TAW Capital Purchase Program and the FDIC's Temporary Liquidity Guaranty Program are providing funds that are helping to bolster participating banks' overall capital and liquidity levels and thus may be indirectly supporting some of these assets that banks may still be holding on their balance sheets. However, given the fungible nature of this funding, it is not possible to identify specific assets that may be supported.

Q.10. Based on this experience, would you recommend a different regulatory treatment for similar transactions in the future? What about accounting treatment?

A.10. Regulatory capital requirements for securitization exposures generally are based on whether the underlying assets held by the securitization structure are reported on- or off-balance sheet of the bank under generally accepted accounting principles (GAAP). Most SIVs have been structured to qualify for off-balance sheet treatment under GAAP. As such, bank capital requirements are based on the bank's actual exposures to the structure, which may include, for example, recourse obligations, residual interests, liquidity facilities, and loans, and which typically are far less than the amount of assets held in the structure.

The Financial Accounting Standards Board (FASB), in part as a response to banks' supporting SIV structures beyond their contractual obligation to do so, proposed changes to the standards that require banks to consolidate special purpose vehicles and conduits such as SIVs. Under the proposed new standards, which are expected to become effective January 1, 2010, the criteria for consolidation would require banks to conduct a qualitative analysis, based on facts and circumstances (power, rights, and obligations), to de-

termine if the bank is the primary beneficiary of the structure. One factor in determining whether the bank sponsoring a SIV structure is the primary beneficiary would be whether the risk to the bank's reputation in the marketplace if the structure entity does not operate as designed would create an implicit financial responsibility for the bank to support the structure. The proposed new standards likely would require banks to consolidate more SIV structures than they are required to consolidate under current GAAP. The U.S. banking agencies are evaluating what changes, if any, to propose to our regulatory capital rules in response to the proposed FASB changes.

In addition, in January 2009, the Basel Committee on Banking Supervision proposed enhancements to the Basel II framework that include increasing the credit conversion factor for short-term liquidity facilities from 20 percent to 50 percent. This change would make the conversion factor for short-term liquidity facilities equal to the credit conversion factor for long-term liquidity facilities. The U.S. banking agencies are evaluating whether to propose a rule change to increase the credit conversion factor for short-term liquidity facilities to 50 percent for banks operating in the United States under both Basel I and Basel II.

Q.11. *Regulatory Conflict of Interest*—Federal Reserve Banks which conduct bank supervision are run by bank presidents that are chosen in part by bankers that they regulate.

Mr. Dugan and Mr. Polakoff does the fact that your agencies' funding stream is affected by how many institutions you are able to keep under your charters affect your ability to conduct supervision?

A.11. No. Receiving funding through assessments on regulated entities is the norm in the financial services industry. In the case of the OCC and OTS, Congress has determined that assessments and fees on national banks and thrifts, respectively, will fund supervisory activities, rather than appropriations from the United States Treasury. Neither the Federal Reserve Board nor the FDIC receives appropriations. State banking regulators typically are also funded by assessments on the entities they charter and supervise.

Since enactment of the National Bank Act in 1864, the OCC has been funded by various types of fees imposed on national banks. Over the more than 145 years that the OCC has regulated national banks, in times of prosperity and times of economic stress, there has never been any evidence that this funding mechanism has caused the OCC to fail to hold national banks responsible for unsafe or unsound practices or violations of law, including laws that protect consumers.

Rather, through comprehensive examination processes, the OCC's track record is one of proactively addressing both consumer protection and safety and soundness issues. Among the banking agencies, we have pioneered enforcement approaches, including utilization of section 5 of the Federal Trade Commission Act, to protect consumers. Indeed, the OCC frequently has been criticized for being too "tough," and we have seen institutions leave the national

banking system to seek more favorable regulatory treatment of their operations. [1]

Simply put, the OCC never has compromised robust bank supervision, including enforcement of consumer protection laws, to attract or retain bank charters.

Q.12. *Too-Big-To-Fail*—Chairman Bair stated in her written testimony that "the most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of those institutions similar to that which exists for FDIC-insured bank. In short we need to end too big to fail."

I would agree that we need to address the too-big-to-fail issue, both for banks and other financial institutions. Could each of you tell us whether putting a new resolution regime in place would address this issue? How would we be able to convince the market that these systemically important institutions would not be protected by taxpayer resources as they had been in the past?

A.12. As noted in the previous responses to Senator Crapo, there is currently no system for the orderly resolution of nonbank firms. This needs to be addressed with an explicit statutory regime for facilitating the resolution of systemically important nonbank companies. This new statutory regime should provide tools that are similar to those the FDIC currently has for resolving banks, including the ability to require certain actions to stabilize a firm; access to a significant funding source if needed to facilitate orderly dispositions, such as a significant line of credit from the Treasury; the ability to wind down a firm if necessary, and the flexibility to guarantee liabilities and provide open institution assistance if necessary to avoid serious risk to the financial system. In addition, there should be clear criteria for determining which institutions would be subject to this resolution regime, and how to handle the foreign operations of such institutions. While such changes would make orderly resolutions of systemically important firms more feasibly, they would not eliminate the possibility of using extraordinary government assistance to protect the financial system.

Q.13. *Pro-Cyclicality*—I have some concerns about the pro-cyclical nature of our present system of accounting and bank capital regulation. Some commentators have endorsed a concept requiring banks to hold more capital when good conditions prevail, and then allow banks to temporarily hold less capital in order not to restrict access to credit during a downturn. Advocates of this system believe that counter cyclical policies could reduce imbalances within financial markets and smooth the credit cycle itself.

What do you see as the costs and benefits of adopting a more counter-cyclical system of regulation ?

A.13. The question as to how best to address pro-cyclicality concerns associated with our present system of accounting and capital regulation is an area of significant focus for policy makers domestically and internationally. In addressing this matter, it is important

[1] Applebaum, *Washington Post,* By Switching Their Charters, Banks Skirt Supervision, January 22, 2009; A01.

to distinguish between cyclicality and pro-cyclicality. Due to their sensitivity to risk, the current accounting and capital regimes are clearly, and intentionally, cyclical, broadly reflecting the prevailing trends in the economy. The more difficult and unresolved issue is whether those regimes are also "pro-cyclical," by amplifying otherwise normal business fluctuations.

As noted, there are ongoing efforts to assess pro-cyclicality issues with respect to both our current accounting and regulatory capital regimes. The most recent public statement on this matter is found in the Financial Stability Board's April 2, 2009 document "Report of the Financial Stability Forum on Addressing Pro-cyclicality in the Financial System" (FSB Report).[2] In this report, the FSB makes numerous policy recommendations to address pro-cyclicality concerns in three broad areas: regulatory capital; bank loan loss provisioning practices; and valuation.

With respect to capital, the FSB Report set forth various recommendations to address potential pro-cyclicality, including the establishment of counter-cyclical capital buffers. In that regard, the Report encouraged the Basel Committee to "develop mechanisms by which the quality of the capital base and the buffers above the regulatory minimum are built up during periods of strong earnings growth so that they are available to absorb greater losses in stressful environments." In terms of benefits, building such a counter-cyclical capital buffer on banks' earnings capacity would provide a simple and practical link between: (i) the portfolio composition and risk profile of individual banks; (ii) the build-up of risk in the banking system; and (iii) cycles of credit growth, financial innovation and leverage in the broader economy. We also believe it is critically important to focus on the quality of capital, with common stock, retained earnings, and reserves for loan losses, being the predominant form of capital within the Tier 1 requirement.

The establishment of counter-cyclical capital buffers do present challenges, the most significant of which relate to international consistency and operational considerations. In normal cyclical downturns, there are clear differences in national economic cycles, with certain regions experiencing material deterioration in economic activity, while other regions are completely unaffected. In such an environment, it will be extremely difficult to balance the need for international consistency while reflecting differences in national economic cycles.

With respect to loan loss reserves, the FSB Report stated that earlier recognition of loan losses could have dampened cyclical moves in the current crisis. Under the current accounting requirements of an incurred loss model, a provision for loan losses is recognized only when a loss impairment event or events have taken place that are likely to result in nonpayment of a loan in the future. Earlier identification of credit losses is consistent both with financial statement users' needs for transparency regarding changes in credit trends and with prudential objectives of safety

[2] The FSB Report was developed as a result of collaborative work carried out by working groups composed of staff from: banking agencies from the U.S. and other jurisdictions; securities regulators from the U.S. and other jurisdictions; accounting standard setters; the Basel Committee on Banking Supervision; International Organization of Securities Commissions; and other organizations.

and soundness. To address this issue, the FSB Report set forth recommendations to accounting standard setters and the Basel Committee. Included in the Report was a recommendation to accounting standard setters to reconsider their current loan loss provisioning requirements and related disclosures.

The OCC and other Federal banking agencies continue to discuss these difficult issues within the Basel Committee and other international forums.

Q.14. Do you see any circumstances under which your agencies would take a position on the merits of counter-cyclical regulatory policy?

A.14. The OCC has actively participated in various efforts to assess and mitigate possible pro-cyclical effects of current accounting and regulatory capital regimes and I served as a chairperson of the FSB's Working Group on Provisioning discussed in the FSB Report discussed above. Consistent with recommendations in the FSB Report, I have publicly endorsed enhancements to existing provisions of regulatory capital rules and generally accepted accounting principles (GAAP) to address pro-cyclicality concerns.

Q.15. *G20 Summit and International Coordination*—Many foreign officials and analysts have said that they believe the upcoming G20 summit will endorse a set of principles agreed to by both the Financial Stability Forum and the Basel Committee, in addition to other government entities. There have also been calls from some countries to heavily re-regulate the financial sector, pool national sovereignty in key economic areas, and create powerful supranational regulatory institutions. (Examples are national bank resolution regimes, bank capital levels, and deposit insurance.) Your agencies are active participants in these international efforts.

What do you anticipate will be the result of the G20 summit?

A.15. The materials subsequent to the April 2, 2009, G20 Summit offer a constructive basis for a coordinated international response to the current economic crisis. The documents issued by the G20 working groups, especially Working Group 1: Enhancing Sound Regulation and Strengthening Transparency; and Working Group 2: Reinforcing International Cooperation and Promoting Integrity in Financial Markets, will be a particular focus of attention for the OCC and the other Federal banking agencies.

Q.16. Do you see any examples or areas where supranational regulation of financial services would be effective?

A.16. Issues uniquely related to the activities and operations of internationally active banking organizations compel a higher level of coordination among international supervisors. In fact, the Standards Implementation Group of the Basel Committee is designed to provide international supervisors a forum to discuss such issues and, to the extent possible, harmonize examination activities and supervisory policies related to those institutions.

Q.17. How far do you see your agencies pushing for or against such supranational initiatives?

A.17. The OCC is supportive of continued efforts to harmonize activities and policies related to the supervision of internationally active banks. The actions of the G20 and its working groups present

the opportunity to continue current dialogue with a broader array of jurisdictions. However, we are keenly aware of the need to protect U.S. sovereignty over the supervision of national banks, and will not delegate that responsibility.

Q.18. What steps has the OCC taken to promote the use of central counterparties for credit default swap transactions by national banks?

A.18. The OCC is an active participant in the Derivatives Infrastructure Project. One of the key accomplishments of this project is working with industry participants in developing a central counterparty solution for credit derivatives. Representatives from the OCC previously testified that credit derivatives risk mitigation is encouraged including the use of a central clearing party. The industry committed in its July 31, 2008, letter to use central clearing for eligible index, single name, and tranche index CDS where practicable. The industry renewed this commitment in October of 2008. Our ongoing supervision efforts continue to track the progress of this commitment in the institutions where the OCC is the primary supervisor. As a result, central clearinghouses have been established and central clearing of index trades began in March of this year.

The OCC granted national banks the legal authority to become members of a central clearing house for credit derivatives. The legal approval is also subject to stringent safety and soundness requirements to ensure banks can effectively manage and measure their exposures to central counterparties.

The OCC continues to work with market participants and other regulators on increasing the volume and types of credit derivatives cleared via a central counterparty. In a meeting on April 1 at the Federal Reserve Bank of New York, market participants discussed broadening the use of a central clearing party to include a wider range of firms and credit derivative products. Participants agreed to form an industry group to address challenges to achieving these objectives and associated issues surrounding initial margin segregation and portability. The industry will report back to regulators with plans on how to progress.

Q.19. What other classes of OTC derivatives are good candidates for central clearing and what steps is the OCC taking to encourage the development and use of central clearing counterparties?

A.19. The OCC believes that all types of OTC derivative products, including foreign exchange, interest rate, commodities, and equities, will have some contracts that are appropriate candidates for central clearing. The key to increasing the volume of centrally cleared derivatives is increasing product standardization. Some OTC derivatives products are more amenable to this standardization than others. Over time, a central question for policymakers will be the extent to which the risks of customized OTC derivatives products can be effectively managed off of centralized clearinghouses or exchanges, and whether the benefits exceed the risks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM JOHN C. DUGAN

Q.1. It is clear that our current regulatory structure is in need of reform. At my subcommittee hearing on risk management, March 18, 2009, GAO pointed out that regulators often did not move swiftly enough to address problems they had identified in the risk management systems of large, complex financial institutions.

My questions may be difficult, but please answer the following:

- If this lack of action is a persistent problem among the regulators, to what extent will changing the structure of our regulatory system really get at the issue?
- Along with changing the regulatory structure, how can Congress best ensure that regulators have clear responsibilities and authorities, and that they are accountable for exercising them "effectively and aggressively"?

A.1. As was discussed in Senior Deputy Comptroller Long's March 18th testimony before the Subcommittee on Securities, Insurance, and Investment, looking back on the events of the past two years, there are clearly things we may have done differently or sooner, but I do not believe our supervisory record indicates that there was a "lack of action" by the OCC. For example, we began alerting national banks to our concerns about increasingly liberal underwriting practices in certain loan products as early as 2003. Over the next few years, we progressively increased our scrutiny and responses, especially with regard to credit cards, residential mortgages, and commercial real estate loans even though the underlying "fundamentals" for these products and market segments were still robust. Throughout this period, our examiners were diligent in identifying risks and directing banks to take corrective action. Nonetheless, we and the industry initially underestimated the magnitude and severity of the disruptions that we have subsequently seen in the market and the rapidity at which these disruptions spilled over into the overall economy. In this regard, we concur with the GAO that regulators and large, complex banking institutions need to develop better stress test mechanisms that evaluate risks across the entire firm and that identify interconnected risks and potential tail events. We also agree that more transparency and capital is needed for certain off-balance sheet conduits and products that can amplify a bank's risk exposure.

While changes to our regulatory system are warranted—especially in the area of systemic risk—I do not believe that fundamental changes are required to the structure for conducting banking supervision.

Q.2. How do we overcome the problem that in the boom times no one wants to be the one stepping in to tell firms they have to limit their concentrations of risk or not trade certain risky products?

What thought has been put into overcoming this problem for regulators overseeing the firms? Is this an issue that can be addressed through regulatory restructure efforts?

A.2. A key issue for bankers and supervisors is determining when the accumulation of risks either within an individual firm or across the system has become too high, such that corrective or mitigating actions are needed. Knowing when and how to strike this balance

is one of the most difficult jobs that supervisors face. Taking action too quickly can constrain economic growth and impede access to credit by credit-worthy borrowers. Waiting too long can result in an overhang of risk becoming embedded into banks that can lead to failure and, in the marketplace, that can lead to the types of dislocations we have seen over the past year. This need to balance supervisory actions, I believe, is fundamental to bank supervision and is not an issue that can be addressed through regulatory restructure—the same issue will face whatever entity or agency is ultimately charged with supervision.

There are, however, actions that I believe we can and should take to help dampen some of the effects of business and economic cycles. First, as previously noted, I believe we need to insist that large institutions establish more rigorous and comprehensive stress tests that can identify risks that may be accumulating across various business and product lines. As we have seen, some senior bank managers thought they had avoided exposure to subprime residential mortgages by deliberately choosing not to originate such loans in the bank, only to find out after the fact that their investment banks affiliates had purchased subprime loans elsewhere. For smaller, community banks, we need to develop better screening mechanisms that we can use to help identify banks that are building up concentrations in a particular product line and where mitigating actions may be necessary. We have been doing just that for our smaller banks that may have significant commercial real estate exposures.

We also need to ensure that banks have the ability to strengthen their loan loss reserves at an appropriate time in the credit cycle, as their potential future loans losses are increasing. A more forward-looking "life of the loan" or "expected loss" concept would allow provisions to incorporate losses expected over a more realistic time horizon, and would not be limited to losses incurred as of the balance sheet date, as under the current regime. Such a revision would help to dampen the decidedly pro-cyclical effect that the current rules are having today. This is an issue that I am actively engaged in through my role as Chairman of the Financial Stability Board's Working Group on Provisioning.

Similarly, the Basel Committee on Bank Supervision recently announced an initiative to introduce standards that would promote the build up of capital buffers that can be drawn upon in periods of stress. Such a measure could also potentially serve as a buffer or governor to the build up of risk concentrations.

There are additional measures we could consider, such as establishing absolute limits on the concentration a bank could have to a particular industry or market segment, similar to the loan limits we currently have for loans to an individual borrower. The benefits of such actions would need to be carefully weighed against the potential costs this may impose. For example, such a regime could result in a *de facto* regulatory allocation of credit away from various industries or markets. Such limits could also have a disproportionate affect on smaller, community banks whose portfolios by their very nature, tend to be concentrated in their local communities and, often, particular market segments such as commercial real estate.

Q.3. As Mr. Tarullo and Mrs. Bair noted in their testimony, some financial institution failures emanated from institutions that were under federal regulation. While I agree that we need additional oversight over and information on unregulated financial institutions, I think we need to understand why so many regulated firms failed.

Why is it the case that so many regulated entities failed, and many still remain struggling, if our regulators in fact stand as a safety net to rein in dangerous amounts of risk-taking?

A.3. As alluded to in Governor Tarullo and Chairman Bair's testimonies, most of the prominent failures that have occurred and contributed to the current market disruption primarily involved systemically important firms that were not affiliated with an insured bank and were thus not overseen by the Federal Reserve or subject to the provisions of the Bank Holding Company Act. Although portions of these firms may have been subject to some form of oversight, they generally were not subject to the type or scope of consolidated supervision applied to banks and bank holding companies.

Nonetheless, large national banking companies clearly have not been immune to the problems we have seen over the past eighteen months and several have needed active supervisory intervention or the assistance of the capital and funding programs instituted by the U.S. Treasury, Federal Reserve, and FDIC. As I noted in my previous answer, prior to the recent market disruptions our examiners had been identifying risks and risk management practices that needed corrective action and were working with bank management teams to ensure that such actions were being implemented. We were also directing our large banks to shore up their capital levels and during the eight month period from October 2007 through early June 2008, the largest national banking companies increased their capital and debt levels through public and private offerings by over $100 billion.

I firmly believe that our actions that resulted in banks strengthening their underwriting standards, increasing their capital and reserves, and shoring up their liquidity were instrumental to the resilience that the national banking system as whole has shown during this period of unprecedented disruption in bank funding markets and significant credit losses. Indeed several of the largest national banks have served as a source of strength to the financial system by acquiring significant problem thrift institutions (*i.e.,* Countrywide and Washington Mutual) and broker-dealer operations (*i.e.,* Bear Stearns and Merrill Lynch). In addition, we worked to successfully resolve via acquisition by other national banks, two large national banks—National City and Wachovia—that faced severe funding pressures in the latter part of 2008. While both of these banks had adequate capital levels, they were unable to roll over their short term liabilities in the marketplace at a time when market perception and sentiment for many banking companies were under siege. Due to these funding pressures, both banks had to be taken over by companies with stronger capital and funding bases. As the breadth and depth of credit problems accelerated in late 2008, two other large banking companies, Citigroup and Bank of America, required additional financial assistance

through Treasury's Asset Guarantee and Targeted Investment programs to help stabilize their financial condition. As part of the broader Supervisory Capital Assessment Program that the OCC, Federal Reserve, and FDIC recently conducted on the largest recipients of funds under the Treasury's Troubled Assets Relief Program, we are closely monitoring the adequacy of these firms' capital levels to withstand further adverse economic conditions and will be requiring them to submit capital plans to ensure that they have sufficient capital to weather such conditions. In almost all cases, our large national banking organizations are on track to meet any identified capital needs and have been able to raise private capital through the marketplace, a sign that investor confidence may be returning to these institutions.

While the vast majority of national banks remain sound, many national banks will continue to face substantial credit losses as credit problems work through the banking system. In addition, until the capital and securitization markets are more fully restored, larger banks will continue to face potential liquidity pressures and funding constraints. As I have stated in previous testimonies, we do expect that the number of problem banks and bank failures will continue to increase for some time given current economic conditions. In problem bank situations, our efforts focus on developing a specific plan that takes into consideration the ability and willingness of management and the board to correct deficiencies in a timely manner and return the bank to a safe and sound condition. In most instances our efforts, coupled with the commitment of bank management, result in a successful rehabilitation of the bank. There will be cases, however, where the situation is of such significance that we will require the sale, merger, or liquidation of the bank, if possible. Where that is not possible, we will appoint the FDIC as receiver.

Q.4. While we know that certain hedge funds, for example, have failed, have any of them contributed to systemic risk?

A.4. The failure of certain hedge funds, while not by themselves systemically important (in contrast to the failure of Long Term Capital Management in 1998), led to a reduction in market liquidity as leveraged investors accelerated efforts to reduce exposures by selling assets. Given significant uncertainty over asset values, reflecting sharply reduced market liquidity, this unwinding of leveraged positions has put additional strains on the financial system and contributed to lack of investor confidence in the markets.

Q.5. Given that some of the federal banking regulators have examiners on-site at banks, how did they not identify some of these problems we are facing today?

A.5. At the outset, it is important to be clear that bank examiners do not have authority over the nonbank companies in a holding company. These nonbank firms were the source of many of the issues confronting large banking firms. With respect to banks, as noted above, we were identifying issues and taking actions to address problems that we were seeing in loan underwriting standards and other areas. At individual banks, we were directing banks to strengthen risk management and corporate governance practices and, at some institutions, were effecting changes in key managerial

positions. Nonetheless, in retrospect, it is clear that we should have been more aggressive in addressing some of the practices and risks that were building up across the banking system during this period. For example, it is clear that we and many bank managers put too much reliance on the various credit enhancements used to support certain collateralized debt obligations and not enough emphasis on the quality of, and correlations across, the underlying assets supporting those obligations. Similarly, we were not sufficiently attuned to the systemic risk implications of the significant migration by large banks to an "originate-to-distribute model" for commercial and leveraged loan products. Under this model, banks originated a significant volume of loans with the express purpose of packaging and selling them to institutional investors who generally were willing to accept more liberal underwriting standards than the banks themselves would accept, in return for marginally higher yields. In the fall of 2007, when the risk appetite of investors changed dramatically (and at times for reasons not directly related to the exposures they held), banks were left with significant pipelines of loans that they needed to fund, thus exacerbating their funding and capital pressures. As has been well-documented, similar pressures were leading to relaxation of underwriting standards within the residential mortgage loan markets. While the preponderance of the subprime and "Alt-A" loans that have been most problematic were originated outside of the national banking system, the subsequent downward spiral in housing prices that these practices triggered have clearly affected all financial institutions, including national banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOHN C. DUGAN

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of federal and state functional regulation for large, interconnected, and large firms like AIG?

A.1. The financial crisis has highlighted significant regulatory gaps in the oversight of our financial system. Large nonbank financial institutions like AIG, Fannie Mae and Freddie Mac, Bear Steams, and Lehman were subject to varying degrees and different kinds of government oversight. No one regulator had access to risk information from these nonbank firms in the same way that the Federal Reserve has with respect to bank holding companies. The result was that the risk these firms presented to the financial system as a whole could not be managed or controlled before their problems reached crisis proportions.

Assigning to one agency the oversight of systemic risk throughout the financial system could address certain of these regulatory gaps. For example, such an approach would fix accountability, centralize data collection, and facilitate a unified approach to identifying and addressing large risks across the system. However, a sin-

gle systemic regulator approach also would face challenges due to the diverse nature of the firms that could be labeled systemically significant. Key issues would include the type of authority that should be provided to the regulator; the types of financial firms that should be subject to its jurisdiction; and the nature of the new regulator's interaction with existing prudential supervisors. It would be important, for example, for the systemic regulatory function to build on existing prudential supervisory schemes, adding a systemic point of view, rather than replacing or duplicating regulation and supervisory oversight that already exists. How this would be done would need to be evaluated in light of other restructuring goals, including providing clear expectations for financial institutions and clear responsibilities and accountability for regulators; avoiding new regulatory inefficiencies; and considering the consequences of an undue concentration of responsibilities in a single regulator.

Moreover, the contours of new systemic authority may need to vary depending on the nature of the systemically significant entity. For example, prudential regulation of banks involves extensive requirements with respect to risk reporting, capital, activities limits, risk management, and enforcement. The systemic supervisor might not need to impose all such requirements on all types of systemically important firms. The ability to obtain risk information would be critical for all such firms, but it might not be necessary, for example, to impose the full array of prudential standards, such as capital requirements or activities limits on all types of systemically important firms, *e.g.,* hedge funds (assuming they were subject to the new regulator's jurisdiction). Conversely, firms like banks that are already subject to extensive prudential supervision would not need the same level of oversight as firms that are not—and if the systemic overseer were the Federal Reserve Board, very little new authority would be required with respect to banking companies, given the Board's current authority over bank holding companies.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. A number of options for regulatory reform have been put forward, including those mentioned in this question. Each raises many detailed issues.

The Treasury Blueprint offers a thoughtful approach to the realities of financial services regulation in the 21st century. In particular, the Blueprint's recommendation to establish a new federal charter for systemically significant payment and settlement systems and authorizing the Federal Reserve Board to supervise them is appropriate given the Board's extensive experience with payment system regulation.

The Group of 30 Report compares and analyzes the financial regulatory approaches of seventeen jurisdictions—including the United Kingdom, the United States and Australia—in order to illustrate the implications of the four principal models of supervisory oversight. The Group of 30 Report then sets forth 18 proposals for banks and nonbanks. For all countries, the Report recommends that bank supervision be consolidated under one prudential regulator. Under the proposals, banks that are deemed systemically important would face restrictions on high-risk proprietary activities. The report also calls for raising the level at which banks are considered to be well-capitalized, Proposals for nonbanks include regulatory oversight and the production or regular reports on leverage and performance. For banks and nonbanks alike, the Report calls for a more refined analysis of liquidity in stressed markets and more robust contingency planning.

The Financial Services Authority model is one in which all supervision is consolidated in one agency.

As debate on these and other proposals continues, the OCC believes two fundamental points are essential. First, it is important to preserve the Federal Reserve Board's role as a holding company supervisor. Second, it is equally if not more important to preserve the role of a dedicated, front-line prudential supervisor for our nation's banks.

The Financial Services Authority model raises the fundamental problem that consolidating all supervision in a new, single independent agency would take bank supervisory functions away from the Federal Reserve Board. As the central bank and closest agency we have to a systemic risk regulator, the Board needs the window it has into banking organizations that it derives from its role as bank holding company supervisor. Moreover, given its substantial role and direct experience with respect to capital markets, payments systems, the discount window, and international supervision, the Board provides unique resources and perspective to bank holding company supervision.

Second, and perhaps more important, is preserving the very real benefit of having an agency whose sole mission is bank supervision. The benefits of dedicated supervision are significant. Where it occurs, there is no confusion about the supervisor's goals and objectives, and no potential conflict with competing objectives. Responsibility is well defined, and so is accountability. Supervision does not take a back seat to any other part of the organization, and the result is a strong culture that fosters the development of the type of seasoned supervisors that are needed to confront the many challenges arising from today's banking business.

Q.3. If there are institutions that are too big to fail, how do we identify that? How do we define the circumstance where a single company is so systemically significant to the rest of our financial circumstances and our economy that we must not allow it to fail? We need to have a better idea of what this notion of too big to fail is—what it means in different aspects of our industry and what our proper response to it should be. How should the federal government approach large, multinational and systemically significant companies? What does "fail" mean? In the context of AIG, we are

talking about whether we should have allowed an orderly Chapter 11 bankruptcy proceeding to proceed. Is that failure?

A.3. There a number of ways "too big to fail" can be defined, including the size of an institution, assets under management, interrelationships or interconnections with other significant economic entities, or global reach. Likewise, "failure" could have several definitions, including bankruptcy. But whatever definition of these terms Congress may choose, it is important that there be an orderly process for resolving systemically significant firms.

U.S. law has long provided a unique and well developed framework for resolving distressed and failing banks that is distinct from the federal bankruptcy regime. Since 1991, this unique framework, contained in the Federal Deposit Insurance Act, has also provided a mechanism to address the problems that can arise with the potential failure of a systemically significant bank—including, if necessary to protect financial stability, the ability to use the bank deposit insurance fund to prevent uninsured depositors, creditors, and other stakeholders of the bank from sustaining loss.

No comparable framework exists for resolving most systemically significant financial firms that are not banks, including systemically significant holding companies of banks. Such firms must therefore use the normal bankruptcy process unless they can obtain some form of extraordinary government assistance to avoid the systemic risk that might ensue from failure or the lack of a timely and orderly resolution. While the bankruptcy process may be appropriate for resolution of certain types of firms, it may take too long to provide certainty in the resolution of a systemically significant firm, and it provides no source of funding for those situations where substantial resources are needed to accomplish an orderly solution.

This gap needs to be addressed with an explicit statutory regime for facilitating the resolution of systemically important nonbank companies as well as banks. This new statutory regime should provide tools that are similar to those currently available for resolving banks, including the ability to require certain actions to stabilize a firm; access to a significant funding source if needed to facilitate orderly dispositions, such as a significant line of credit from the Treasury; the ability to wind down a firm if necessary; and the flexibility to guarantee liabilities and provide open institution assistance if needed to avoid serious risk to the financial system. In addition, there should be clear criteria for determining which institutions would be subject to this resolution regime, and how to handle the foreign operations of such institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL FROM JOHN C. DUGAN

Q.1. Two approaches to systemic risk seem to be identified, (1) monitoring institutions and taking steps to reduce the size/activities of institutions that approach a "too large to fail" or "too systemically important to fail" or (2) impose an additional regulator and additional rules and market discipline on institutions that are considered systemically important. Which approach do you endorse?

A.1. The functions and authorities of a systemic risk regulator may need to differ depending on the nature of the systemically significant entity. Some types of firms, including banks, already are subject to federally imposed capital requirements, federal constraints on their activities, and the enforcement jurisdiction of a federal prudential regulator. These oversight functions should not be duplicated in the systemic supervisor. Doing so increases the potential for uncertainty about the standards to which firms will be held and for inconsistency between requirements administered by the primary and the systemic regulator.

In practice, the role of a systemic risk overseer may vary at different points in time depending on whether financial markets are functioning normally, or are instead experiencing unusual stress or disruption. For example, in a stable economic environment, the systemic risk regulator might focus most on obtaining and analyzing information about risks. Such additional information and analysis would be valuable not only for the systemic risk regulator, but also for prudential supervisors in terms of their understanding of firms' exposure to risks occurring in other parts of the financial services system to which they have no direct access. And it could facilitate the implementation of supervisory strategies to address and contain such risk before it increased to unmanageable levels. On the other hand, in times of stress or disruption it may be desirable for the systemic regulator to take actions to stabilize a firm or apply stricter than normal standards to aspects of its operations.

Q.2. Please identify all regulatory or legal barriers to the comprehensive sharing of information among regulators including insurance regulators, banking regulators, and investment banking regulators. Please share the steps that you are taking to improve the flow of communication among regulators within the current legislative environment.

A.2. At the federal level, no barriers to information sharing exist between federal banking regulators because the Federal Deposit Insurance Act, at 12 U.S.C. 1821t, provides that "a covered agency" does not waive any privilege when it transfers information or permits information to be used by a covered agency or any other agency of the federal government. A "covered agency" includes a federal banking agency, but not a state authority. This would also protect privilege when the OCC shares information with other federal agencies, such as the SEC, with which the OCC shares information pursuant to letter agreements in connection with the SEC's enforcement investigations and inspection functions.

In 1984, a joint statement of policy was issued by the OCC, FRB, FDIC, and the FHLBB that contained agreements relating to confidentiality safeguards that would be observed in connection with the sharing of certain categories of confidential supervisory information between those agencies. Presently, these and other protocols are observed in connection with the sharing of broader and other categories of supervisory information with other federal agencies that occurs pursuant to OCC's regulations or, as indicated above with respect to the SEC, written agreements or memoranda of understanding. It is crucial that the confidentiality of any information shared between federal and state authorities concerning

bank condition or personal consumer information be assured. The OCC has therefore entered into a number of agreements with various state regulators that govern the sharing, and protect the confidentiality, of information held by federal and state regulators:

- The OCC has entered into written sharing agreements or memoranda with 48 of the 50 states, the District of Columbia, and Puerto Rico. These documents, most of which were executed between 1987 and 1992, generally provide for the sharing of broad categories of information when needed for supervisory purposes.
- The OCC has executed a model Memorandum of Understanding with the Conference of State Bank Supervisors (CSBS) that is intended to facilitate the referral of customer complaints between the OCC and individual states, and to share information about the disposition of these complaints. As of December, 2008, this model agreement has served as the basis for information sharing agreements between the OCC and 44 states and Puerto Rico.
- In addition, the OCC has insurance information-sharing agreements with 49 States and the District of Columbia.
- The OCC has entered into many case specific agreements with states attorneys general in order to obtain information relevant to misconduct within the national banking system. We also encourage states attorneys general to refer complaints of misconduct by OCC regulated entities directly to the OCC's Customer Assistance Group. Finally, the OCC Customer Assistance Group refers consumer complaints that it receives with respect to State regulated entities to the appropriate state officials.
- The OCC exchanges information with state securities regulators on a case-by-case basis pursuant to letter agreements.

Moreover, the OCC has worked cooperatively with the states to address specific supervisory and consumer protection issues. For example, in the area of supervisory guidance, federal and state regulators have worked constructively in connection with implementation of the nontraditional mortgage and subprime mortgage guidance issued initially by the federal banking agencies.

More generally, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), the OCC actively participates in the development and implementation of uniform principles, standards, and report forms for the examination of financial institutions by the federal agencies who are members of the FFIEC, which include (in addition to the OCC) the Federal Reserve Board, the FDIC, the OTS, and the NCUA. In 2006, the Chair of the State Liaison Committee (SLC) was added to the FFIEC as a voting member. The SLC includes representatives of the Conference of State Bank Supervisors (CSBS), the American Council of State Savings Supervisors (ACSSS), and the National Association of State Credit Union Supervisors (NASCUS). Working through its Task Forces (such as the Task Force on Supervision and the Task Force on Compliance), the FFIEC also develops recommendations to promote uniformity in the supervision of financial institutions.

The OCC also participates in the President's Working Group on Financial Markets, a group composed of the Treasury Department, the Federal Reserve Board, the SEC, and the CFTC, which considers significant financial institutions' policy issues on an ongoing basis.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HUTCHISON FROM JOHN C. DUGAN

Q.1. Will each of you commit to do everything within your power to prevent performing loans from being called by lenders? Please outline the actions you plan to take.

A.1. The OCC has and will continue to encourage bankers to work with borrowers and to meet the credit needs of credit-worthy borrowers. Ultimately, however, the decision about whether to call a particular loan is a business decision that a banker must make. Such decisions must be based on the specific facts and circumstances of the bank, including its overall risk profile and its relationship with the borrower.

There has been a perception that examiners are requiring bankers to call or classify performing loans, resulting in what some have called a "performing nonperforming loan." Let me be clear, examiners do not tell bankers to call or renegotiate a loan, nor will they direct bankers to classify a loan or borrowers who have the demonstrated ability to service their debts under reasonable repayment schedules. In an effort to clarify how examiners approach this issue, it is important to define the term "performing loan." Some define performance as simply being contractually current on all principal and interest payments. In many cases this definition is sufficient for a particular credit relationship and accurately portrays the status of the loan. In other cases, however, being contractually current on payments can be a very misleading gauge of the credit risk embedded in the loan. This is especially the case where the loan's underwriting structure can mask credit weaknesses and obscure the fact that a borrower may be unable to meet the full terms of the loan. This phenomenon was vividly demonstrated in certain nontraditional rate residential mortgage products where a borrower may have been qualified at a low "teaser" rate or with interest-only payments, without regard as to whether they would be able to afford the loan once the rates or payments adjusted to a fully indexed rate or included principal repayments.

Analysis of payment performance must consider under what terms the performance has been achieved. For example, in many acquisition, development and construction loans for residential developments, it is common for the loans to be structured with what is referred to as an "interest reserve" for the initial phase of the project. These interest reserves are established as part of the initial loan proceeds at the time the loan is funded and provide funds for interest payments as lots are being developed, with repayment of principal occurring as each lot or parcel is sold and released. However, if the development project stalls for any number of reasons, the interest will continue to be paid from the initial interest reserve even though the project is not generating any cash flows to repay loan principal. In such cases, the loan will be contractually

current due to the interest payments being made from the reserves, but the repayment of principal is in jeopardy. We are seeing instances where projects such as these have completely stalled with lot sales significantly behind schedule or even nonexistent and the loan, including the interest reserve, is set to mature shortly. This is an example where a loan is contractually current, but is not performing as intended.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SHEILA C. BAIR

Q.1. *Consumer Protection Regulation*—Some have advocated that consumer protection and prudential supervision should be divorced, and that a separate consumer protection regulation regime should be created. They state that one source of the financial crisis emanated from the lack of consumer protection in the underwriting of loans in the originate-to-distribute space.

What are the merits of maintaining it in the same agency? Alternatively, what is the best argument each of you can make for a new consumer protection agency?

A.1. As I said in my testimony, there can no longer be any doubt about the link between protecting consumers from abusive products and practices and the safety and soundness of the financial system. Products and practices that strip individual and family wealth undermine the foundation of the economy. As the current crisis demonstrates, increasingly complex financial products combined with frequently opaque marketing and disclosure practices result in problems not just for consumers, but for institutions and investors as well.

To protect consumers from potentially harmful financial products, a case has been made for a new independent financial product safety commission. Certainly, more must be done to protect consumers. The FDIC could support the establishment of a new entity to establish consistent consumer protection standards for banks and nonbanks. However, we believe that such a body should include the perspective of bank regulators as well as nonbank enforcement officials such as the FTC. However, as Congress considers the options, we recommend that any new plan ensure that consumer protection activities are aligned and integrated with other bank supervisory information, resources, and expertise, and that enforcement of consumer protection rules for banks be left to bank regulators.

The current bank regulation and supervision structure allows the banking agencies to take a comprehensive view of financial institutions from both a consumer protection and safety-and-soundness perspective. Banking agencies' assessments of risks to consumers are closely linked with and informed by a broader understanding of other risks in financial institutions. Conversely, assessments of other risks, including safety and soundness, benefit from knowledge of basic principles, trends, and emerging issues related to consumer protection. Separating consumer protection regulation and supervision into different organizations would reduce information that is necessary for both entities to effectively perform their functions. Separating consumer protection from safety and soundness

would result in similar problems. Our experience suggests that the development of policy must be closely coordinated and reflect a broad understanding of institutions' management, operations, policies, and practices—and the bank supervisory process as a whole.

One of the fundamental principles of the FDIC's mission is to serve as an independent agency focused on maintaining consumer confidence in the banking system. The FDIC plays a unique role as deposit insurer, federal supervisor of state nonmember banks and savings institutions, and receiver for failed depository institutions. These functions contribute to the overall stability of and consumer confidence in the banking industry. With this mission in mind, if given additional rulemaking authority, the FDIC is prepared to take on an expanded role in providing consumers with stronger protections that address products posing unacceptable risks to consumers and eliminate gaps in oversight.

Q.2. *Regulatory Gaps or Omissions*—During a recent hearing, the Committee has heard about massive regulatory gaps in the system. These gaps allowed unscrupulous actors like AIG to exploit the lack of regulatory oversight. Some of the counterparties that AIG did business with were institutions under your supervision.

Why didn't your risk management oversight of the AIG counterparties trigger further regulatory scrutiny? Was there a flawed assumption that AIG was adequately regulated, and therefore no further scrutiny was necessary?

A.2. The FDIC did not have supervisory authority over AIG. However, to protect taxpayers the FDIC recommends that a new resolution regime be created to handle the failure of large nonbanks such as AIG. This special receivership process should be outside bankruptcy and be patterned after the process we use for bank and thrift failures.

Q.3. Was there dialogue between the banking regulators and the state insurance regulators? What about the SEC?

A.3. The FDIC did not have supervisory authority for AIG and did not engage in discussions regarding the entity. However, the need for improved interagency communication demonstrates that the reform of the regulatory structure also should include the creation of a systemic risk council (SRC) to address issues that pose risks to the broader financial system. The SRC would be responsible for identifying institutions, practices, and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, completing analyses and making recommendations on potential systemic risks, setting capital and other standards and ensuring that the key supervisors with responsibility for direct supervision apply those standards. The macroprudential 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.

Q.4. If the credit default swap contracts at the heart of this problem had been traded on an exchange or cleared through a clearinghouse, with requirement for collateral and margin payments, what

additional information would have been available? How would you have used it?

A.4. As with other exchange traded instruments, by moving the contracts onto an exchange or central counterparty, the overall risk to any counterparty and to the system as a whole would have been greatly reduced. The posting of daily variance margin and the mutuality of the exchange as the counterparty to market participants would almost certainly have limited the potential losses to any of AIG's counterparties.

For exchange traded contracts, counterparty credit risk, that is, the risk of a counterparty not performing on the obligation, would be substantially less than for bilateral OTC contracts. That is because the exchange becomes the counterparty for each trade.

The migration to exchanges or central clearinghouses of credit default swaps and OTC derivatives in general should be encouraged and perhaps required. The opacity of CDS risks contributed to significant concerns about the transmission of problems with a single credit across the financial system. Moreover, the customized mark to model values associated with OTC derivatives may encourage managements to be overly optimistic in valuing these products during economic expansions, setting up the potential for abrupt and destabilizing reversals.

The FDIC or other regulators could use better information derived from exchanges or clearinghouses to analyze both individual and systemic risk profiles. For those contracts which are not standardized, we urge complete reporting of information to trade repositories so that information would be available to regulators. With additional information, regulators may better analyze and ascertain concentrated risks to the market participants. This is particularly true for large counterparty exposures that may have systemic ramifications if the contracts are not well collateralized among counterparties.

Q.5. *Liquidity Management*—A problem confronting many financial institutions currently experiencing distress is the need to roll-over short-term sources of funding. Essentially these banks are facing a shortage of liquidity. I believe this difficulty is inherent in any system that funds long-term assets, such as mortgages, with short-term funds. Basically the harm from a decline in liquidity is amplified by a bank's level of "maturity-mismatch."

I would like to ask each of the witnesses, should regulators try to minimize the level of a bank's maturity-mismatch? And if so, what tools would a bank regulator use to do so?

A.5. The funding of illiquid assets, whose cash flows are realized over time and with uncertainty, with shorter-maturity volatile or credit sensitive funding, is at the heart of the liquidity problems facing some financial institutions. If a regulator determines that a bank is assuming amounts of liquidity risk that are excessive relative to its capital structure, then the regulator should require the bank to address this issue.

In recognition of the significant role that liquidity risks have played during this crisis, regulators the world over are considering ways to enhance supervisory approaches. There is better recognition of the need for banks to have an adequate cushion of liquid

assets, supported by *pro forma* cash flow analysis under stressful scenarios, well diversified and tested funding sources, and a liquidity contingency plan. The FDIC issued supervisory guidance on liquidity risk in August of 2008.

Q.6. *Too-Big-To-Fail*—Chairman Bair stated in her written testimony that "the most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of those institutions similar to that which exists for FDIC-insured banks. In short we need to end too big to fail. I would agree that we need to address the too-big-to-fail issue, both for banks and other financial institutions."

Could each of you tell us whether putting a new resolution regime in place would address this issue?

A.6. There are three key elements to addressing the problem of systemic risk and too big to fail.

First, 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 assessments on institutions and their activities would act as disincentives to the types of growth and complexity that raise systemic concerns.

The second important element in addressing too big to fail is an enhanced structure for the supervision of systemically important institutions. This structure should include both the direct supervision of systemically significant financial firms and the oversight of developing risks that may pose risks to the overall U.S. financial system. Centralizing the responsibility for supervising these institutions in a single systemic risk regulator would bring clarity and accountability to the efforts needed to identify and mitigate the buildup of risk at individual institutions. In addition, a systemic risk council could be created to address issues that pose risks to the broader financial system by identifying cross-cutting practices, and products that create potential systemic risks.

The third element to address systemic risk is the establishment of a legal mechanism for quick and orderly resolution of these institutions similar to what we use for FDIC insured banks. The purpose of the resolution authority should not be to prop up a failed entity indefinitely or to insure all liabilities, but to permit a timely and orderly resolution and the absorption of assets by the private sector as quickly as possible. Done correctly, the effect of the resolution authority will be to increase market discipline and protect taxpayers.

Q.7. How would we be able to convince the market that these systemically important institutions would not be protected by taxpayer resources as they had been in the past?

A.7. Given the long history of government bailouts for economically and systemically important firms, it will be extremely difficult to convince market participants that current practices have changed. Still, it is critical that we dispel the presumption that some institutions are "too big to fail."

As outlined in my testimony, it is imperative that we undertake regulatory and legislative reforms that force TBTF institutions to internalize the social costs of bailouts and put shareholders, creditors, and managers at real risk of loss. Capital and other requirements should be put in place to provide disincentives for institutions to become too large or complex. This must be linked with a legal mechanism for the orderly resolution of systemically important nonbank financial firms—a mechanism similar to that which currently exists for FDIC-insured depository institutions.

Q.8. *Pro-Cyclicality*—I have some concerns about the pro-cyclical nature of our present system of accounting and bank capital regulation. Some commentators have endorsed a concept requiring banks to hold more capital when good conditions prevail, and then allow banks to temporarily hold less capital in order not to restrict access to credit during a downturn. Advocates of this system believe that counter cyclical policies could reduce imbalances within financial markets and smooth the credit cycle itself.

What do you see as the costs and benefits of adopting a more counter-cyclical system of regulation?

A.8. The FDIC would be supportive of a capital and accounting framework for insured depository institutions that avoids the unintended pro-cyclical outcomes we have experienced in the current crisis. Capital and other appropriate buffers should be built up during more benign parts of the economic cycle so that they are available during more stressed periods. The FDIC firmly believes that financial statements should present an accurate depiction of an institution's capital position, and we strongly advocate robust capital levels during both prosperous and adverse economic cycles. Some features of existing capital regimes, and certainly the Basel II Advanced Approaches, lead to reduced capital requirements during good times and increased capital requirements during more difficult economic periods. Some part of capital should be risk sensitive, but it must serve as a cushion throughout the economic cycle. We believe a minimum leverage capital ratio is a critical aspect of our regulatory process as it provides a buffer against unexpected losses and the vagaries of models-based approaches to assessing capital adequacy.

Adoption of banking guidelines that mitigate the effects of pro-cyclicality could potentially lessen the government's financial risk arising from the various federal safety nets. In addition, they would help financial institutions remain sufficiently reserved against loan losses and adequately capitalized during good and bad times. In addition, some believe that counter-cyclical approaches would moderate the severity of swings in the economic cycle as banks would have to set aside more capital and reserves for lending, and thus take on less risk during economic expansions.

Q.9. Do you see any circumstances under which your agencies would take a position on the merits of counter-cyclical regulatory policy?

A.9. The FDIC would be supportive of a capital and accounting framework for insured depository institutions that avoids the unintended pro-cyclical outcomes we have experienced in the current crisis. Again, we are strongly supportive of robust capital standards

for banks and thrifts as well as conservative accounting guidelines which accurately represent the financial position of insured institutions.

Q.10. *G20 Summit and International Coordination*—Many foreign officials and analysts have said that they believe the upcoming G20 summit will endorse a set of principles agreed to by both the Financial Stability Forum and the Basel Committee, in addition to other government entities. There have also been calls from some countries to heavily re-regulate the financial sector, pool national sovereignty in key economic areas, and create powerful supranational regulatory institutions. (Examples are national bank resolution regimes, bank capital levels, and deposit insurance.) Your agencies are active participants in these international efforts.

What do you anticipate will be the result of the G20 summit?

A.10. The G20 summit communique addressed a long list of principles and actions that were originally presented in the so-called Washington Action Plan. The communique provided a full progress report on each of the 47 actions in that plan. The major reforms included expansion and enhancement of the Financial Stability Board (formerly the Financial Stability Forum). The FSB will continue to assess the state of the financial system and promote coordination among the various financial authorities. To promote international cooperation, the G20 countries also agreed to establish supervisory colleges for significant cross-border firms, implement cross-border crisis management, and launch an Early Warning Exercise with the IMF. To strengthen prudent financial regulation, the G20 endorsed a supplemental nonrisk based measure of capital adequacy to complement the risk-based capital measures, incentives for improving risk management of securitizations, stronger liquidity buffers, regulation and oversight of systemically important financial institutions, and a broad range of compensation, tax haven, and accounting provisions.

Q.11. Do you see any examples or areas where supranational regulation of financial services would be effective?

A.11. If we are to restore financial health across the globe and be better prepared for the next global financial situation, we must develop a sound basis of financial regulation both in the U.S. and internationally. This is particularly important in the area of cross-border resolutions of systemically important financial institutions. Fundamentally, the focus must be on reforms of national policies and laws in each country. Among the important requirements in many laws are on-site examinations, a leverage ratio as part of the capital regime, an early intervention system like prompt corrective action, more flexible resolution powers, and a process for dealing with troubled financial companies. This last reform also is needed in this country. However, we do not see any appetite for supranational financial regulation of financial services among the G20 countries at this time.

Q.12. How far do you see your agencies pushing for or against such supranational initiatives?

A.12. At this time and until the current financial situation is resolved, I believe the FDIC should focus its efforts on promoting an

international leverage ratio, minimizing the pro-cyclicality of the Basel II capital standards, cross-border resolutions, and other initiatives that the Basel Committee is undertaking. In the short run, achieving international cooperation on these issues will require our full attention.

Q.13. *Regulatory Reform*—Chairman Bair, Mr. Tarullo noted in his testimony the difficulty of crafting a workable resolution regime and developing an effective systemic risk regulation scheme.

Are you concerned that there could be unintended consequences if we do not proceed with due care?

A.13. Once the government formally appoints a systemic risk regulator (SRR), market participants may assume that the likelihood of systemic events will be diminished going forward. By explicitly accepting the task of ensuring financial sector stability and appointing an agency responsible for discharging this duty, the government could create expectations that weaken market discipline. Private sector market participants may incorrectly discount the possibility of sector-wide disturbances. Market participants may avoid expending private resources to safeguard their capital positions or arrive at distorted valuations in part because they assume (correctly or incorrectly) that the SRR will reduce the probability of sector-wide losses or other extreme events. In short, the government may risk increasing moral hazard in the financial system unless an appropriate system of supervision and regulation is in place. Such a system must anticipate and mitigate private sector incentives to attempt to profit from this new form of government oversight and protection at the expense of taxpayers.

When establishing a SRR, it is also important for the government to manage expectations. Few if any existing systemic risk monitors were successful in identifying financial sector risks prior to the current crisis. Central banks have, for some time now, acted as systemic risk monitors and few if any institutions anticipated the magnitude of the current crisis or the risk exposure concentrations that have been revealed. Regulators and central banks have mostly had to catch up with unfolding events with very little warning about impending firm and financial market failures.

The need for and duties of a SRR can be reduced if we alter supervision and regulation in a manner that discourages firms from forming institutions that are systemically important or too-big-to fail. Instead of relying on a powerful SSR, we need instead to develop a "fail-safe" system where the failure of any one large institution will not cause the financial system to break down. In order to move in this direction, we need to create disincentives that limit the size and complexity of institutions whose failure would otherwise pose a systemic risk.

In addition, the reform of the regulatory structure also should include the creation of a systemic risk council (SRC) to address issues that pose risks to the broader financial system. The SRC would be responsible for identifying institutions, practices, and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, completing analyses and making recommendations on potential systemic risks, setting capital and other standards and ensuring that the key super-

visors with responsibility for direct supervision apply those standards. 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.

It also is essential that these reforms be time to the establishment of a legal mechanism for quick and orderly resolution of these institutions similar to what we use for FDIC insured banks. The purpose of the resolution authority should not be to prop up a failed entity indefinitely or to insure all liabilities, but to permit a timely and orderly resolution and the absorption of assets by the private sector as quickly as possible. Done correctly, the effect of the resolution authority will be to increase market discipline and protect taxpayers.

Q.14. *Credit Rating Agencies*—Ms. Bair, you note the role of the regulatory framework, including capital requirements, in encouraging blind reliance on credit ratings. You recommend pre-conditioning ratings based capital requirements on wide availability of the underlying data.

Wouldn't the most effective approach be to take ratings out of the regulatory framework entirely?

A.14. We need to consider a range of options for prospective capital requirements based on the lessons we are learning from the current crisis. Data from credit rating agencies can be a valuable component of a credit risk assessment process, but capital and risk management should not rely on credit ratings. This issue will need to be explored further as regulatory capital guidelines are considered.

Q.15. *Systemic Regulator*—Ms. Bair, you observed that many of the failures in this crisis were failures of regulators to use authority that they had.

In light of this, do you believe layering a systemic risk regulator on top of the existing regime is the optimal way to proceed with regulatory restructuring?

A.15. A distinction should be drawn between the direct supervision of systemically significant financial firms and the macro-prudential oversight of developing risks that may pose systemic risks to the U.S. financial system. The former appropriately calls for a single regulator for the largest, most systemically significant firms, including large bank holding companies. 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 would suggest creation of a systemic risk council (SRC) to provide analytical support, develop needed prudential policies, and have the power to mitigate developing risks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM SHEILA C. BAIR

Q.1.a. It is clear that our current regulatory structure is in need of reform. At my subcommittee hearing on risk management, March 18, 2009, GAO pointed out that regulators often did not move swiftly enough to address problems they had identified in the risk management systems of large, complex financial institutions.

Chair Bair's written testimony for today's hearing put it very well: " . . . the success of any effort at reform will ultimately rely on the willingness of regulators to use their authorities more effectively and aggressively."

My questions may be difficult, but please answer the following:

If this lack of action is a persistent problem among the regulators, to what extent will changing the structure of our regulatory system really get at the issue?

A.1.a. It is unclear whether a change in the U.S. regulatory structure would have made a difference in mitigating the outcomes of this crisis. Countries that rely on a single financial regulatory body are experiencing the same financial stress the U.S. is facing now. Therefore, it is not certain that a single powerful federal regulator would have acted aggressively to restrain risk taking during the years leading up to the crisis.

For this reason, the reform of the regulatory structure also should include the creation of a systemic risk council (SRC) to address issues that pose risks to the broader financial system. The SRC would be responsible for identifying institutions, practices, and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, completing analyses and making recommendations on potential systemic risks, setting capital and other standards and ensuring that the key supervisors with responsibility for direct supervision apply those standards. 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.

In the long run it is important to develop a "fail-safe" system where the failure of any one large institution will not cause the financial system to break down-that is, a system where firms are not systemically large and are not too-big-to fail. In order to move in this direction, we need to create incentives that limit the size and complexity of institutions whose failure would otherwise pose a systemic risk.

Finally, a key element to address systemic risk is the establishment of a legal mechanism for quick and orderly resolution of these institutions similar to what we use for FDIC insured banks. The purpose of the resolution authority should not be to prop up a failed entity indefinitely or to insure all liabilities, but to permit a timely and orderly resolution and the absorption of assets by the private sector as quickly as possible. Done correctly, the effect of the resolution authority will be to increase market discipline and protect taxpayers.

Q.1.b. Along with changing the regulatory structure, how can Congress best ensure that regulators have clear responsibilities and authorities, and that they are accountable for exercising them "effectively and aggressively"?

A.1.b. History shows that banking supervisors are reluctant to impose wholesale restrictions on bank behavior when banks are making substantial profits. Regulatory reactions to safety and soundness risks are often delayed until actual bank losses emerge from the practices at issue. While financial theory suggests that above average profits are a signal that banks have been taking above average risk, bankers often argue otherwise and regulators are all too often reluctant to prohibit profitable activities, especially if the activities are widespread in the banking system and do not have a history of generating losses. Supervision and regulation must become more proactive and supervisors must develop the capacity to intervene before significant losses are realized.

In order to encourage proactive supervision, Congress could require semi-annual hearings in which the various regulatory agencies are required to: (1) report on the condition of their supervised institutions; (2) comment on the sustainability of the most profitable business lines of their regulated entities; (3) outline emerging issues that may engender safety and soundness concerns within the next three years; (4) discuss specific weaknesses or gaps in regulatory authorities that are a source of regulatory concern and, when appropriate, propose legislation to attenuate safety and soundness issues. This requirement for semi-annual testimony on the state of regulated financial institutions is similar in concept to the Humphrey-Hawkins testimony requirement on Federal Reserve Board monetary policy.

Q.2.a. How do we overcome the problem that in the boom times no one wants to be the one stepping in to tell firms they have to limit their concentrations of risk or not trade certain risky products?

What thought has been put into overcoming this problem for regulators overseeing the firms?

A.2.a. During good times and bad, regulators must strike a balance between encouraging prudent innovation and strong bank supervision. Without stifling innovation, we need to ensure that banks engage in new activities in a safe-and-sound manner and originate responsible loans using prudent underwriting standards and loan terms that borrowers can reasonably understand and have the capacity to repay.

Going forward, the regulatory agencies should be more aggressive in good economic times to contain risk at institutions with high levels of credit concentrations, particularly in novel or untested loan products. Increased examination oversight of institutions exhibiting higher-risk characteristics is needed in an expanding economy, and regulators should have the staff expertise and resources to vigilantly conduct their work.

Q.2.b. Is this an issue that can be addressed through regulatory restructure efforts?

A.2.b. Reforming the existing regulatory structure will not directly solve the supervision of risk concentration issues going forward, but may play a role in focusing supervisory attention on areas of

emerging risk. For example, a more focused regulatory approach that integrates the supervision of traditional banking operations with capital markets business lines supervised by a nonbanking regulatory agency will help to address risk across the entire banking company.

Q.3.a. As Mr. Tarullo and Mrs. Bair noted in their testimony, some financial institution failures emanated from institutions that were under federal regulation. While I agree that we need additional oversight over and information on unregulated financial institutions, I think we need to understand why so many regulated firms failed.

Why is it the case that so many regulated entities failed, and many still remain struggling, if our regulators in fact stand as a safety net to rein in dangerous amounts of risk-taking?

A.3.a. Since 2007, the failure of community banking institutions was caused in large part by deterioration in the real estate market which led to credit losses and a rapid decline in capital positions. The causes of such failures are consistent with our receivership experience in past crises, and some level of failures is not totally unexpected with the downturn in the economic cycle. We believe the regulatory environment in the U.S. and the implementation of federal financial stability programs has actually prevented more failures from occurring and will assist weakened banks in ultimately recovering from current conditions. Nevertheless, the bank regulatory agencies should have been more aggressive earlier in this decade in dealing with institutions with outsized real estate loan concentrations and exposures to certain financial products.

For the larger institutions that failed, unprecedented changes in market liquidity had a significant negative effect on their ability to fund day-to-day operations as the securitization and inter-bank lending markets froze. The rapidity of these liquidity related failures was without precedent and will require a more robust regulatory focus on large bank liquidity going forward.

Q.3.b. While we know that certain hedge funds, for example, have failed, have any of them contributed to systemic risk?

A.3.b. Although hedge funds are not regulated by the FDIC, they can comprise large asset pools, are in many cases highly leveraged, and are not subject to registration or reporting requirements. The opacity of these entities can fuel market concern and uncertainty about their activities. In times of stress these entities are subject to heightened redemption requests, requiring them to sell assets into distressed markets and compounding downward pressure on asset values.

Q.3.c. Given that some of the federal banking regulators have examiners on-site at banks, how did they not identify some of these problems we are facing today?

A.3.c. As stated above, the bank regulatory agencies should have been more aggressive earlier in this decade in dealing with institutions with outsized real estate loan concentrations and exposures to certain financial products. Although the federal banking agencies identified concentrations of risk and a relaxation of underwriting standards through the supervisory process, we could have

been more aggressive in our regulatory response to limiting banks' risk exposures.

Q.4.a. From your perspective, how dangerous is the "too big to fail" doctrine and how might it be addressed?

Is it correct that deposit limits have been in place to avoid monopolies and limit risk concentration for banks?

A.4.a. While there is no formal "too big to fail" (TBTF) doctrine, some financial institutions have proven to be too large to be resolved within our traditional resolution framework. Many argued that creating very large financial institutions that could take advantage of modem risk management techniques and product and geographic diversification would generate high enough returns to assure the solvency of the firm, even in the face of large losses. The events of the past year have convincingly proven that this assumption was incorrect and is why the FDIC has recommended the establishment of resolution authority to handle the failure of large financial firms. There are three key elements to addressing the problem of systemic risk and too big to fail.

First, 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 assessments on institutions and their activities would act as disincentives to the types of growth and complexity that raise systemic concerns.

The second important element in addressing too big to fail is an enhanced structure for the supervision of systemically important institutions. This structure should include both the direct supervision of systemically significant financial firms and the oversight of developing risks that may pose risks to the overall U.S. financial system. Centralizing the responsibility for supervising these institutions in a single systemic risk regulator would bring clarity and accountability to the efforts needed to identify and mitigate the buildup of risk at individual institutions. In addition, a systemic risk council could be created to address issues that pose risks to the broader financial system by identifying cross-cutting practices, and products that create potential systemic risks.

The third element to address systemic risk is the establishment of a legal mechanism for quick and orderly resolution of these institutions similar to what we use for FDIC insured banks. The purpose of the resolution authority should not be to prop up a failed entity indefinitely or to insure all liabilities, but to permit a timely and orderly resolution and the absorption of assets by the private sector as quickly as possible. Done correctly, the effect of the resolution authority will be to increase market discipline and protect taxpayers.

With regard to statutory limits on deposits, there is a 10 percent nationwide cap on domestic deposits imposed in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. While this regulatory limitation has been somewhat effective in preventing concentration in the U.S. system, the Riegle-Neal constraints have some significant limitations. First, these limits only apply to interstate bank mergers. Also, deposits in savings and

loan institutions generally are not counted against legal limits. In addition, the law restricts only domestic deposit concentration and is silent on asset concentration, risk concentration or product concentration. The four largest banking organizations have slightly less than 35 percent of the domestic deposit market, but have over 45 percent of total industry assets. As we have seen, even with these deposit limits, banking organizations have become so large and interconnected that the failure of even one can threaten the financial system.

Q.4.b. Might it be the case that for financial institutions that fund themselves less by deposits and more by capital markets activities that they should be subject to concentration limits in certain activities? Would this potentially address the problem of too big to fail?

A.4.b. A key element in addressing TBTF would be legislative and regulatory initiatives that are designed to force firms to internalize the costs of government safety-net benefits and other potential costs to society. Firms should face additional capital charges based on both size and complexity, higher deposit insurance related premiums or systemic risk surcharges, and be subject to tighter Prompt Corrective Action (PCA) limits under U.S. laws.

In addition, we need to end investors' perception that TBTF continues to exist. This can only be accomplished by convincing the institutions (their management, their shareholders, and their creditors) that they are at risk of loss should the institution become insolvent. Although limiting concentrations of risky activities might lower the risk of insolvency, it would not change the presumption that a government bailout would be forthcoming to protect creditors from losses in a bankruptcy proceeding.

An urgent priority in addressing the TBTF problem is the establishment of a special resolution regime for nonbank financial institutions and for financial and bank holding companies—with powers similar to those given to the FDIC for resolving insured depository institutions. The FDIC's authority to act as receiver and to set up a bridge bank to maintain key functions and sell assets as market conditions allow offers a good model for such a regime. A temporary bridge bank allows the government time to prevent a disorderly collapse by preserving systemically critical functions. It also enables losses to be imposed on market players who should appropriately bear the risk.

Q.5. It appears that there were major problems with these risk management systems, as I heard in GAO testimony at my subcommittee hearing on March 18, 2009, so what gave the Fed the impression that the models were ready enough to be the primary measure for bank capital?

A.5. Throughout the development and implementation of Basel II, large U.S. commercial and investment banks touted their sophisticated systems for measuring and managing risks, and urged regulators to align regulatory capital requirements with banks' own risk measurements. The FDIC consistently expressed concerns that the U.S. and international regulatory communities collectively were putting too much reliance on financial institutions' representations about the quality of their risk measurement and management systems.

Q.6. Moreover, how can the regulators know what "adequately capitalized" means if regulators rely on models that we now know had material problems?

A.6. The FDIC has had long-standing concerns with Basel II's reliance on model-based capital standards. If Basel II had been implemented prior to the recent financial crisis, we believe capital requirements at large institutions would have been far lower going into the crisis and our financial system would have been worse off as a result. Regulators are working internationally to address some weaknesses in the Basel II capital standards and the Basel Committee has announced its intention to develop a supplementary capital requirement to complement the risk based requirements.

Q.7. Can you tell us what main changes need to be made in the Basel II framework so that it effectively calculates risk? Should it be used in conjunction with a leverage ratio of some kind?

A.7. The Basel II framework provides a far too pro-cyclical capital approach. It is now clear that the risk mitigation benefits of modeling, diversification and risk management were overestimated when Basel II was designed to set minimum regulatory capital requirements for large, complex financial institutions. Capital must be a solid buffer against unexpected losses, while modeling by its very nature tends to reflect expectations of losses looking back over relatively recent experience.

- The risk-based approach to capital adequacy in the Basel II framework should be supplemented with an international leverage ratio. Regulators should judge the capital adequacy of banks by applying a leverage ratio that takes into account off-balance-sheet assets and conduits as if these risks were on-balance-sheet.
- Institutions should be required to hold more capital through the cycle and we should require better quality capital. Risk-based capital requirements should not fall so dramatically during economic expansions only to increase rapidly during a downturn.

The Basel Committee is working on both of these concepts as well as undertaking a number of initiatives to improve the quality and level of capital. That being said, however, the Committee and the U.S. banking agencies do not intend to increase capital requirements in the midst of the current crisis. The plan is to develop proposals and implement these when the time is right, so that the banking system will have a capital base that is more robust in future times of stress.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM SHEILA C. BAIR

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need

to reevaluate the weaknesses of federal and state functional regulation for large, interconnected, and large firms like AIG?

A.1. The activities that caused distress for AIG were primarily those related to its credit default swap (CDS) and securities lending businesses. The issue of lack of regulation of the credit derivatives market had been debated extensively in policy circles since the late 1990s. The recommendations contained in the 1999 study by the President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," were largely adopted in the Commodity Futures Modernization Act of 2000, where credit derivatives contracts were exempted from CFTC and SEC regulations other than those related to SEC antifraud provisions. As a consequence of the exclusions and environment created by these legislative changes, there were no major coordinated U.S. regulatory efforts undertaken to monitor CDS trading and exposure concentrations outside of the safety and soundness monitoring that was undertaken on an intuitional level by the primary or holding company supervisory authorities.

AIG chartered AIG Federal Savings Bank in 1999, an OTS supervised institution. In order to meet European Union (EU) Directives that require all financial institutions operating in the EU to be subject to consolidated supervision, the OTS became AIG's consolidated supervisor and was recognized as such by the Bank of France on February 23, 2007 (the Bank of France is the EU supervisor with oversight responsibility for AIG's EU operations). In its capacity as consolidated supervisor of AIG, the OTS had the authority and responsibility to evaluate AIG's CDS and securities lending businesses. Even though the OTS had supervisory responsibility for AIG's consolidated operations, the OTS was not organized or staffed in a manner that provided the resources necessary to evaluate the risks underwritten by AIG.

The supervision of AIG demonstrates that reliance solely on the supervision of these institutions is not enough. We also need a "fail-safe" system where if any one large institution fails, the system carries on without breaking down. 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 addition to establishing disincentives to unchecked growth and increased complexity of institutions, two additional fundamental approaches could reduce the likelihood that an institution will be too big to fail. One action is to create or designate a supervisory framework for regulating systemic risk. Another critical aspect to ending too big to fail is to establish a comprehensive resolution authority for systemically significant financial companies that makes the failure of any systemically important institution both credible and feasible.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move

away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. 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, the supervisory structure should include both the direct supervision of systemically significant financial firms and the oversight of developing risks that may pose risks to the overall U.S. financial system. Effective institution specific supervision is needed by functional regulators focused on safety and soundness as well as consumer protection. Finally, there should be a legal mechanism for quick and orderly resolution of these institutions similar to what we use for FDIC insured banks.

Whatever the approach to regulation and supervision, any system must be designed to facilitate coordination and communication among supervisory agencies and the relevant safety-net participants.

In response to your question:

Single Consolidated Regulator. This approach regulates and supervises a total financial organization. It designates a single supervisor to examine all of an organization's operations. Ideally, it must appreciate how the integrated organization works and bring a unified regulatory focus to the financial organization. The supervisor can evaluate risk across product lines and assess the adequacy of capital and operational systems that support the organization as a whole. Integrated supervisory and enforcement actions can be taken, which will allow supervisors to address problems affecting several different product lines. If there is a single consolidated regulator, the potential for overlap and duplication of supervision and regulation is reduced with fewer burdens for the organization and less opportunity for regulatory arbitrage. By centralizing supervisory authority over all subsidiaries and affiliates that comprise a financial organization, the single consolidated regulator model should increase regulatory and supervisory efficiency (for example through economies of scale) and accountability.

With regard to disadvantages, a financial system characterized by a handful of giant institutions with global reach and a single regulator is making a huge bet that those few banks and their regulator over a long period of time will always make the right decisions at the right time. Another disadvantage is the potential for an unwieldy structure and a very cumbersome and bureaucratic organization. It may work best in financial systems with few financial organizations. Especially in larger systems, it may create the risk of a single point of regulatory failure.

The U.S. has consolidated supervision, but individual components of financial conglomerates are supervised by more than one supervisor. For example, the Federal Reserve functions as the con-

solidated supervisor for bank holding companies, but in most cases it does not supervise the activities of the primary depository institutions. Similarly, the Securities and Exchange was the consolidated supervisor for many internationally active investment banking groups, but these institutions often included depository institutions that were regulated by a banking supervisor.

Functional Regulation. Functional regulation and supervision applies a common set of rules to a line of business or product irrespective of the type of institution involved. It is designed to level the playing field among financial firms by eliminating the problem of having different regulators govern equivalent products and services. It may, however, artificially divide a firm's operations into departments by type of financial activity or product. By separating the regulation of the products and services and assigning different regulators to supervise them, absent a consolidated supervisor, no functional supervisor has an overall picture of the firm's operations and how those operations may affect the safety and soundness of the individual pieces. To be successful, this approach requires close coordination among the relevant supervisors. Even then, it is unclear how these alternative functional supervisors can be organized to efficiently focus on the overall safety and soundness of the enterprise.

Functional regulation may be the most effective means of supervising highly sophisticated and emerging aspects of finance that are best reviewed by teams of examiners specializing in such technical areas

Objectives-Based Regulation. This approach attempts to gamer the benefits of the single consolidated regulator approach, but with a realization that the efficacy of safety-and-soundness regulation and supervision may benefit if it is separated from consumer protection supervision and regulation. This regulatory model maintains a system of multiple supervisors, each specializing in the regulation of a particular objective-typically safety and soundness and consumer protection (there can be other objectives as well). The model is designed to bring uniform regulation to firms engaged in the same activities by regulating the entire entity. Arguments have been put forth that this model may be more adaptable to innovation and technological advance than functional regulation because it does not focus on a particular product or service. It also may not be as unwieldy as the consolidated regulator model in large financial systems. It may, however, produce a certain amount of duplication and overlap or could lead to regulatory voids since multiple regulators are involved.

Another approach to organize a system-wide regulatory monitoring effort is through the creation of a systemic risk council (SRC) to address issues that pose risks to the broader financial system. Based on the key roles that they currently play in determining and addressing systemic risk, positions on this council should be held by the U.S. Treasury, the FDIC, the Federal Reserve Board, and the Securities and Exchange Commission. It may be appropriate to add other prudential supervisors as well.

The SRC would be responsible for identifying institutions, practices, and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective informa-

tion flow, completing analyses and making recommendations on potential systemic risks, setting capital and other standards, and ensuring that the key supervisors with responsibility for direct supervision apply those standards. The standards would 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.

The SRC could take a more macro perspective and have the authority to overrule or force actions on behalf of other regulatory entities. In order to monitor risk in the financial system, the SRC also should have the authority to demand better information from systemically important entities and to ensure that information is shared more readily.

The creation of comprehensive systemic risk regulatory regime will not be a panacea. Regulation can only accomplish so much. Once the government formally establishes a systemic risk regulatory regime, market participants may assume that the likelihood of systemic events will be diminished. Market participants may incorrectly discount the possibility of sector-wide disturbances and avoid expending private resources to safeguard their capital positions. They also may arrive at distorted valuations in part because they assume (correctly or incorrectly) that the regulatory regime will reduce the probability of sector-wide losses or other extreme events.

To truly address the risks posed by systemically important institutions, it will be necessary to utilize mechanisms that once again impose market discipline on these institutions and their activities. For this reason, improvements in the supervision of systemically important entities must be coupled with disincentives for growth and complexity, as well as a credible and efficient structure that permits the resolutions of these entities if they fail while protecting taxpayers from exposure.

Q.3. If there are institutions that are too big to fail, how do we identify that? How do we define the circumstance where a single company is so systemically significant to the rest of our financial circumstances and our economy that we must not allow it to fail?

A.3. At present, the federal banking regulatory agencies likely have the best information regarding which large, complex, financial organizations (LCFO) would be "systemically significant" institutions if they were in danger of failing. Whether an institution is systemically important, however, would depend on a number of factors, including economic conditions. For example, if markets are functioning normally, a large institution could fail without systemic repercussions. Alternatively, in times of severe financial sector distress, much smaller institutions might well be judged to be systemic. Ultimately, identification of what is systemic will have to be decided within the structure created for systemic risk regulation.

Even if we could identify the "too big to fail" (TBTF) institutions, it is unclear that it would be prudent to publicly identify the institutions or fully disclose the characteristics that identify an institution as systemic. Designating a specific firm as TBTF would have a number of undesirable consequences: market discipline would be

fully suppressed and the firm would have a competitive advantage in raising capital and funds. Absent some form of regulatory cost associated with systemic status, the advantages conveyed by such status create incentives for other firms to seek TBTF status—a result that would be counterproductive.

Identifying TBTF institutions, therefore, must be accompanied by legislative and regulatory initiatives that are designed to force TBTF firms to internalize the costs of government safety-net benefits and other potential costs to society. TBTF firms should face additional capital charges based on both size and complexity, higher deposit insurance related premiums or systemic risk surcharges, and be subject to tighter Prompt Corrective Action (PCA) limits under U.S. laws.

Q.4. We need to have a better idea of what this notion of too big to fail is—what it means in different aspects of our industry and what our proper response to it should be. How should the federal government approach large, multinational and systemically significant companies?

A.4. "Too-Big-To-Fail" implies that an organization is of such importance to the financial system that its failure will impose widespread costs on the economy and the financial system either by causing the failure of other linked financial institutions or by seriously disrupting intermediation in banking and financial markets. In such cases, the failure of the organization has potential spillover effects that could lead to widespread depositor runs, impair public confidence in the broader financial system, or cause serious disruptions in domestic and international payment and settlement systems that would in turn have negative and long lasting implications for economic growth.

Although TBTF is generally associated with the absolute size of an organization, it is not just a function of size, but also of the complexity of the organization and its position in national and international markets (market share). Systemic risk may also arise when organizations pose a significant amount of counterparty risk (for example, through derivative market exposures of direct guarantees) or when there is risk of important contagion effects when the failure of one institution is interpreted as a negative signal to the market about the condition of many other institutions.

As described above, a financial system characterized by a handful of giant institutions with global reach and a single regulator is making a huge bet that those few banks and their regulator over a long period of time will always make the right decisions at the right time. There are three key elements to addressing the problem of too big to fail.

First, 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 assessments on institutions and their activities would act as disincentives to the types of growth and complexity that raise systemic concerns.

The second important element in addressing too big to fail is an enhanced structure for the supervision of systemically important

institutions. This structure should include both the direct supervision of systemically significant financial firms and the oversight of developing risks that may pose risks to the overall U.S. financial system. Centralizing the responsibility for supervising these institutions in a single systemic risk regulator would bring clarity and accountability to the efforts needed to identify and mitigate the buildup of risk at individual institutions. In addition, a systemic risk council could be created to address issues that pose risks to the broader financial system by identifying cross-cutting practices, and products that create potential systemic risks.

The third element to address systemic risk is the establishment of a legal mechanism for quick and orderly resolution of these institutions similar to what we use for FDIC insured banks. The purpose of the resolution authority should not be to prop up a failed entity indefinitely or to insure all liabilities, but to permit a timely and orderly resolution and the absorption of assets by the private sector as quickly as possible. Done correctly, the effect of the resolution authority will be to increase market discipline and protect taxpayers.

Q.5. What does "fail" mean? In the context of AIG, we are talking about whether we should have allowed an orderly Chapter 11 bankruptcy proceeding to proceed. Is that failure?

A.5. A firm fails when it becomes insolvent; the value of its assets is less than the value of its liabilities or when its regulatory capital falls below required regulatory minimum values. Alternatively, a firm can fail when it has insufficient liquidity to meet its payment obligations which may include required payments on liabilities or required transfers of cash-equivalent instruments to meet collateral obligations.

According to the above definition, AIG's initial liquidity crisis qualifies it as a failure. AIG's need for cash arose as a result of increases in required collateral obligations triggered by a ratings downgrade, increases in the market value of the CDS protection AIG sold, and by mass redemptions by counterparties in securities lending agreements where borrowers returned securities and demand their cash collateral. At the same time, AIG was unable to raise capital or renew commercial paper financing to meet increased need for cash.

Subsequent events suggest that AIG's problems extended beyond a liquidity crisis to insolvency. Large losses AIG has experienced depleted much of its capital. For instance, AIG reported a net loss in the fourth quarter 2008 of $61.7 billion bringing its net loss for the full year (2008) to $99.3 billion. Without government support, which is in excess of $180 billion, AIG would be insolvent and a bankruptcy filing would have been unavoidable.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL FROM SHEILA C. BAIR

Q.1. Two approaches to systemic risk seem to be identified, (1) monitoring institutions and taking steps to reduce the size/activities of institutions that approach a "too large to fail" or "too systemically important to fail" or (2) impose an additional regulator

and additional rules and market discipline on institutions that are considered systemically important.

Which approach do you endorse? If you support approach one how you would limit institution size and how would you identify new areas creating systemic importance?

If you support approach two how would you identify systemically important institutions and what new regulations and market discipline would you recommend?

A.1. There are three key elements to addressing the problem of systemic risk and too big to fail.

First, 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 assessments on institutions and their activities would act as disincentives to the types of growth and complexity that raise systemic concerns.

The second important element in addressing too big to fail is an enhanced structure for the supervision of systemically important institutions. This structure should include both the direct supervision of systemically significant financial firms and the oversight of developing risks that may pose risks to the overall U.S. financial system. Centralizing the responsibility for supervising these institutions in a single systemic risk regulator would bring clarity and accountability to the efforts needed to identify and mitigate the buildup of risk at individual institutions. In addition, a systemic risk council could be created to address issues that pose risks to the broader financial system by identifying cross-cutting practices, and products that create potential systemic risks. Based on the key roles that they currently play in determining and addressing systemic risk, positions on this council should be held by the U.S. Treasury, the FDIC, the Federal Reserve Board, and the Securities and Exchange Commission. It may be appropriate to add other prudential supervisors as well.

The creation of comprehensive systemic risk regulatory regime will not be a panacea. Regulation can only accomplish so much. Once the government formally establishes a systemic risk regulatory regime, market participants may assume that the likelihood of systemic events will be diminished. Market participants may incorrectly discount the possibility of sector-wide disturbances and avoid expending private resources to safeguard their capital positions. They also may arrive at distorted valuations in part because they assume (correctly or incorrectly) that the regulatory regime will reduce the probability of sector-wide losses or other extreme events.

To truly address the risks posed by systemically important institutions, it will be necessary to utilize mechanisms that once again impose market discipline on these institutions and their activities. This leads to the third element to address systemic risk—the establishment of a legal mechanism for quick and orderly resolution of these institutions similar to what we use for FDIC insured banks. The purpose of the resolution authority should not be to prop up a failed entity indefinitely or to insure all liabilities, but to permit a timely and orderly resolution and the absorption of assets by the

private sector as quickly as possible. Done correctly, the effect of the resolution authority will be to increase market discipline and protect taxpayers.

Q.2. Please identify all regulatory or legal barriers to the comprehensive sharing of information among regulators including insurance regulators, banking regulators, and investment banking regulators. Please share the steps that you are taking to improve the flow of communication among regulators within the current legislative environment.

A.2. Through the Federal Financial Institutions Examination Council (FFIEC), the federal and state bank regulatory agencies have adopted a number of information-sharing protocols and joint operational work streams to promote consistent information flow and reasonable access to supervisory activities among the agencies. The FFIEC's coordination efforts and joint examination process (when necessary) is an efficient means to conduct joint federal and state supervision efforts at banking organizations with multiple lines of business. The FFIEC initiates projects regularly to enhance our supervision processes, examination policies and procedures, examiner training, and outreach to the industry.

The FFIEC collaboration process for bank supervision works well. However, for the larger and more complex institutions, the layering of insurance and securities/capital markets units on a traditional banking organization increases the complexity of the overall federal supervisory process. This complexity is most pronounced within the small universe of systemically important institutions which represent a concentration of risk to the FDIC's Deposit Insurance Fund. The banking regulators generally do not have jurisdiction over securities and insurance activities which are vested in the U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC) for securities activities, and state insurance regulators for insurance operations.

In some cases, large banking organizations have significant involvement in securities and capital markets-related activities supervised by the SEC. The FFIEC agencies do have information sharing protocols with the securities regulators and rely significantly on the SEC's examination findings when evaluating a company's overall financial condition. In fact, the FDIC has signed information-sharing agreements with the SEC as well as the state securities and insurance commissioners. Prospectively, it may be appropriate to integrate the securities regulators' activities more closely with the FFIEC's processes to enhance information sharing and joint supervisory analyses.

Finally, as mentioned in the previous question, an additional way to improve information sharing would be through the creation of a systemic risk council (SRC) to address issues that pose risks to the broader financial system. The SRC would be responsible for identifying institutions, practices, and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, completing analyses and making recommendations on potential systemic risks, setting capital and other standards and ensuring that the key supervisors with responsibility for direct supervision apply those standards. In order to

monitor risk in the financial system, the SRC also should have the authority to demand better information from systemically important entities and to ensure that information is shared among regulators more readily.

Q.3. If Congress charged the FDIC with the responsibility for the "special resolution regime" that you discuss in your written testimony, what additional regulatory authorities would you need and what additional resources would you need to be successful? Can you describe the difference in treatment for the shareholders of Bear Sterns under the current situation verses the situation if the "special resolution regime" was already in place?

A.3. *Additional Regulatory Authorities*—Resolution authority for both (1) systemically significant financial companies and (2) non-systemically significant depository institution holding companies, including:

- Powers and authorities similar to those provided in the Federal Deposit Insurance Act for resolving failed insured depository institutions;
- Funding mechanisms, including potential borrowing from and repayment to the Treasury;
- Separation from bankruptcy proceedings for all holding company affiliates, including those directly controlling the IDI, when necessary to address the interdependent enterprise carried out by the insured depository institution and the remainder of the organization; and
- Powers and authorities similar to those provided in the Federal Deposit Insurance Act for assistance to open entities in the case of systemically important entities, conservatorships, bridge institutions, and receiverships.

Additional Resources—The FDIC seeks to rely on in-house expertise to the extent possible. Thus, for example, the FDIC's staff has experts in capital markets, including securitizations. When pertinent expertise is not readily available in-house, the FDIC contracts out to complement its resources. If the FDIC identifies a longer-term need for such expertise, it will bring the necessary expertise in-house.

Difference in the Treatment for the Shareholders of Bear Stearns—With the variety of liquidation options now proposed, the FDIC would have had a number of tools at its disposal that would have enhanced its ability to effect an orderly resolution of Bear Stearns. In particular, the appointment of the FDIC as receiver would have essentially terminated the rights of the shareholders. Any recovery on their equity interests would be limited to whatever net proceeds of asset liquidations remained after the payment in full of all creditors. This prioritization of recovery can assist to establish greater market discipline.

Q.4. Your testimony recommends that "any new plan ensure that consumer protection activities are aligned with other bank supervisory information, resources, and expertise, and that enforcement of consumer protection rules be left to bank regulators."

Can you please explain how the agency currently takes into account consumer complaints and how the agency reflects those com-

plaints when investigating the safety and soundness of an institution? Do you feel that the FDIC has adequate information sharing between the consumer protection examiners and safety and soundness examiners? If not, what are your suggestions to increase the flow of information between the different types of examiners?

A.4. Consumer complaints can indicate potential safety-and-soundness or consumer protection issues. Close cooperation among FDIC Consumer Affairs, compliance examination, and safety-and-soundness examination staff in the Field Office, Regional Office, and Washington Office is essential to addressing issues raised by consumer complaints and determining the appropriate course of action.

Consumer complaints are received by the FDIC and financial institutions. Complaints against non FDIC-supervised institutions are forwarded to the appropriate primary regulator. The FDIC's Consumer Affairs staff receives the complaints directed to the FDIC and responds to and maintains files on these complaints. Consumer Affairs may request that examiners assist with a complaint investigation if an on-site review at a financial institution is deemed necessary.

Consumer complaints received by the FDIC, as well as the complaints received by a financial institution (or by third party service providers), are reviewed by compliance examiners during the pre-examination planning phase of a compliance examination. In addition, information obtained from the financial institution pertaining to consumer-related litigation, investigations by other government entities, and any institution management reports on the type, frequency, and distribution of consumer complaints are also reviewed. Compliance examiners consider this information, along with other types of information about the institution's operations, when establishing the scope of a compliance examination, including issues to be investigated and regulatory areas to be assessed during the examination. During the on-site compliance examination, examiners review the institution's complaint response processes as part of a comprehensive evaluation of the institution's compliance management system.

During risk management examinations, examiners will review information about consumer complaints and determine the potential for safety-and-soundness concerns. This, along with other types of information about the institution's operations, is used to determine the scope of a safety-and-soundness examination. Examples of complaints that may raise such concerns include allegations that the bank is extending poorly underwritten loans, a customer's account is being fraudulently manipulated, or insiders are receiving benefits not available to other bank customers. Where feasible, safety-and-soundness and compliance examinations may be conducted concurrently. At times, joint examination teams have been formed to evaluate and address risks at institutions offering complex products or services that prompted an elevated level of supervisory concern.

Apart from examination-related activity, the Consumer Affairs staff forwards to regional management all consumer complaints that appear to raise safety-and-soundness concerns as quickly as possible. Regional management will confirm that a consumer com-

plaint raises safety-and-soundness issues and determine the appropriate course of action to investigate the complaint under existing procedures and guidance. If the situation demonstrates safety-and-soundness issues, a Case Manager will assume responsibility for coordinating the investigation and, in certain situations, may prepare the FDIC's response to the complaint or advise the Consumer Affairs staff in their efforts to respond to the complaint. The Case Manager determines whether the complaint could be an indicator of a larger, more serious issue within the institution.

Quarterly, the Consumer Affairs staff prepares a consumer complaint summary report from its Specialized Tracking and Reporting System for institutions identified on a regional office's listing of institutions that may generate a higher number of complaints. These types of institutions may include, but are not limited to, banks with composite ratings of "4" and "5," subprime lenders, high loan-to-value lenders, consumer lenders, and credit card specialty institutions. This report provides summary data on the number and nature of consumer complaints received during the previous quarter. The Case Manager reviews the consumer complaint information for trends that may indicate a safety-and-soundness issue and documents the results of the review.

We believe FDIC examination staff effectively communicates, coordinates, and collaborates. Safety-and-soundness and compliance examiners work in the same field offices, and therefore, the regular sharing of information is commonplace. To ensure that pertinent examination or other relevant information is shared between the two groups of examiners, field territories hold quarterly meetings where consumer protection/compliance and risk management issues are discussed. In addition, Relationship Managers, Case Managers, and Review Examiners in every region monitor institutions and facilitate communication about compliance and risk management issues and develop cohesive supervisory plans. Both compliance examination and risk management examination staff share the same senior management. Effective information sharing ensures the FDIC is consistent in its examination approach, and compliance and risk management staffs are working hand in hand.

Although some suggest that an advantage of a separate agency for consumer protection would be its single-focus mission, this position may not acknowledge the reality of the interconnectedness of safety-and-soundness and consumer protection concerns, as well as the value of using existing expertise and examination infrastructure, noted above. Thus, even if such an agency only were tasked with rule-writing responsibilities, it would not be in a position to fully consider the safety-and-soundness dimensions of consumer protection issues. Moreover, if the agency also were charged with enforcing those rules, replicating the uniquely comprehensive examination and supervisory presence to which federally regulated financial institutions are currently subject would involve creating an extremely large new federal bureaucracy. Just providing enforcement authority, without examination or supervision, would simply duplicate the Federal Trade Commission.

Placing consumer compliance examination activities in a separate organization, apart from other supervisory responsibilities, ultimately will limit the effectiveness of both programs. Over time,

staff at both agencies would lose the expertise and understanding of how consumer protection and the safe and sound conduct of a financial institution's business operations interrelate.

Q.5. In your written testimony you state that "failure to ensure that financial products were appropriate and sustainable for consumers has caused significant problems, not only for those consumers, but for the safety and soundness of financial institutions." Do you believe that there should be a suitability standard placed on lending institutions?

A.5. Certainly, as a variety of nontraditional mortgage products became widely available, a growing number of consumers began to receive mortgage loans that were unlikely to be affordable in the long term. This was a major precipitating factor in the current financial crisis.

With regard to mortgage lending, lenders should apply an affordability standard to ensure that a borrower has the ability to repay the debt according to the terms of the contract. Loans should be affordable and sustainable over the long-term and should be underwritten to the fully indexed rate. Such a standard would also be valuable if applied across all credit products, including credit cards, and should help eliminate practices that do not provide financial benefits to consumers.

However, an affordability standard will serve its intended purpose only if it is applied to all originators of home loans, including financial institutions, mortgage brokers, and other third parties.

Q.6. *Deposit Insurance Question*—Recently, the FDIC has asked Congress to increase their borrowing authority from the Treasury up to $100 billion, citing that this would be necessary in order avoid imposing significant increases in assessments on insured financial institutions. Currently, the FDIC provides rebates to depository financial institutions when the DIF reaches 1.5 percent. Given the increase in bank closings over the past 12 months, do you believe the rebate policy should be reviewed or eliminated? What do you think is an appropriate level for the insurance fund in order to protect depositors at the increased amount of $250,000?

A.6. While the Federal Deposit Insurance Reform Act of 2005 provided the FDIC with greater flexibility to base insured institutions' assessments on risk, it restricted the growth of the DIF. Under the Reform Act, when the DIF reserve ratio is above 1.35 percent, the FDIC is required to dividend half of the amount in excess of the amount required to maintain the reserve ratio at 1.35 percent. In addition, when the DIF reserve ratio is above 1.50 percent, the FDIC is required to dividend all amounts above the amount required to maintain the reserve ratio at 1.5 percent. The result of these mandatory dividends is to effectively cap the size of the DIF and to limit the ability of the fund to grow in good times.

A deposit insurance system should be structured with a countercyclical bias-that is, funds should be allowed to accumulate during strong economic conditions when deposit insurance losses may be low, as a cushion against future needs when economic circumstances may be less favorable and losses higher. However, the current restrictions on the size of the DIF limit the ability of the FDIC to rebuild the fund to levels that can offset the pro-cyclical

effect of assessment increases during times of economic stress. Limits on the size of the DIF of this nature inevitably mean that the FDIC will have to charge higher premiums when economic conditions cause significant numbers of bank failures. As part of the consideration of broader regulatory restructuring, Congress may want to consider the impact of the mandatory rebate requirement or the possibility of providing for greater flexibility to permit the DIF to grow to levels in good times that will establish a sufficient cushion against losses in the event of an economic downturn.

Although the process of weighing options against the backdrop of the current crisis is only starting, taking a look at what might have occurred had the DIF reserve ratio been higher at its onset may be instructive.

The reserve ratio of the DIF declined from 1.22 percent as of December 31, 2007, to 0.36 percent as of December 31, 2008, a decrease of 86 basis points. If at the start of the current economic downturn the reserve ratio of the DIF had been 2.0 percent, allowing for a similar 86 basis point decrease, the reserve ratio would have been 1.14 percent at the end of the first quarter of 2009. At that level, given the current economic climate and the desire to structure the deposit insurance system in a counter-cyclical manner, it is debatable whether the FDIC would have found either the special assessment or an immediate increase in deposit insurance premiums necessary.

An increase in the deposit insurance level will increase total insured deposits. While increasing the coverage level to $250,000 will decrease the actual DIF reserve ratio (which is the ratio of the fund to estimated insured deposits), it will not necessarily change the appropriate reserve ratio. As noted in the response to the previous question, building reserve ratios to higher levels during good times may obviate the need for higher assessments during downturns.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HUTCHISON FROM SHEILA C. BAIR

Q.1. I have concerns about the recent decision by the Federal Deposit Insurance Corporation (FDIC) Board of Directors to impose a special assessment on insured institutions of 20 basis points, with the possibility of assessing an additional 10 basis points at any time as may be determined by the Board.

Since this decision was announced, I have heard from many Texas community bankers, who have advised me of the potential earnings and capital impact on their financial institutions, and more importantly, the resulting loss of funds necessary to lend to small business customers and consumers in Texas communities. It is estimated that assessments on Texas banks, if implemented as proposed, will remove nearly one billion dollars from available capital. When leveraged, this results in nearly eight to twelve billion dollars that will no longer be available for lending activity throughout Texas. At a time when responsible lending is critical to pulling our nation out of recession, this sort of reduction in local lending has the potential to extend our economic downturn.

I understand you believe that any assessments on the banking industry may be reduced by roughly half, or 10 basis points, should

Congress provide the FDIC an increase in its line of credit at the Department of Treasury from $30 billion to $100 billion. That is why I have signed on as a cosponsor of The Depositor Protection Act of 2009, which accomplishes that goal.

However, my banking community informs me that even this modest proposed reduction in the special assessments will still disproportionately penalize community banks, the vast majority of which neither participated nor contributed to the irresponsible lending tactics that have led to the erosion of the FDIC deposit insurance fund (DIF).

I understand that there are various alternatives to ensure the fiscal stability of the DIF without adversely affecting the community banking industry, such as imposing a systemic risk premium, basing assessments on assets with an adjustment for capital rather than total insured deposits, or allowing banks to amortize the expenses over several years.

I respectfully request the following:

- Could you outline several proposals to improve the soundness of the DIF while mitigating the negative effects on the community banking industry?
- Could you outline whether the FDIC has the authority to implement these policy proposals, or whether the FDIC would need additional authorities?
- If additional authority is needed, from which entity (*i.e.,* Congress? Treasury?) Would the FDIC need those additional authorities?

A.1. The FDIC realizes that assessments are a significant expense for the banking industry. For that reason, we continue to consider alternative ways to alleviate the pressure on the DIF. In the proposed rule on the special assessment (adopted in final on May 22, 2009), we specifically sought comment on whether the base for the special assessment should be total assets or some other measure that would impose a greater share of the special assessment on larger institutions. The Board also requested comment on whether the special assessment should take into account the assistance that has been provided to systemically important institutions. The final rule reduced the proposed special assessment to five basis points on each insured depository institutions assets, minus its Tier 1 capital, as of June 30, 2009. The assessment is capped at 10 basis points of an institution's domestic deposits so that no institution will pay an amount greater than they would have paid under the proposed interim rule.

The FDIC has taken several other actions under its existing authority in an effort to alleviate the burden of the special assessment. On February 27, 2009, the Board of Directors finalized new risk-based rules to ensure that riskier institutions bear a greater share of the assessment burden. We also imposed a surcharge on guaranteed bank debt under the Temporary Liquidity Guarantee Program (TLGP) and will use the money raised by the surcharge to reduce the proposed special assessment.

Several other steps to improve the soundness of the DIF would require congressional action. One such step would be for Congress to establish a statutory structure giving the FDIC the authority to

resolve a failing or failed depository institution holding company (a bank holding company supervised by the Federal Reserve Board or a savings and loan holding company, including a mutual holding company, supervised by the Office of Thrift Supervision) with one or more subsidiary insured depository institutions that are failing or have failed.

As the corporate structures of bank holding companies, their insured depository and other affiliates continue to become more complex, an insured depository institution is likely to be dependent on affiliates that are subsidiaries of its holding company for critical services, such as loan and deposit processing and loan servicing. Moreover, there are many cases in which the affiliates are dependent for their continued viability on the insured depository institution. Failure and the subsequent resolution of an insured depository institution whose key services are provided by affiliates present significant legal and operational challenges. The insured depository institutions' failure may force its holding company into bankruptcy and destabilize its subsidiaries that provide indispensable services to the insured depository institution. This phenomenon makes it extremely difficult for the FDIC to effectuate a resolution strategy that preserves the franchise value of the failed insured depository institution and protects the DIF. Bankruptcy proceedings, involving the parent or affiliate of an insured depository institution, are time-consuming, unwieldy, and expensive. The threat of bankruptcy by the bank holding company or its affiliates is such that the Corporation may be forced to expend considerable sums propping up the bank holding company or entering into disadvantageous transactions with the bank holding company or its subsidiaries in order to proceed with an insured depository institution's resolution. The difficulties are particularly extreme where the Corporation has established a bridge depository institution to preserve franchise value, protect creditors (including uninsured depositors), and facilitate disposition of the failed institution's assets and liabilities.

Certainty regarding the resolution of large, complex financial institutions would also help to build confidence in the strength of the DIF. Unlike the clearly defined and proven statutory powers that exist for resolving insured depository institutions, the current bankruptcy framework available to resolve large complex nonbank financial entities and financial holding companies was not designed to protect the stability of the financial system. Without a system that provides for the orderly resolution of activities outside of the depository institution, the failure of a systemically important holding company or nonbank financial entity will create additional instability. This problem could be ameliorated or cured if Congress provided the necessary authority to resolve a large, complex financial institution and to charge systemically important firms fees and assessments necessary to fund such a systemic resolution system.

In addition, 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. Restrictions on leverage and the imposition of risk-based assessments on institu-

tions and their activities also would act as disincentives to the types of growth and complexity that raise systemic concerns.

Q.2. I commend you for your tireless efforts in helping our banking system survive this difficult environment, and I look forward to working closely with you to arrive at solutions to support the community banking industry while ensuring the long-term stability of the DIF to protect insured depositors against loss.

Will each of you commit to do everything within your power to prevent performing loans from being called by lenders? Please outline the actions you plan to take.

A.2. The FDIC understands the tight credit conditions in the market and is engaged in a number of efforts to improve the current situation. Over the past year, we have issued guidance to the institutions we regulate to encourage banks to maintain the availability of credit. Moreover, our examiners have received specific instructions on properly applying this guidance to FDIC supervised institutions.

On November 12, 2008, we joined the other federal banking agencies in issuing the Interagency Statement on Meeting the Needs of Creditworthy Borrowers (FDIC FIL-128-2008). This statement reinforces the FDIC's view that the continued origination and refinancing of loans to creditworthy borrowers is essential to the vitality of our domestic economy. The statement encourages banks to continue making loans in their markets, work with borrowers who may be encountering difficulty during this challenging period, and pursue initiatives such as loan modifications to prevent unnecessary foreclosures.

In light of the present challenges facing banks and their customers, the FDIC hosted in March a roundtable discussion focusing on how regulators and financial institutions can work together to improve credit availability. Representatives from the banking industry were invited to share their concerns and insights with the federal bank regulators and representatives from state banking agencies. The attendees agreed that open, two-way communication between the regulators and the industry was vital to ensuring that safety and soundness considerations are well balanced with the critical need of providing credit to businesses and consumers.

One of the important points that came out of the session was the need for ongoing dialog between bankers and their regulators as they work jointly toward a solution to the current financial crisis. Toward this end, the FDIC created a new senior level position to expand community bank outreach. In conjunction with this office, the FDIC plans to establish an advisory committee to address the unique concerns of this segment of the banking community.

As part of our ongoing supervisory evaluation of banks that participate in federal financial stability programs, the FDIC also is taking into account how available capital is deployed to make responsible loans. It is necessary and prudent for banking organizations to track the use of the funds made available through federal programs and provide appropriate information about the use of these funds. On January 12, 2009, the FDIC issued a Financial Institution Letter titled *Monitoring the Use of Funding from Federal Financial Stability and Guarantee Programs* (FDIC FIL-1-2009),

advising insured institutions that they should track their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs as part of a process for determining how these federal programs have improved the stability of the institution and contributed to lending to the community. Equally important to this process is providing this information to investors and the public. This Financial Institution Letter advises insured institutions to include information about their use of the funds in public reports, such as shareholder reports and financial statements.

Internally at the FDIC, we have issued guidance to our bank examiners for evaluating participating banks' use of funds received through the TARP Capital Purchase Program and the Temporary Liquidity Guarantee Program, as well as the associated executive compensation restrictions mandated by the Emergency Economic Stabilization Act. Examination guidelines for the new Public-Private Investment Fund will be forthcoming. During examinations, our supervisory staff will be reviewing banks' efforts in these areas and will make comments as appropriate to bank management. We will review banks' internal metrics on the loan origination activity, as well as more broad data on loan balances in specific loan categories as reported in Call Reports and other published financial data. Our examiners also will be considering these issues when they assign CAMELS composite and component ratings. The FDIC will measure and assess participating institutions' success in deploying TARP capital and other financial support from various federal initiatives to ensure that funds are used in a manner consistent with the intent of Congress, namely to support lending to U.S. businesses and households.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MICHAEL E. FRYZEL

Q.1. *Consumer Protection Regulation*—Some have advocated that consumer protection and prudential supervision should be divorced, and that a separate consumer protection regulation regime should be created. They state that one source of the financial crisis emanated from the lack of consumer protection in the underwriting of loans in the originate-to-distribute space.

What are the merits of maintaining it in the same agency? Alternatively, what is the best argument each of you can make for a new consumer protection agency?

A.1. Credit unions occupy a very small space within the originate-to-distribute landscape. Less than 8 percent of the $250 billion in loans originated by credit unions in 2008 were sold in whole to another party. While selling loans has grown within the credit union industry, it remains a small portion of business, with most credit unions choosing to hold their loans in portfolio when possible. Additionally, the abuses of consumers seen in some areas have not manifested themselves within the credit union community.

The originate-to-distribute model would seem to create an environment where the loan originator is less concerned about consumer protection and more concerned with volume and fee generation. The lender using this model may focus less on what is best

for the borrower, as they will not be the entity retaining the liability should the borrower later default.

Maintaining consumer protection with the same regulator who is responsible for prudential supervision adds economies of scale and improves efficiencies for completing the supervision of the institutions. This approach allows one regulator to possess all information and authority regarding the supervision of individual institutions. In the past, NCUA has performed consumer compliance examinations separate from safety and soundness examinations. However, in order to maximize economies of scales and allow examiners to possess all information regarding the institution, the separation of consumer compliance and safety and soundness examinations was discontinued. Some federal and state agencies currently perform those functions as two separate types of examination under one regulator.

The oversight of consumer protection could be given to a separate regulatory agency. The agency would likely have broad authority over all financial institutions and affiliated parties. In theory, creating such an agency would allow safety and soundness examiners to focus on those particular risks. For those agencies without consumer compliance examiners, it would create an agency of subject matter experts to help ensure consumer protection laws are adhered to.

Q.2. *Regulatory Gaps or Omissions*—During a recent hearing, the Committee has heard about massive regulatory gaps in the system. These gaps allowed unscrupulous actors like AIG to exploit the lack of regulatory oversight. Some of the counterparties that AIG did business with were institutions under your supervision.

Why didn't your risk management oversight of the AIG counterparties trigger further regulatory scrutiny? Was there a flawed assumption that AIG was adequately regulated, and therefore no further scrutiny was necessary?

Was there dialogue between the banking regulators and the state insurance regulators? What about the SEC?

If the credit default swap contracts at the heart of this problem had been traded on an exchange or cleared through a clearinghouse, with requirement for collateral and margin payments, what additional information would have been available? How would you have used it?

A.2. NCUA does not directly or indirectly regulate or oversee the operation of AIG. Therefore, we defer to the other regulatory bodies. Chartering and regulatory restrictions prevent federally chartered credit unions from investing in companies such as AIG. Federally chartered credit unions are generally limited to investing in government issued or guaranteed securities and cannot invest in the diverse range of higher yielding products, including commercial paper and corporate debt securities.

Q.3. *Liquidity Management*—A problem confronting many financial institutions currently experiencing distress is the need to roll-over short-term sources of funding. Essentially these banks are facing a shortage of liquidity. I believe this difficulty is inherent in any system that funds long-term assets, such as mortgages, with short-

term funds. Basically the harm from a decline in liquidity is amplified by a bank's level of "maturity-mismatch."

I would like to ask each of the witnesses, should regulators try to minimize the level of a bank's maturity-mismatch? And if so, what tools would a bank regulator use to do so?

A.3. Funding long-term, fixed-rate loans with short-term funds is a significant concern. The inherent risk in such balance sheet structuring is magnified with the increased probability that the United States may soon enter a period of inflation and rising rates on short-term funding sources. The effects of a rising interest rate environment when most funding sources have no maturity or a maturity of less than one year creates the potential for substantial narrowing of net interest margins moving forward.

NCUA recently analyzed how credit union balance sheets have transformed over the last 10 years, especially in the larger institutions. Letter to Credit Unions 08-CU-20, Evaluating Current Risks to Credit Unions, examines the changing balance sheet risk profile. The Letter provides the industry words of caution as well as direction on addressing current risks. NCUA has also issued several other Letters to Credit Unions over the past several years regarding this very issue and has developed additional examiner tools for evaluating liquidity and interest rate risk.

While there are various tools the industry uses for measuring interest rate and liquidity risk, the tools involve making many assumptions. The assumptions become more involved as balance sheets become more complex. Each significant assumption needs to be evaluated for reasonableness, with the underlying assumption not necessarily having been tested over time or over all foreseeable scenarios. The grey area in such analysis is significant. In our proposed regulatory changes for corporate credit unions, better matching of maturities of assets and liabilities will be regulated with concentration and sector limits as well as other controls.

Q.4. *Too-Big-To-Fail*—Chairman Bair stated in her written testimony that "the most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of those institutions similar to that which exists for FDIC-insured banks. In short we need to end too big to fail. I would agree that we need to address the too-big-to-fail issue, both for banks and other financial institutions."

Could each of you tell us whether putting a new resolution regime in place would address this issue?

A.4. While the NCUA continues to recommend maintaining multiple financial regulators and charter options to enable the continued checks and balances such a structure produces, the agency also agrees with the need for establishing a regulatory oversight entity to help mitigate risk to the nation's financial system. Extending the reach of this entity beyond the federally regulated financial institutions may help impose market discipline on systemically important institutions. Care needs to be taken in deciding how to address the too-big-to-fail issue. Overreaching could stifle financial innovation and actually cause more harm than good. At the same time, under

reaching could provide inadequate resolution when it is needed most.

The statutory construct of federal credit unions limits growth with membership restrictions, so no new initiatives are deemed necessary to address the "too big to faily7is sue for credit unions. Federally insured credit unions hold $8 13.44 billion in assets, while financial institutions insured by the FDIC hold $13.85 trillion in assets. Federally insured credit unions make up only 5.56 percent of all federally insured assets.[1] Therefore, the credit union industry as a whole does not pose a systemic risk to the financial industry. However, federally insured credit unions serve a unique role in the financial industry by providing basic and affordable financial services to their members. In order to preserve this role, federally insured credit unions must maintain their independent regulator and insurer.

Q.5. How would we be able to convince the market that these systemically important institutions would not be protected by taxpayer resources as they had been in the past?

A.5. It will be difficult to convince a market accustomed to seeing taxpayer bailouts of systemically important institutions that those institutions will no longer be protected by taxpayer resources. A regulatory oversight entity empowered to resolve institutions deemed systemically important would help impose greater market discipline. Given the recent and historical government intercession, consumers and the marketplace have become accustomed to and grown to expect financial assistance from the government. The greater the expectation for government to use taxpayer resources to resolve institutions the greater the moral hazard becomes. This could cause institutions to take greater levels of risk knowing they will not have to face the consequences.

Q.6. *Pro-Cyclicality*—I have some concerns about the pro-cyclical nature of our present system of accounting and bank capital regulation. Some commentators have endorsed a concept requiring banks to hold more capital when good conditions prevail, and then allow banks to temporarily hold less capital in order not to restrict access to credit during a downturn. Advocates of this system believe that counter cyclical policies could reduce imbalances within financial markets and smooth the credit cycle itself.

What do you see as the costs and benefits of adopting a more counter-cyclical system of regulation?

A.6. In managing the National Credit Union Share Insurance Fund (NCUSIF), the NCUA Board's Normal Operating Level policy considers the counter-cyclical impact when managing the Fund's equity level. During otherwise stable or prosperous economic periods, the Board may assess a premium, up to the statutory limits, to increase the Fund equity level, in order to avoid the need to charge premiums at the trough of the business cycle. In order to improve this system, NCUA would need the ability to charge premiums, during good times, above the current threshold (an equity level of 1.30).

[1] Based on December 31, 2008, financial data.

A more robust and flexible risk-based capital requirement for credit unions would improve counter-cyclical impact. Currently, NCUA does not have authority to allow overall capital levels to vary based on swings in the business cycle. Prompt Corrective Action (12 U.S.C. §1790d) establishes statutory minimum levels of capital which are not flexible.

Q.7. Do you see any circumstances under which your agencies would take a position on the merits of counter-cyclical regulatory policy?

A.7. NCUA will support efforts to improve counter-cyclical regulatory policy. Greater flexibility in the management of the NCUSIF's equity level and improvements in the measurement and retention of capital for credit unions are good starting points.

Q.8. *G20 Summit and International Coordination*—Many foreign officials and analysts have said that they believe the upcoming G20 summit will endorse a set of principles agreed to by both the Financial Stability Forum and the Basel Committee, in addition to other government entities. There have also been calls from some countries to heavily re-regulate the financial sector, pool national sovereignty in key economic areas, and create powerful supranational regulatory institutions. (Examples are national bank resolution regimes, bank capital levels, and deposit insurance.) Your agencies are active participants in these international efforts.

What do you anticipate will be the result of the G20 summit?

Do you see any examples or areas where supranational regulation of financial services would be effective?

How far do you see your agencies pushing for or against such supranational initiatives?

A.8. Many news accounts characterize the recent G20 summit as a forum for international cooperation to discuss the condition of the international financial system and to promote international financial stability. NCUA supports these efforts to share information and ideas and to marshal international support for a concerted effort to stabilize the global economy.

In comparison to banks, federally insured credit unions are relatively small institutions. Additionally, because of the limited nature of a credit union's field of membership (those individuals a credit union is authorized to serve), U.S. credit unions are almost exclusively domestic institutions with virtually no, or highly limited, international presence. Accordingly, NCUA believes that a supranational regulatory institution would not be an effective tool for credit union regulation. Because of credit unions' small size and unique structure, NCUA believes credit unions need the customized supervisory approach that can only be provided by an agency dedicated to the exclusive regulation of credit unions, and which understands the unique nature of credit union operations. In the broader financial regulatory context, NCUA is hesitant to endorse the creation of powerful supranational regulatory institutions without knowing more about the extent of authority and jurisdiction those regulatory entities would have over U.S. financial institutions. While NCUA supports international cooperation, NCUA believes it is vital to economic and national security to maintain complete U.S. sovereignty over U.S. financial institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM MICHAEL E. FRYZEL

Q.1. It is clear that our current regulatory structure is in need of reform. At my subcommittee hearing on risk management, March 18, 2009, GAO pointed out that regulators often did not move swiftly enough to address problems they had identified in the risk management systems of large, complex financial institutions.

Chair Bair's written testimony for today's hearing put it very well: " . . . the success of any effort at reform will ultimately rely on the willingness of regulators to use their authorities more effectively and aggressively."

My questions may be difficult, but please answer the following:

If this lack of action is a persistent problem among the regulators, to what extent will changing the structure of our regulatory system really get at the issue?

A.1. For the most part, the credit unions have not become large, complex financial institutions. By virtue of their enabling legislation along with regulations established by the NCUA, federal credit unions are more restricted in their operation than other financial institutions. For example, investment options for federal credit unions are largely limited to U.S. debt obligations, federal government agency instruments, and insured deposits. Federal credit unions cannot invest in a diverse range of higher yielding products, including commercial paper and corporate debt securities. Another example of restrictions in the credit union industry includes the affiliation limitations. Federal credit unions are much more limited than other financial institutions in the types of businesses in which they engage and in the kinds of affiliates with which they deal. Federal credit unions cannot invest in the shares of an insurance company or control another financial depository institution. Limitations such as these have helped the credit union industry weather the current economic downturn. These limitations among the other unique characteristics of credit unions make credit unions fundamentally different from other forms of financial institutions and demonstrate the need to ensure their charter is preserved in order to continue to meet their members' financial needs.

Restructuring the regulatory system to include a systemic regulator would add a level of checks and balances to the system to address the issue of regulators using their authorities more effectively and aggressively. The systemic regulator should be responsible for establishing general safety and soundness guidelines for financial institutions and then monitoring the financial regulators to ensure these guidelines are implemented. This extra layer of monitoring would help ensure financial regulators effectively and aggressively address problems at hand.

Q.2. Along with changing the regulatory structure, how can Congress best ensure that regulators have clear responsibilities and authorities, and that they are accountable for exercising them "effectively and aggressively"?

A.2. If a systemic regulator is established, one of its responsibilities should include monitoring the implementation of the established safety and soundness guidelines. This monitoring will help ensure financial regulators effectively and aggressively enforce the estab-

lished guidelines. The oversight entity's main functions should be to establish broad safety and soundness principles and then monitor the individual financial regulators to ensure the established principles are implemented. This structure also allows the oversight entity to set objective-based standards in a more proactive manner, and would help alleviate competitive conflict detracting from the resolution of economic downturns. This type of structure would also promote uniformity in the supervision of financial institutions while affording the preservation of the different segments of the financial industry, including the credit union industry.

Financial regulators should be encouraged to aggressively address areas of increased risk as they are discovered. Rather than financial institution management alone determining risk limits, financial regulators must take administrative action when the need arises. Early recognition of problems and implementing resolutions will help ensure necessary actions are taken earlier rather than later. In addition, financial regulators should more effectively use off-site monitoring to identify and then increase supervision in areas of greater risk within the financial institutions.

Q.3. How do we overcome the problem that in the boom times no one wants to be the one stepping in to tell firms they have to limit their concentrations of risk or not trade certain risky products?

What thought has been put into overcoming this problem for regulators overseeing the firms?

A.3. There is a need to establish concentration limits on risky products. NCUA already has limitations in place that have helped the credit union industry avoid some of the issues currently faced by other institutions. For example:

- Federal credit unions' investments are largely limited to United States debt obligations, federal government agency instruments, and insured deposits.[2] Federal credit unions cannot invest in a diverse range of higher yielding products, including commercial paper and corporate debt securities. Also, federal credit unions have limited authority for broker-dealer relationships.[3]
- Federal credit unions are much more limited than other financial institutions in the types of businesses in which they engage and in the kinds of affiliates with which they deal. Federal credit unions cannot invest in the shares of an insurance company or control another financial depository institution. Also, they cannot be part of a financial services holding company and become affiliates of other depository institutions or insurance companies.
- Unlike other financial institutions, federal credit unions cannot issue stock to raise additional capital.[4] Also, federal credit unions have borrowing authority limited to 50 percent of paid-in and unimpaired capital and surplus.[5]

[2] NCUA Rules and Regulations Part 703.
[3] NCUA Rules and Regulations Part 703.
[4] 12 U.S.C. §1790d(b)(1)(B)(i).
[5] 12 U.S.C. §1757(9).

Sound decision making should always take precedence over following the current trend. The addition of a systemic regulator would provide the overall monitoring for systemic risk that should be limited. The systemic regulator would then establish principles-based regulations for the financial regulators to implement. This would provide checks and balances to ensure regulators were addressing the issues identified. The systemic regulator should be charged with monitoring and implementing guidelines for the systemic risks to the industry, while the financial regulators would supervise the financial institutions and implement the guidelines established by the systemic regulator. Since the systemic regulator only has oversight over the financial regulators, they would not have direct supervision of the financial institutions. This buffer would help overcome the issue of when limits should be implemented.

Q.4. Is this an issue that can be addressed through regulatory restructure efforts?

A.4. As stated above, the addition of a systemic regulator would help address these issues by providing a buffer between the systemic regulator establishing principles-based regulations and the financial regulators implementing the regulations. The addition of the systemic regulator could change the approach of when and how regulators address areas of risk.

The monitoring performed by the systemic regulator would help ensure the financial regulators were taking a more proactive approach to supervising the institutions for which they are responsible.

Q.5. As Mr. Tarullo and Mrs. Bair noted in their testimony, some financial institution failures emanated from institutions that were under federal regulation. While I agree that we need additional oversight over and information on unregulated financial institutions, I think we need to understand why so many regulated firms failed.

Why is it the case that so many regulated entities failed, and many still remain struggling, if our regulators in fact stand as a safety net to rein in dangerous amounts of risk-taking?

A.5. While regulators are a safety net to guard against dangerous amounts of risk taking, the confluence of events that led to the current level of failures and troubled institutions may have been beyond the control of individual regulators. While many saw the risk in lower mortgage loan standards and the growth of alternative mortgage products, the combination of these and the worst recessionary conditions and job losses in decades ended with devastating results to the financial industry. Exacerbating this combination was the layering of excess leverage that built over time, not only in businesses and the financial industry, but also in individual households.

In regards to the credit union industry's record in the current economic environment, 82 federally insured credit unions have failed in the past 5 years (based on the number of credit unions causing a loss to the National Credit Union Share Insurance Fund). Overall, federally insured credit unions maintained reasonable financial performance in 2008. As of December 31, 2008, feder-

ally insured credit unions maintained a strong level of capital with an aggregate net worth ratio of 10.92 percent. While earnings decreased from prior levels due to the economic downturn, federally insured credit unions were able to post a 0.30 percent return on average assets in 2008. Delinquency was reported at 1.37 percent, while net charge-offs was 0.84 percent. Shares in federally insured credit unions grew at 7.71 percent, with membership growing at 2.01 percent, and loans growing at 7.08 percent.[6]

Q.6. While we know that certain hedge funds, for example, have failed, have any of them contributed to systemic risk?

A.6. As the NCUA does not regulate or oversee hedge funds, it is not within our scope to be able to comment on the impact of failed hedge funds and whether or not those failures contributed to systemic risk.

Q.7. Given that some of the federal banking regulators have examiners on-site at banks, how did they not identify some of these problems we are facing today?

A.7. NCUA does not have on-site examiners in natural person credit unions. However, as a result of the current economy, NCUA has shortened the examination cycle to 12 months versus the prior 18 months schedule. NCUA also performs quarterly reviews of the financial data submitted to the agency by the credit union.

NCUA does have on-site examiners in some corporate credit unions. Natural person credit unions serve members of the public, whereas corporate credit unions serve the natural person credit unions. On March 20,2009, NCUA placed two corporate credit unions into conservatorship, due mainly to the decline in value of mortgage backed securities held on their balance sheets. Conventional evaluation techniques did not sufficiently identify the risks of these newer structured securities or the insufficiency of the credit enhancements that supposedly protected the securities from losses. NCUA's evaluation techniques did not fully keep pace with the speed of change in the structure and risk of these securities. Additionally, much of the information obtained by on-site examiners is provided by the regulated institutions. These institutions may become less than forthcoming in providing negative information when trends are declining. NCUA is currently evaluating the structure of the corporate credit union program to determine what changes are necessary. NCUA is also reviewing the corporate credit union regulations and will be making changes to strengthen these entities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MICHAEL E. FRYZEL

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need

[6] Based on December 31, 2008, Call Report (NCUA Form 5300) data.

to reevaluate the weaknesses of federal and state functional regulation for large, interconnected, and large firms like AIG?

A.1. NCUA has previously expressed its support for establishing a systemic risk regulator to monitor financial institution regulators, issue principles-based regulations and guidance, and establish general safety and soundness guidance for financial regulators under its control. This oversight entity would monitor systemic risk across institution types.[7] This broad oversight would complement NCUA's more in-depth and customized approach to regulating federally insured credit unions.

Credit unions are unique, cooperative, not-for-profit entities with a statutory mandate to serve people of modest means. NCUA believes the combination of federal functional regulators performing front-line examinations and oversight by a systemic risk regulator would be a good method to fill weaknesses exposed by AIG. Additionally, because of the small size of most credit unions and the limitations placed on their charters, credit unions generally do not become part of a large conglomerate of business entities.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. Credit unions have not become financial service conglomerates due to limitations within the laws impacting credit unions including restricted fields of membership and limited potential activity. Therefore, the functional regulatory approach currently in place has worked in the credit union industry. While there is no perfect regulatory model to adopt and follow that addresses all of the current issues in the financial services industry, we can take portions from different plans to create a regulatory system that meets the needs of the current economy.

A modernized functional regulatory system would divide the financial services industry into at least five categories: credit unions, banks, insurance, securities, and futures. This approach would allow the functional regulators to operate with expertise within their segment of the financial institutions. A functional regulator provides regulation for the specific issues facing their financial sector. This approach also allows a single regulator to possess the information and authority necessary to completely oversee the regulated entities within their segment of the industry while eliminating inefficiencies made with multiple overseers of the same entity. One drawback of this system is the possibility of regulators addressing the same issue with different approaches. One way to ad-

[7] For purposes of this response, financial institutions include commercial banks and other insured depository institutions, insurers, companies engaged in securities and futures transactions, finance companies, and specialized companies established by the government as defined by the Treasury Blueprint. Individual financial regulators would implement and enforce the established guidelines for the institutions they regulate.

dress this issue is the addition of a systemic oversight agency to the financial services industry. A systemic oversight agency could issue principles-based regulations and guidance, promoting uniformity in the supervision of the industry, while allowing the functional regulators to implement the regulations and guidance in a manner most appropriate for their financial segment. This type of structure would help preserve the different segments of the industry and maintain the checks and balances afforded by the different segments within the industry.

With the single consolidated regulator approach, authority over all aspects of regulated institutions would be established under one regulator. This approach would allow the regulator to possess all information and authority regarding individual institutions, which would eliminate inefficiencies of multiple overseers for the same institution. This approach would also ensure the financial services industry operated under a consistent regulatory approach. However, this approach could result in the loss of specialized attention and focus on the various distinct segments of the financial institutions. An agency responsible for all institutions might focus on the larger institutions where the systemic risk predominates, potentially to the detriment of smaller institutions. For example, as federally insured credit unions are generally the smaller, less complex institutions in a consolidated financial regulator arrangement, the unique character of credit unions would quickly be lost, absorbed by the for-profit model and culture of other financial institutions. Loss of credit unions as a type of financial institution would limit access to the affordable services for persons of modest means that are offered by credit unions.

An objectives-based regulatory approach as outlined in the Treasury Blueprint (market stability, prudential, and business conduct regulators) would ensure all financial institutions operated under a consistent regulatory approach. However, like the single consolidated regulator, this approach could also result in the loss of specialized attention and focus on the distinct segments of financial institutions, thus harming the credit union charter. Again, each regulator might focus on the larger financial institutions where the systemic risk predominates, while not addressing the different types of risks found in the smaller institutions. This approach also would result in multiple regulators for the same institution, where no single regulator possessed all of the information and authority necessary to monitor the overall systemic risk of the institution. In addition, disputes between the regulators regarding jurisdiction over the different objectives would arise. Inefficiencies would be created with multiple regulators supervising the same institution. Again, the focus on the objective rather than the charter could potentially harm the credit union industry where credit unions only comprise a small part of the financial institution community.

In closing, the approach selected to regulate the financial services providers must protect the unique regulatory needs of the various components of the financial sectors, including the credit union industry.

Q.3. If there are institutions that are too big to fail, how do we identify that? How do we define the circumstance where a single

company is so systemically significant to the rest of our financial circumstances and our economy that we must not allow it to fail?

A.3. If the definition of "too big to fail" encompasses only those institutions that are systemically significant enough where their failure would have an adverse impact on financial markets and the economy, then credit unions would not be considered too big to fail.

Within the credit union system there are regulatory safeguards in place to reduce the potential for "too big to fail" entities. The field of membership restrictions that govern membership of the credit union limit the potential for any systemic risk. The impact of a failure of a large natural person credit union would be limited to any cost of the failure, which would be passed on to all other federally insured credit unions via the assessment of a premium should the equity level of the NCUSIF fall below the required level.

Q.4. We need to have a better idea of what this notion of too big to fail is—what it means in different aspects of our industry and what our proper response to it should be. How should the federal government approach large, multinational and systemically significant companies?

A.4. In large, multinational and systemically significant institutions, federal regulators should take an aggressive approach to examining and monitoring. As issues are discovered, the regulator must quickly and firmly take the appropriate action before the issue escalates.

Very few federally insured credit unions have a multinational presence. Due to field of membership limitations, only credit unions where a portion of their members are located in foreign counties, such as a Department of Defense related credit union, would have multinational exposure.[8] In those cases, there is limited multinational significance to the credit union business model.

Q.5. What does "fail" mean? In the context of AIG, we are talking about whether we should have allowed an orderly Chapter 11 bankruptcy proceeding to proceed. Is that failure?

A.5. NCUA regulates federally insured credit unions, which do not file Chapter 11 bankruptcies. However, federally insured credit unions can become insolvent and be liquidated. No member of a federally insured credit union has ever lost a penny of insured shares. In order to preserve confidence in the credit union industry, NCUA usually pays out members within three days from the time a federally insured credit union fails. NCUA has an Asset Management and Assistance Center that is available to quickly handle credit union liquidations and perform management and asset recovery.

Based on the requirements set forth in 12 U.S.C. §1790d of the Federal Credit Union Act, NCUA considers a credit union in danger of closing (a potential failure) when the credit union:

- Is subject to mandatory conservatorship, liquidation or "other corrective action" for not maintaining required levels of capital;

[8] Credit unions are chartered to serve a field of membership that shares a common bond such as the employees of a company, members of an association, or a local community. Therefore, credit unions may not serve the general public like other financial institutions and the credit unions' activities are largely limited to domestic activities, which has minimized the impact of globalization in the credit union industry.

- Is subject to discretionary conservatorship or liquidation or is required to merge for not maintaining required levels of capital;
- Is subject to a high probability of sustaining an identifiable loss (*e.g.,* fraud, unexpected and sudden outflow of funds, operational failure, natural disaster, *etc.*) and could not maintain required levels of capital, so that it would be subject to conservatorship or liquidation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL FROM MICHAEL E. FRYZEL

Q.1. Two approaches to systemic risk seem to be identified, (1) monitoring institutions and taking steps to reduce the size/activities of institutions that approach a "too large to fail" or "too systemically important to fail" or (2) impose an additional regulator and additional rules and market discipline on institutions that are considered systemically important.

Which approach do you endorse? If you support approach one how you would limit institution size and how would you identify new areas creating systemic importance?

If you support approach two how would you identify systemically important institutions and what new regulations and market discipline would you recommend?

A.1. Federally insured credit unions hold $8 13.44 billion in assets, while financial institutions insured by the FDIC hold $13.85 trillion in assets. Federally insured credit unions make up only 5.56 percent of all federally insured asset.[9] Therefore, the credit union industry as a whole does not pose a systemic risk to the financial industry. However, federally insured credit unions serve a unique role in the financial industry by providing basic and affordable financial services to their members. The credit union system of regulation has produced natural limits on size. Though under stress, the credit union system has continued their long history of financial stability and quality service. So, implementing some limits on size may be prudent given the success of the credit union regulatory model.

Q.2. Please identify all regulatory or legal barriers to the comprehensive sharing of information among regulators including insurance regulators, banking regulators, and investment banking regulators. Please share the steps that you are taking to improve the flow of communication among regulators within the current legislative environment.

A.2. NCUA does not believe there are any significant regulatory or legal barriers to prevent it from information sharing with other agency regulators. NCUA currently shares information with state credit union supervisors on a regular basis, trains and provides computer equipment to state examiners, and often conducts joint supervisory examinations with state agencies. NCUA regional management meets with state credit union supervisors in order to discuss such things as problem areas, problem institutions, and eco-

[9] Based on December 31, 2008, financial data.

nomic issues. In addition, NCUA executive management meets with the National Association of State Credit Union Supervisors (NASCUS) at least semi-annually to discuss current issues.

NCUA also participates in Federal Financial Institutions Examination Council (FFIEC)[10] where information is shared and resources are pooled together to develop regulations, policies, training materials, *etc.* Working groups within the FFIEC also include representatives from other federal agencies outside of the financial regulatory agencies as needed.

NCUA believes information sharing can be a valuable tool to ensure safe and sound operations for various kinds of financial institutions. Of course, appropriate parameters must be established to clarify what information is to be shared and for what purposes and to ensure the confidential treatment of sensitive information.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HUTCHISON FROM MICHAEL E. FRYZEL

Q.1. Will each of you commit to do everything within your power to prevent performing loans from being called by lenders? Please outline the actions you plan to take.

A.1. NCUA has strongly encouraged federally insured credit unions to work with borrowers under financial stress. While credit unions must be prudent in their approach, there are avenues they need to explore in working through these situations that can result in positive outcomes for both parties. In April of 2007, NCUA issued Letter to Credit Unions 07-CU-06 titled "Working with Residential Mortgage Borrowers," which included an FFIEC initiative to encourage institutions to consider all loan workout arrangements. NCUA subsequently issued Letter to Credit Unions 08-CU-05 in March of 2008 supporting the Hope NOW alliance, which focuses on modifying qualified loans. More recently, NCUA Letter to Credit Unions 09-CU-04, issued in March 2009, encourages credit union participation in the Making Home Affordable loan modification program. NCUA is currently in the process of developing a Letter to Credit Unions that will further address loan modifications. NCUA has been, and will remain, supportive of all prudent efforts to avoid calling loans and taking foreclosure actions.

While NCUA remains supportive of workout arrangements in general, the data available does not suggest performing loans are being called at a significant level within the credit union industry. What is more likely to occur is the curtailing of existing lines of credit for both residential and construction and development lending. It is conceivable that underlying collateral values supporting such loans have deteriorated and no longer support lines of credit outstanding or unused commitments. In those instances, a business decision must be made regarding whether to curtail the line of credit. There likely will be credit union board established credit risk parameters that need to be considered as well as regulatory considerations, especially as it relates to construction and development lending.

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[10] The FFIEC includes the Board of Governors of the Federal Reserve (FRB), the Federal Deposit Insurance Corporation (FDIC), the NCUA, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the State Liaison Committee (SLC).

Credit union business lending is restricted by statute to the lesser of 1.75 times the credit union's net worth or 12.25 percent of assets (some exceptions apply). There are further statutory thresholds on the level of construction and development lending, borrower equity requirements for such lending, limits on unsecured business lending, and maximum loan to value limitations (generally 80 percent without insurance or up to 95 percent with insurance). While business lending continues to grow within credit unions, the level of such lending as of December 31, 2008, is 3.71 percent of total credit union assets and 5.32 percent of total credit union loans. Only 6.15 percent of outstanding credit union business loans, or $1.95 billion, are for construction and development, which is a very small piece of the overall construction and development loan market.

Credit union loan portfolios grew at a rate of over 7 percent in 2008. The level of total unfunded loan commitments continues to grow, which suggests there is not a pervasive calling of lines of credit. Credit unions need to continue to act independently in regard to credit decisions. Each loan will involve unique circumstances including varying levels of risk. Some markets have been much more severely impacted by the change in market conditions, creating specific risk considerations for affected loans. Additionally, there are significant differences between loans to the average residential home owner who is current on their loan even though their loan to value ratio is now 110 percent, versus the developer who has a line of credit to fund his commercial use or residential construction project. Continued funding for the developer may be justified or may be imprudent. Continued funding may place the institution at additional risk or beyond established risk thresholds, depending on the circumstances.

The agency continues to support the thoughtful evaluation by credit union management of each performing loan rather than a blanket approach to curtailing the calling of performing loans.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DANIEL K. TARULLO

Q.1. *Consumer Protection Regulation*—Some have advocated that consumer protection and prudential supervision should be divorced, and that a separate consumer protection regulation regime should be created. They state that one source of the financial crisis emanated from the lack of consumer protection in the underwriting of loans in the originate-to-distribute space.

What are the merits of maintaining it in the same agency? Alternatively, what is the best argument each of you can make for a new consumer protection agency?

A.1. The best argument for maintaining supervision of consumer protection in the same agency that provides safety and soundness and supervision is that the two are linked both substantiveIy and practically. Thus there are substantial efficiency and information advantages from having the two functions housed in the same agency. For example, risk assessments related to an institution's management of consumer compliance functions are closely linked with other safety and soundness risks, and factor in to assessments

of bank management and financial, legal, and reputation risks. Likewise, evaluations of management or controls in lending processes in safety and soundness examinations factor in to assessments of compliance risk management. Supervisory assessments for both safety and soundness and consumer protection, as well as enforcement actions or supervisory follow up, are best made with the benefit of the broader context of the entire organization's risks and capacity. Furthermore, determinations that certain products or practices are "unfair and deceptive" in some cases require an understanding of how products are priced, offered, and marketed in an individual institution. This information is best obtained through supervisory monitoring and examinations.

A related point is that responsibility for prudential and consumer compliance examinations and enforcement benefits consumer protection rulewriting responsibilities. Examiners are often the first government officials to see problems with the application and implementation of rules in consumer transactions. Examiners are an important source of expertise in banking operations and lending activities, and they are trained to understand the interplay of all the risks facing individual banking organizations.

The best argument for an independent consumer agency within the financial regulatory structure is that it will focus single-mindedly on consumer protection as its primary mission. The argument is that the leadership of an agency with multiple functions may trade one off against the other one, at times, be distracted by responsibilities in one area and less attentive to problems in the other. A corollary of this basic point is that the agency would be more inclined to act to deter use of harmful financial products and, if properly structured and funded, may be less susceptible to the sway of powerful industry influences. Proponents of a separate agency also argue that a single consumer regulator responsible for monitoring and enforcing compliance would end the competition among regulatory agencies that they believe promotes a "competition in laxity" for fear that supervised entities will engage in charter shopping.

Apart from the relative merits of the foregoing arguments, two points of context are probably worth making: First, any agency assigned rulewriting authority will be effective only if it has considerable expertise in consumer credit markets, retail payments, banking operations, and economic analysis. Successful rulewriting requires an understanding of the likely effects of protections to prevent abuses on the availability of responsible and affordable credit. Second, the policies and performance of both an "integrated" agency and a free-standing consumer protection agency will depend importantly on the leadership appointed to head those entities.

Q.2. *Regulatory Gaps or Omissions*—During a recent hearing, the Committee has heard about massive regulatory gaps in the system. These gaps allowed unscrupulous actors like AIG to exploit the lack of regulatory oversight. Some of the counterparties that AIG did business with were institutions under your supervision.

Why didn't your risk management oversight of the AIG counterparties trigger further regulatory scrutiny? Was there a flawed assumption that AIG was adequately regulated, and therefore no further scrutiny was necessary?

Was there dialogue between the banking regulators and the state insurance regulators? What about the SEC?

If the credit default swap contracts at the heart of this problem had been traded on an exchange or cleared through a clearinghouse, with requirement for collateral and margin payments, what additional information would have been available? How would you have used it?

A.2. The problems created by AIG provide perhaps the best case study in showing the need for regulatory reform, enhanced consolidated supervision of institutions and business lines that perform the same function, and an explicit regulatory emphasis on systemic risk. Importantly, some of the largest counterparties to AIG were foreign institutions and investments banks not directly supervised by the Federal Reserve. Even then, however, established industry practices prior to the crisis among financial institution counterparties with high credit ratings called for little exchange of initial margins on OTC derivative contracts. Such practices and AIG's high credit rating thus inhibited the checks and balances initial margins would have placed on AIG's positions. Federal Reserve supervisory reviews of counterparty credit risk exposures at individual firms prior to the crisis did not flag AIG as posing significant counterparty credit risk since AIG was regularly able to post its variation margins on OTC derivative contracts thus reducing its exposure. Moreover, AIG spread its exposures across a number of different counterparties and instruments.

The over-reliance on credit ratings in a number of areas leading up to the current crisis, as well as the need for better information on market-wide exposures in the OTC derivatives market, have motivated supervisory efforts to move the industry to the use of central clearing parties and the implementation of a data warehouse on OTC derivative transactions. This effort, reinforced with appropriate statutory authority, is a critical part of a systemic risk agenda.

The Federal Reserve actively participates on an insurance working group, which includes other federal banking and thrift agencies and the National Association of Insurance Commissioners (NAIC). The working group meets quarterly to discuss developments in the insurance and banking sectors, legislative developments, and other topics of particular significant. In addition, to the working group, the Federal Reserve communicates regularly with the NAIC and insurance regulators on specific matters. With respect to the SEC, the Federal Reserve has information sharing arrangements in place for companies under our supervision. Since the Federal Reserve had no supervisory responsibility for AIG, we did not discuss the company or its operations with either the state insurance regulators or the SEC until the time of our initial discount window loan in September 2008.

Credit default swap contracts may be centrally cleared (whether they are traded over the counter or listed on an exchange) only if they are sufficiently standardized. Presently, sufficiently standardized CDS contracts comprise those written on CDS indices, on tranches of CDS indices, and on some corporate single-name entities. The CDS contracts at the heart of the AIG collapse were written mainly on tranches of ABS CDOs, which are generally individ-

ually tailored (*e.g.,* bespoke transactions) in nature and therefore not feasible either for exchange trading or central clearing. For such nonstandard transactions we are strongly advocating the use of centralized trade repositories, which would maintain official records of all noncentrally-cleared CDS deals. It is important to note that the availability of information on complex deals in a central repository or otherwise is necessary but not sufficient for fully understanding the risks of these positions. Even if additional information on AIG's positions had been available from trade repositories and other sources, the positions would have been as difficult to value and monitor for risk without considerable additional analysis.

Most critically, both trade repositories and clearinghouses provide information on open CDS contracts. Of most value and interest to regulators are the open interest in CDS written on specific underliers and the open positions of a given entity vis-a-vis its counterparties. Both could provide regulators with information on aggregate and participant exposures in near real time. A clearinghouse could in addition provide information on collateral against these exposures and the CCP's valuation of the contracts cleared. An exchange on top of a clearinghouse would be able to provide real-time information on trading interest in terms of prices and volumes, which could be used by regulators to monitor market activity.

Q.3. *Systemic Risk Regulation*—The Federal Reserve and the OTS currently have consolidated supervisory authority over bank and thrift holding companies respectively. This authority grants the regulators broad powers to regulate some of our Nation's largest, most complex firms, yet some of these firms have failed or are deeply troubled.

Mr. Tarullo, do you believe there were failures of the Federal Reserve's holding company supervision regime and, if so, what would be different under a new systemic risk regulatory scheme?

A.3. I expect that when the history of the financial crisis is finally written, culpability will be shared by essentially every part of the government responsible for constructing and implementing financial regulation, including the Federal Reserve. Since just about all financial institutions have been adversely affected by the financial crisis—not just those that have failed—all supervisors have lessons to learn from this crisis.

As to what will be different going forward, I would suggest the following:

First, the Federal Reserve is already implementing a number of changes, such as enhancing risk identification processes to more quickly detect emerging risks. The Board is also improving the processes to issue supervisory guidance and policies to make them more timely and effective. In 2008 the Board issued supervisory guidance on consolidated supervision to clarify the Federal Reserve's role as consolidated supervisor and to assist the examination staff as they carry out supervision of banking institutions, particularly large, complex firms with multiple legal entities.

Second, I would hope that both statutory provisions and administrative practices would change so as to facilitate a truly com-

prehensive approach to consolidated supervision. This would include, among other things, amending the Gramm-Leach-Bliley Act, whose emphasis on "functional regulation" for prudential purposes is at odds with the comprehensive approach that is needed to supervise large, complex institutions effectively for safety and soundness and systemic risks. For example, the Act places certain limits on the Federal Reserve's ability to examine or obtain reports from functionally regulated subsidiaries of a bank holding company.

Third, our increasing focus on risks that are created across institutions and in interactions among institutions should improve identification of incipient risks within specific institutions that may not be so evident based on examination of a single firm. In this regard, the Federal Reserve is expanding and refining the use of horizontal supervisory reviews. An authority charged with systemic risk regulatory tasks would presumably build on this kind of approach, but it is also important in more conventional, institution-specific consolidated supervision.

Fourth, I believe it is fair to say that there is a different orientation towards regulation and supervision within the current Board than may have been the case at times in the past.

Q.4. *Liquidity Management*—A problem confronting many financial institutions currently experiencing distress is the need to roll-over short-term sources of funding. Essentially these banks are facing a shortage of liquidity. I believe this difficulty is inherent in any system that funds long-term assets, such as mortgages, with short-term funds. Basically the harm from a decline in liquidity is amplified by a bank's level of "maturity-mismatch."

I would like to ask each of the witnesses, should regulators try to minimize the level of a bank's maturity-mismatch? And if so, what tools would a bank regulator use to do so?

A.4. The current crisis has proven correct those who have maintained in recent years that liquidity risk management needed considerably more attention from banks, holding companies, and supervisors. As will be described below, a number of steps are already being taken to address this need, but additional analysis will clearly be needed. At the outset, though, it is worth emphasizing that maturity transformation through adequately controlled maturity mismatches is an important economic function that banks provide in promoting overall economic growth. Indeed, the current problems did not arise solely from balance sheet maturity mismatches that banks carried into the current crisis. For almost 2 years, many financial institutions have been unable to roll over short-term and maturing intermediate-term funding or have incurred maturity mismatches primarily because of their inability to obtain longer-term funds as a result of solvency concerns in the market. This has been exacerbated by some institutions having to take onto their balance sheets assets that were previously considered off-balance sheet.

To elaborate this point, it is important to note that most of the serious mismatches that led to significant "tail" liquidity risks occurred in instruments and activities outside of traditional bank lending and borrowing businesses. The most serious mismatches encountered were engineered into various types of financial prod-

ucts and securitization vehicles such as structured investment vehicles (SIVs), variable rate demand notes (VRDNs) and other products sold to institutional and retail customers. In addition, a number of managed stable value investment products such as registered money market mutual funds and unregistered stable value investment accounts and hedge funds undertook significant mismatches that compromised their integrity. Many of these mismatches were transferred to banking organizations during the crisis through contractual commitments to extend liquidity to such vehicles and products. Where no such contractual commitments existed, assets came onto banks' balance sheets as a result of their decisions to support sponsored securitization vehicles, customer funding products, and investment management funds in the interest of mitigating the banks' brand reputation risks.

However, such occurrences do not minimize the significant mismatches that occurred through financial institutions', and their hedge fund customers', significant use of short-term repurchase agreements and reverse repurchase agreements to finance significant potions off their dealer inventories and trading positions. Such systemic reliance on short-term funding placed significant pressures on the triparty repo market.

The task for regulators and policy makers is to ensure that any mismatches taken by banking organizations are appropriately managed and controlled. The tools used by supervisors to achieve this goal include the clear articulation of supervisory expectations surrounding sound practices for liquidity risk management and effective on-site assessment as to whether institutions are complying with those expectations. In an effort to strengthen these tools, supervisors have taken a number of steps. In September 2008 the Basel Committee on Bank Supervision (BCBS) issued a revised set of international principles on liquidity risk management. The U.S. bank regulatory agencies plan to issue joint interagency guidance endorsing those principles and providing a single set of U.S. supervisory expectations that aggregates well-established guidance issued by each agency in the past. Both the international and U.S. guidance, which highlight the need for banks to assess the liquidity risk embedded in off-balance sheet exposures, should re-enforce both banks' efforts to enhance their liquidity risk management processes and supervisory actions to improve oversight of these processes. In addition, the BCBS currently has efforts underway to establish international standards on liquidity risk exposures that is expected to be issued for comment in the second half of 2009. Such standards have the potential for setting the potential limits on maturity mismatches and requirements for more stable funding of dealer operations, while acknowledging the important role maturity mismatches play in promoting economic growth.

Q.5. *What Is Really Off-Balance Sheet*—Chairman Bair noted that structured investment vehicles (SIVs) played an important role in funding credit risk that are at the core of our current crisis. While the banks used the SIVs to get assets of their balance sheet and avoid capital requirements, they ultimately wound up reabsorbing assets from these SIVs.

Why did the institutions bring these assets back on their balance sheet? Was there a discussion between the OCC and those with

these off-balance sheet assets about forcing the investor to take the loss?

How much of these assets are now being supported by the Treasury and the FDIC?

Based on this experience, would you recommend a different regulatory treatment for similar transactions in the future? What about accounting treatment?

A.5. Companies that sponsored SIVs generally acted as investment managers for the SIVs and funded holdings of longer-term assets with short-term commercial paper and medium-term notes. As the asset holdings began to experience market value declines and the liquidity for commercial paper offerings deteriorated, SIVs faced ratings pressure on outstanding debt. In addition, SIV sponsors faced legal and reputational risk as losses began accruing to third-party holders of equity interests in the SIVs. Market events caused some SIV sponsors to reconsider their interests in the vehicles they sponsored and to conclude that they were the primary beneficiary as defined in FASB Interpretation No. 46(R), which required them to consolidate the related SIVs. In addition, market events caused some SIV sponsors to commit formally to support SIVs through credit or liquidity facilities with the intention of maintaining credit ratings on outstanding senior debt. Those additional commitments caused the sponsors to conclude that they were the primary beneficiary of the related vehicles and, therefore, to consolidate.

Very few U.S. banks consolidated SIV assets in 2007 and 2008. Citigroup disclosed in their 2008 Annual Report that $6.4 billion in SIV assets were part of an agreed asset pool covered in the U.S. government loss sharing arrangement announced November 23, 2008. We are not aware of other material direct support of SIV assets through the Treasury Department or the FDIC.

Recent events have demonstrated the need for supervisors and banks to better assess risks associated with off-balance sheet exposures. The Federal Reserve participated in the development of proposed guidance published by the BCBS in January 2009, to strengthen supervisory expectations for capturing firm-wide risk concentrations arising from both on- and off-balance-sheet exposures. These include both contractual exposures, as well as the potential impact on overall risk, capital, and liquidity of noncontractual exposures such as reputational risk exposure to off-balance-sheet vehicles and asset management activities. Exercises to evaluate possible additional supervisory and regulatory changes to the requirements for off-balance-sheet exposures are ongoing and include the BCBS efforts to develop international standards surrounding banks' liquidity risk profiles.

The Federal Reserve supports recent efforts by the Financial Accounting Standards Board to amend and clarify the accounting treatment for off-balance-sheet vehicles such as SIVs, securitization trusts, and structured finance conduits. We applauded the FASB for requiring additional disclosure of such entities in public company financials starting with year-end 2008 reports, as well. We are hopeful that the amended accounting guidance for consolidation of special purpose entities like SIVs will result in consistent application in practice and enhanced transparency. That outcome would permit financial statement users, including regulators, to assess

potential future risks facing financial institutions by virtue of the securitization and structured finance activities in which it engages.

Q.6. *Regulatory Conflict of Interest*—Federal Reserve Banks which conduct bank supervision are run by bank presidents that are chosen in part by bankers that they regulate.

Mr. Tarullo, do you see the potential for any conflicts of interest in the structural characteristics of the Fed's bank supervisory authorities?

A.6. The Board of Governors has the statutory responsibility for supervising bank holding companies, state member banks, and the other banking organizations for which the Federal Reserve System has supervisory authority under the Bank Holding Company Act, the Federal Reserve Act, and other federal laws. See, *e.g.,* 12 U.S.C. §248(a) (state member banks), §1844 (bank holding companies), and §3106(c) (U.S. branches and agencies of foreign banks). Although the Board has delegated authority to the Reserve Banks to conduct many of the Board's supervisory functions with respect to banking organizations, applicable regulations and policies are adopted by the Board alone. The Reserve Banks conduct supervisory activities subject to oversight and monitoring by the Board. It is my expectation that the Board will exercise this oversight vigorously.

The recently completed Supervisory Capital Assessment Program (SCAP) provides an excellent example of how this oversight and interaction can operate effectively in practice. The SCAP process was a critically important part of the government's efforts to promote financial stability and ensure that the largest banking organizations have sufficient capital to continue providing credit to households and businesses even under adverse economic conditions. The Board played a lead and active role in the design of the SCAP, the coordination and implementation of program policies, and the assessment of results across all Federal Reserve districts. These efforts were instrumental in ensuring that the SCAP was rigorous, comprehensive, transparent, effective, and uniformly applied. The Board is considering ways to apply the lessons learned from the SCAP to the Federal Reserve's regular supervisory activities to make them stronger, more effective, and more consistent across districts.

Q.7. *Too-Big-To-Fail*—Chairman Bair stated in her written testimony that "the most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of those institutions similar to that which exists for FDIC-insured banks. In short we need to end too big to fail." I would agree that we need to address the too-big-to-fail issue, both for banks and other financial institutions.

Could each of you tell us whether putting a new resolution regime in place would address this issue?

How would we be able to convince the market that these systemically important institutions would not be protected by taxpayer resources as they had been in the past?

A.7. As we have seen in the current financial crisis, large, complex, interconnected financial firms pose significant challenges to super-

visors. Policymakers have strong incentives to prevent the failure of such firms because of the risks such a failure would pose to the financial system and the broader economy. However, the belief of market participants that a particular firm will receive special government assistance if it becomes troubled 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 size and complexity, 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, of course, the government rescues of such firms are potentially very costly to taxpayers.

Improved resolution procedures for systemically important financial firms would help reduce the too-big-to-fail problem in two ways. First, such procedures would visibly provide the authorities with the legal tools needed to manage the failure of a systemically important firm while still ensuring that creditors and counterparties suffer appropriate losses in the event of the firm's failure. As a result, creditors and counterparties should have greater incentives to impose market discipline on financial firms. Second, by giving the government options other than general support to keep a distressed firm operating, resolution procedures should give the managers of systemically important firms somewhat better incentives to limit risk taking and avoid failure.

While resolution authority of this sort is an important piece of an agenda to control systemic risk, it is no panacea. In the first place, resolving a large, complex financial institution is a completely different task from resolving a small or medium-sized bank. No part of the U.S. Government has experience in this task. Although one or more agencies could acquire relevant expertise as needed, we cannot be certain how this resolution mechanism would operate in practice. Second, precisely because of the uncertainties that will, at least for a time, surround a statutory mechanism of this sort, there must also be effective supervision and regulation of these institutions that is targeted more directly at their systemic importance.

Q.8. *Pro-Cyclicality*—I have some concerns about the pro-cyclical nature of our present system of accounting and bank capital regulation. Some commentators have endorsed a concept requiring banks to hold more capital when good conditions prevail, and then allow banks to temporarily hold less capital in order not to restrict access to credit during a downturn. Advocates of this system believe that counter-cyclical policies could reduce imbalances within financial markets and smooth the credit cycle itself.

What do you see as the costs and benefits of adopting a more counter-cyclical system of regulation?

Do you see any circumstances under which your agencies would take a position on the merits of counter-cyclical regulatory policy?

A.8. There is a good bit of evidence that current capital standards, accounting rules, certain other regulations, and even deposit insurance premiums have made the financial sector excessively pro-cyclical—that is, they lead financial institutions to ease credit in booms and tighten credit in downturns more than is justified by changes

in the creditworthiness of borrowers, thereby intensifying cyclical changes.

For example, capital regulations require that banks' capital ratios meet or exceed fixed minimum standards in order for the bank to be considered safe and sound by regulators. Because banks typically find raising capital to be difficult in economic downturns or periods of financial stress, their best means of boosting their regulatory capital ratios during difficult periods may be to reduce new lending, perhaps more so than is justified by the credit environment.

As I noted in my testimony, the Federal Reserve is working with other U.S. and foreign supervisors to strengthen the existing capital rules to achieve a higher level and quality of required capital. As one part of this overall effort, we have been assessing various proposals for mitigating the pro-cyclical effects of existing capital rules, including dynamic provisioning or a requirement that financial institutions establish strong capital buffers above current regulatory minimums in good times, so that they can weather financial market stress and continue to meet customer credit needs. This is but one of a number of important ways in which the current procyclical features of financial regulation could be modified, with the aim of counteracting rather than exacerbating the effects of financial stress.

Q.9. *G20 Summit and International Coordination*—Many foreign officials and analysts have said that they believe the upcoming G20 summit will endorse a set of principles agreed to by both the Financial Stability Forum and the Basel Committee, in addition to other government entities. There have also been calls from some countries to heavily re-regulate the financial sector, pool national sovereignty in key economic areas, and create powerful supranational regulatory institutions. (Examples are national bank resolution regimes, bank capital levels, and deposit insurance.) Your agencies are active participants in these international efforts.

What do you anticipate will be the result of the G20 summit?

Do you see any examples or areas where supranational regulation of financial services would be effective?

How far do you see your agencies pushing for or against such supranational initiatives?

A.9. As you point out, the Federal Reserve has for many years worked with international organizations such as the Basel Committee on Banking Supervision, the Financial Stability Forum (now the Financial Stability Board), the Joint Forum and others on matters of mutual interest. Our participation reflects our long-held belief, reinforced by the current financial crisis, that the international dimensions of financial supervision and regulation and financial stability are critical to the health and stability of the U.S. financial system and economy, as well as to the competitiveness of our financial firms. Thus, it is very much in the self-interest of the United States to play an active role in international forums. Our approach in these groups has not been on the development of supranational authorities. Rather, it has been on the voluntary collection and sharing of information, the open discussion of views, the development of international contacts and knowledge, the transfer of tech-

nical expertise, cooperation in supervising globally active financial firms, and agreements an basic substantive rules such as capital requirements. As evidenced in the activities of the G20 and the earlier-mentioned international fora, the extraordinary harm worked by the current financial crisis on an international scale suggests the need for continued evolution of these approaches to ensure the stability of major financial firms and systems around the world.

Q.10. *Consolidated Supervised Entities*—Mr. Tarullo, in your testimony you noted that "the SEC was forced to rely on a voluntary regime" because it lacked the statutory authority to act as a consolidated supervisor.

Who forced the SEC to set up the voluntary regime? Was it the firm that wanted to avoid being subject to a more rigorous consolidated supervision regime?

A.10. Under the Securities Exchange Act of 1934 (15 U.S.C. §§78a, *et seq.*), the Securities and Exchange Commission (SEC) has broad supervisory authority over SEC-registered broker-dealers, but only limited authority with respect to a company that controls a registered broker-dealer. See 15 U.S.C. §§78o and 78q(h). In 2002, the European Union (EU) adopted a directive that required banking groups and financial conglomerates based outside the EU to receive, by August 2004, a determination that the financial group was subject to consolidated supervision by its home country authorities in a manner equivalent to that required by the EU for EU-based financial groups. If a financial group could not obtain such a determination, the directive permitted EU authorities to take a range of actions with respect to the non-EU financial group, including requiring additional reports from the group or, potentially, requiring the group to reorganize all its EU operations into a single EU holding company that would be subject to consolidated supervision by a national regulator within the EU. See Directive 2002/87/EC of the European Parliament and of the Council of 16 (Dec. 2002). After this directive was adopted, several of the large U.S. investment banks that were not affiliated at the time with a bank holding company expressed concern that, if they were unable to obtain an equivalency determination from the EU, the firms' significant European operations could be subject to potentially costly or disruptive EU-imposed requirements under the directive.

In light of these facts, and to improve its own ability to monitor and address the risks at the large U.S. investment banks that might present risks to their subsidiary broker-dealers, the SEC in 2004 adopted rules establishing a voluntary consolidated supervision regime for those investment banking firms that controlled U.S. broker-dealers with at least $1 billion in tentative net capital, and at least $500 million of net capital, under the SEC's broker-dealer capital rules. The Goldman Sachs Group, Inc. (Goldman Sachs), Morgan Stanley, Merrill Lynch & Co., Inc. (Merrill Lynch), Lehman Brothers Holdings, Inc. (Lehman), and The Bear Stearns Companies, Inc., each applied and received approval to become consolidated supervised entities (CSEs) under the SEC's rules. These rules were not the same as would have applied to these entities had they became bank holding companies. While operating as

CSEs, Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman also controlled FDIC-insured state banks under a loophole in current law that allows any type of company to acquire an FDIC-insured industrial loan company (LC) chartered in certain states without becoming subject to the prudential supervisory and regulatory framework established under the Bank Holding Company Act of 1956 (BHC Act).[1] As I noted in my testimony, the Board continues to believe that this loophole in current law should be closed.

Q.11. *Credit Default Swaps*—Mr. Tarullo, the Federal Reserve Bank of New York has been actively promoting the central clearing of credit default swaps.

How will you encourage market participants, some of whom benefit from an opaque market, to clear their trades?

Is it your intent to see the establishment of one clearinghouse or are you willing to allow multiple central clearing facilities to exist and compete with one another?

Is the Fed working with European regulators to coordinate efforts to promote clearing of CDS transactions?

How will the Fed encourage market participants, some of whom benefit from an opaque market, to clear their credit default swap transactions?

Is it the Fed's expectation that there will be only one credit default swap clearinghouse or do you envision multiple central clearing counterparties existing in the long run?

How is the Fed working with European regulators to coordinate efforts to promote clearing of credit default swap transactions?

What other classes of OTC derivatives are good candidates for central clearing and what steps is the Fed taking to encourage the development and use of central clearing counterparties?

A.11. The Federal Reserve can employ supervisory tool to encourage derivatives dealers that are banks or part of a bank holding company to centrally clear CDS. These include the use of capital charges to provide incentives, as well as direct supervisory guidance for firms to ensure that any product to which such a dealer is a party will, if possible, be submitted to and cleared by a CCP.

The Federal Reserve is also encouraging greater transparency in the CDS market. Through the Federal Reserve Bank of New York's (FRBW) ongoing initiatives with market participants, the major dealers have been providing regulators with data on the volumes of CDS trades that are recorded in the trade repository and will soon begin reporting data around the volume of CDS trades cleared through a CCP.

There are multiple existing or proposed CCPs for CDS. The Federal Reserve has not endorsed any one CCP proposal. Our top priority is that any CDS CCP be well-regulated and prudently managed. We believe that market forces in a competitive environment should determine which and how many CDS CCPs exist in the long run.

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[1] The ownership of such ILCs also disqualified such firms from potential participation in the alternative, voluntary consolidated supervisory regime that Congress authorized the SEC to establish for "investment bank holding companies" as part of the Gramm-Leach-Bliley Act of 1999. See 15 U.S.C. §78q(i)(1)(A)(i).

The FRBNY has hosted a series of meetings with U.S. and foreign regulators to discuss possible information sharing arrangements and other methods of cooperation within the regulatory community. Most recently, the FRBNY hosted a workshop on April 17, attended by 28 financial regulators including those with direct regulatory authority over a CCP, as well as other interested regulators and governmental authorities that are currently considering CDS market matters. Workshop participants included European regulators with broad coverage such as the European Commission, the European Central Bank and the Committee of European Securities Regulators.[2] Participants discussed CDS CCP regulatory interests and information needs of other authorities and the market more broadly and agreed to a framework to facilitate information sharing and cooperation.

The FRBNY will continue to coordinate with other regulators in the U.S. and Europe to establish a coherent approach for communicating supervisory expectations, to encourage consistent treatment of CCPs across jurisdictions, and to ensure that regulators have adequate access to the information necessary to carry out their respective objectives.

Additionally, since 2005 the FRBNY has been coordinating with foreign regulators[3] in its ongoing work with major dealers and large buy-side firms to strengthen the operational infrastructure of the OTC derivatives market more broadly. The regulatory community holds monthly calls to discuss, these efforts, which include central clearing for CDS.

The degree of risk reduction and enhanced operational efficiency that might be obtained from the use of a CCP may vary across asset classes. However, a CCP for any OTC derivatives asset class must be well designed with effective risk management controls that meet, at a minimum, international standards for central counterparties.

A number of CCPs are already in use for other OTC derivatives asset classes including LCH.Clearnet's SwapClear for interest rates and CME/NYMEX's ClearPort for energy and other OTC commodities. The FRBNY is working with the market participants to ensure that clearing members utilize more fully available clearing services and to encourage CCPs to support additional products and include a wider range of participants. The industry will provide further details to regulators and the public at the end of May addressing many of these issues for the various derivative asset classes.

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[2] Regulators and other interested authorities that attended the April 17 Workshop included: Belgian Banking, Finance and Insurance Commission (CBFA), National Bank of Belgium, Committee of European Securities Regulators (CESR), European Central Bank, European Commission, Bank of France, Commission Bancaire, French Financial Markets Authority (AMF), Deutsche Bundesbank, German Financial Supervisory Authority (BaFin), Committee on Payment and Settlement Systems (CPSS) Bank of Italy, Bank of Japan, Japan Financial Services Agency , Netherlands Authority for the Financial Markets (AFM), Netherlands Bank , Bank of Spain, Spanish National Securities Market Commission (CNMV), Swiss Financial Market Supervisory Authority (FINMA). Swiss National Bank, Bank of England, UK Financial Services Authority, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Federal Reserve Bank of New York, Federal Reserve Board, New York State Banking Department, Office of the Comptroller of the Currency, and the Securities and Exchange Commission.

[3] Foreign regulators engaged in this effort include the UK Financial Services Authority, the German Federal Financial Supervisory Authority, the French Commission Bancaire, and the Swiss Financial Market Supervisory Authority.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM DANIEL K. TARULLO

Q.1. It is clear that our current regulatory structure is in need of reform. At my subcommittee hearing on risk management, March 18, 2009, GAO pointed out that regulators often did not move swiftly enough to address problems they had identified in the risk management systems of large, complex financial institutions.

Chair Bair's written testimony for today's hearing put it very well: " . . . the success of any effort at reform will ultimately rely on the willingness of regulators to use their authorities more effectively and aggressively."

My questions may be difficult, but please answer the following:

- If this lack of action is a persistent problem among the regulators, to what extent will changing the structure of our regulatory system really get at the issue?
- Along with changing the regulatory structure, how can Congress best ensure that regulators have clear responsibilities and authorities, and that they are accountable for exercising them "effectively and aggressively"?

A.1. Changing regulatory structures and—for that matter—augmenting existing regulatory authorities are necessary, but not sufficient, steps to engender strong and effective financial regulation. The regulatory orientation of agency leadership and staff are also central to achieving this end. While staff capacities and expertise will generally not deteriorate (or improve) rapidly, leadership can sometimes change extensively and quickly.

While this fact poses a challenge in organizing regulatory systems, there are some things that can be done. Perhaps most important is that responsibilities and authorities be both clearly defined and well-aligned, so that accountability is clear. Thus, for example, assigning a particular type of rulemaking and rule implementation to a specific agency makes very clear who deserves either blame or credit for outcomes. Where a rulemaking or rule enforcement process is collective, on the other hand, the apparent shared responsibility may mean in practice that no one is responsible: Procedural delays and substantive outcomes can also be attributed to someone else's demands or preferences.

When responsibility is assigned to an agency, the agency should be given adequate authority to execute that responsibility effectively. In this regard, Congress may wish to review the Gramm-Leach-Bliley Act and other statutes to ensure that authorities and responsibilities are clearly defined for both primary and consolidated supervisors of financial firms and their affiliates. Some measure of regulatory overlap may be useful in some circumstances—a kind of constructive redundancy—so long as both supervisors have adequate incentives for balancing various policy objectives. But if, for example, access to information is restricted or one supervisor must rely on the judgments of the other, the risk of misaligned responsibility and authority recurs.

Q.2. How do we overcome the problem that in the boom times no one wants to be the one stepping in to tell firms they have to limit their concentrations of risk or not trade certain risky products?

What thought has been put into overcoming this problem for regulators overseeing the firms?

Is this an issue that can be addressed through regulatory restructure efforts?

A.2. Your questions highlight a very real and important issue—how best to ensure that financial supervisors exercise the tools at their disposal to address identified risk management weaknesses at an institution or within an industry even when the firm, the industry, and the economy are experiencing growth and appear in sound condition. In such circumstances, there is a danger that complacency or a belief that a "rising tide will lift all boats" may weaken supervisory resolve to forcefully address issues. In addition, the supervisor may well face pressure from external sources—including the supervised institutions, industry or consumer groups, or elected officials—to act cautiously so as not to change conditions perceived as supporting growth. For example, in 2006, the Federal Reserve, working in conjunction with the other federal banking agencies, developed guidance highlighting the risks presented by concentrations in commercial real estate. This guidance drew criticism from many quarters, but is particularly relevant today given the substantial declines in many regional and local commercial real estate markets.

Although these dangers and pressures are to some degree inherent in any regulatory framework, there are ways these forces can be mitigated. For example, sound and effective leadership at any supervisory agency is critical to the consistent achievement of that agency's mission. Moreover, supervisory agencies should be structured and funded in a manner that provides the agency appropriate independence. Any financial supervisory agency also should have the resources, including the ability to attract and retain skilled staff, necessary to properly monitor, analyze and—when necessary—challenge the models, assumptions and other risk management practices and internal controls of the firms it supervises, regardless of how large or complex they may be.

Ultimately, however, supervisors must show greater resolve in demanding that institutions remain in sound financial condition, with strong capital and liquidity buffers, and that they have strong risk management. While these may sound like obvious statements in the current environment, supervisors will be challenged when good times return to the banking industry and bankers claim that they have learned their lessons. At precisely those times, when bankers and other financial market actors are particularly confident, when the industry and others are especially vocal about the costs of regulatory burden and international competitiveness, and when supervisors cannot yet cite recognized losses or writedowns, regulators must be firm in insisting upon prudent risk management.

Once again, regulatory restructuring can he helpful, but will not be a panacea. Financial regulators should speak with one, strong voice in demanding that institutions maintain good risk management practices and sound financial condition. We must be particularly attentive to cases where different agencies could be sending conflicting messages. Improvements to the U.S. regulatory structure could provide added benefit by ensuring that there are no reg-

ulatory gaps in the U.S. financial system, and that entities cannot migrate to a different regulator or, in some cases, beyond the boundary of any regulation, so as to place additional pressure on those supervisors who try to maintain firm safety and soundness policies.

Q.3. As Mr. Tarullo and Mrs. Bair noted in their testimony, some financial institution failures emanated from institutions that were under federal regulation. While I agree that we need additional oversight over and information on unregulated financial institutions, I think we need to understand why so many regulated firms failed.

Why is it the case that so many regulated entities failed, and many still remain struggling, if our regulators in fact stand as a safety net to rein in dangerous amounts of risk-taking?

While we know that certain hedge funds, for example, have failed, have any of them contributed to systemic risk?

Given that some of the federal banking regulators have examiners on-site at banks, how did they not identify some of these problems we are facing today?

A.3. My expectation is that, when the history of this financial crisis and its origins is ultimately written, culpability will be shared by essentially every part of the government responsible for constructing and implementing financial regulation, as well as many financial institutions themselves. Since just about all financial institutions have been adversely affected by the financial crisis, all supervisors have lessons to learn from this crisis. The Federal Reserve is already implementing a number of changes, such as enhancing risk identification processes to more quickly detect emerging risks, not just at individual institutions but across the banking system. This latter point is particularly important, related as it is to the emerging consensus that more attention must be paid to risks created across institutions. The Board is also improving the processes to issue supervisory guidance and policies to make them more timely and effective. In 2008 the Board issued supervisory guidance on consolidated supervision to clarify the Federal Reserve's role as consolidated supervisor and to assist examination staff as they carry out supervision of banking institutions, particularly large, complex firms with multiple legal entities.

With respect to hedge funds, although their performance was particularly poor in 2008, and several large hedge funds have failed over the past 2 years, to date none has been a meaningful source of systemic risk or resulted in significant losses to their dealer bank counterparties. Indirectly, the failure of two hedge funds in 2007 operated by Bear Stearns might be viewed as contributing to the ultimate demise of that investment bank 9 months later, given the poor quality of assets the firm had to absorb when it decided to support the funds. However, these failures in and of themselves were not the sole cause of Bear Stearns' problems. Of course, the experience with Long Term Capital Management in 1998 stands as a reminder that systemic risk can be associated with the activities of large, highly leveraged hedge funds.

On-site examiners of the federal banking regulators did identify a number of issues prior to the current crisis, and in some cases

developed policies and guidance for emerging risks and issues that warranted the industry's attention—such as in the areas of nontraditional mortgages, home equity lending, and complex structured financial transactions. But it is clear that examiners should have been more forceful in demanding that bankers adhere to policies and guidance, especially to improve their own risk management capacities. Going forward, changes have been made in internal procedures to ensure appropriate supervisory follow-through on issues that examiners do identify, particularly during good times when responsiveness to supervisory policies and guidance may be lower.

Q.4. While I think having a systemic risk regulator is important, I have concerns with handing additional authorities to the Federal Reserve after hearing GAO's testimony yesterday at my subcommittee hearing.

Some of the Fed's supervision authority currently looks a lot like what it might conduct as a systemic risk regulator, and the record there is not strong from what I have seen.

If the Federal Reserve were to be the new systemic risk regulator, has there been any discussion of forming a board, similar to the Federal Open Market Committee, that might include other regulators and meet quarterly to discuss and publicly report on systemic risks?

If the Federal Reserve were the systemic risk regulator, would it conduct horizontal reviews that it conducts as the supervisor for bank holding companies, in which it looks at specific risks across a number of institutions?

If so, and given what we heard March 18, 2009, at my subcommittee hearing from GAO about the weaknesses with some of the Fed's follow-up on reviews, what confidence can we have that the Federal Reserve would do a better job than it has so far?

A.4. In thinking about reforming financial regulation, it may be useful to begin by identifying the desirable components of an agenda to contain systemic risk, rather than with the concept of a specific systemic risk regulator. In my testimony I suggested several such components—consolidated supervision of all systemically important financial institutions, analysis and monitoring of potential sources of systemic risk, special capital and other rules directed at systemic risk, and authority to resolve nonbank, systemically important financial institutions in an orderly fashion. As a matter of sound administrative structure and practice, there is no reason why all four of these tasks need be assigned to the same agency. Indeed, there may be good reasons to separate some of these functions—for example, conflicts may arise if the same agency were to be both a supervisor of an institution and the resolution authority for that institution if it should fail.

Similarly, there is no inherent reason why an agency charged with enacting and enforcing special rules addressed to systemic risk would have to be the consolidated supervisor of all systemically important institutions. If another agency had requisite expertise and experience to conduct prudential supervision of such institutions, and so long as the systemic risk regulator would have necessary access to information through examination and other proc-

esses and appropriate authority to address potential systemic risks, the roles could be separated. For example, were Congress to create a federal insurance regulator with a safety and soundness mission, that regulator might be the most appropriate consolidated supervisor for nonbank holding company firms whose major activities are in the insurance area.

With respect to analysis and monitoring, it would seem useful to incorporate an interagency process into the framework for systemic risk regulation. Identification of inchoate or incipient systemic risks will in some respects be a difficult exercise, with a premium on identifying risk correlations among firms and markets. Accordingly, the best way to incorporate more expertise and perspectives into the process is through a collective process, perhaps a designated sub-group of the President's Working Group on Financial Markets. Because the aim, of this exercise would be analytic, rather than regulatory, there would be no problem in having both executive departments and independent agencies cooperating. Moreover, as suggested in your question, it may be useful to formalize this process by having it produce periodic public reports. An additional benefit of such a process would be that to allow nongovernmental analysts to assess and, where appropriate, critique these reports. As to potential rule-making, on the other hand, experience suggests that a single agency should have both authority and responsibility. While it may be helpful for a rule-maker to consult with other agencies, having a collective process would seem a prescription for delay and for obscuring accountability.

Regardless of whether the Federal Reserve is given additional responsibilities, we will continue to conduct horizontal reviews. Horizontal reviews of risks, risk management practices and other issues across multiple financial firms are very effective vehicles for identifying both common trends and institution-specific weaknesses. The recently completed Supervisory Capital Assessment Program (SCAP) demonstrates the effectiveness of such reviews and marked an important evolutionary step in the ability of such reviews to enhance consolidated supervision. This exercise was significantly more comprehensive and complex than horizontal supervisory reviews conducted in the past. Through these reviews, the Federal Reserve obtained critical perspective on the capital adequacy and risk management capabilities of the 19 largest U.S. bank holding companies in light of the financial turmoil of the last year.

While the SCAP process was an unprecedented supervisory exercise in an unprecedented situation, it does hold important lessons for more routine supervisory practice. The review covered a wide range of potential risk exposures and available firm resources. Prior supervisory reviews have tended to focus on fewer firms, specific risks and/or individual business lines, which likely resulted in more, "siloed" supervisory views. A particularly innovative and effective element of the SCAP review was the assessment of individual institutions using a uniform set of supervisory devised stress parameters, enabling better supervisory targeting of institution-specific strengths and weaknesses. Follow-up from these assessments was rapid, and detailed capital plans for the institutions will follow shortly.

As already noted, we expect to incorporate lessons from this exercise into our consolidated supervision of bank holding companies. In addition, though, the SCAP process suggests some starting points for using horizontal reviews in systemic risk assessment.

Regarding your concerns about the Federal Reserve's performance in the run-up to the financial crisis, we are in the midst of a comprehensive review of all aspects of our supervisory practices. Since last year, Vice Chairman Kohn has led an effort to develop recommendations for improvements in our conduct of both prudential supervision and consumer protection. We are including advice from the Government Accountability Office, the Congress, the Treasury, and others as we look to improve our own supervisory practices. Among other things, our analysis reaffirms that capital adequacy, effective liquidity planning, and strong risk management are essential for safe and sound banking; the crisis revealed serious deficiencies on the part of some financial institutions in one or more of the areas. The crisis has likewise underscored the need for more coordinated, simultaneous evaluations of the exposures and practices of financial institutions, particularly large, complex firms.

Q.5. Mr. Tarullo, the Federal Reserve has been at the forefront of encouraging countries to adopt Basel II risk-based capital requirements. This model requires, under Pillar I of Basel II, that risk-based models calculate required minimum capital.

It appears that there were major problems with these risk management systems, as I heard in GAO testimony at my subcommittee hearing on March l8th, 2009, so what gave the Fed the impression that the models were ready enough to be the primary measure for bank capital?

Moreover, how can the regulators know what "adequately capitalized" means if regulators rely on models that we now know had material problems?

A.5. The current status of Basel II implementation is defined by the November 2007 rule that was jointly issued by the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and Federal Reserve Board. Banks will not be permitted to operate under the advanced approaches until supervisors are confident the underlying models are functioning in a manner that supports using them as basis for determining inputs to the risk-based capital calculation. The rule imposes specific model validation, stress testing, and internal control requirements that a bank must meet in order to use the Basel II advanced approaches. In addition, a bank must demonstrate that its internal processes meet all of the relevant qualification requirements for a period of at least 1 year (the parallel run) before it may be permitted by its supervisor to begin using those processes to provide inputs for its risk-based capital requirements. During the first 3 years of applying Basel II, a bank's regulatory capital requirement would not be permitted to fall below floors established by reference to current capital rules. Moreover, banks will not be allowed to exit this transitional period if supervisors conclude that there are material deficiencies in the operation of the Basel II approach during these transitional years. Finally, supervisors have the continued authority to require capital beyond the minimum re-

quirements, commensurate with a bank's credit, market, operational, or other risks.

Quite apart from these safeguards that U.S. regulators will apply to our financial institutions, the Basel Committee has undertaken initiatives to strengthen capital requirements—both those directly related to Basel II and other areas such as the quality of capital and the treatment of market risk. Staff of the Federal Reserve and other U.S. regulatory agencies are participating fully in these reviews. Furthermore, we have initiated an internal review on the pace and nature of Basel II implementation, with particular attention to how the long-standing debate over the merits and limitations of Basel II has been reshaped by experience in the current financial crisis. While Basel II was not the operative capital requirement for U.S. banks in the prelude to the crisis, or during the crisis itself, regulators must understand how it would have made things better or worse before permitting firms to use it as the basis for regulatory capital requirements.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM DANIEL K. TARULLO

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of federal and state functional regulation for large, interconnected, and large firms like AIG?

A.1. The approaches of establishing systemic risk regulation and reassessing current statutory patterns of functional regulation need not be mutually exclusive, and Congress may want to consider both. Empowering a governmental authority to monitor, assess and, if necessary, curtail systemic risks across the entire U.S. financial system is one way to help protect the financial system from risks that may arise within or across financial industries or markets that may be supervised or regulated by different financial supervisors or that may be outside the jurisdiction of any financial supervisor. AIG is certainly an example of a firm whose connections with other financial entities constituted a distinct source of systemic risk.

At the same time, strong and effective consolidated supervision provides the institution-specific focus necessary to help ensure that large, diversified organizations operate in a safe and sound manner, regardless of where in the organization its various activities are conducted. Indeed as I indicated in my testimony, systemic risk regulatory authority should complement, not displace, consolidated supervision. While all holding companies that own a bank are subject to group-wide consolidated supervision under the Bank Holding Company Act (12 U.S.C. §§184141 *et seq.*) other systemically significant companies may currently escape such supervision. In addition, as suggested by your question, Congress may wish to consider whether a broader and more robust application of the principle of consolidated supervision would help reduce the potential for the

build up of risk-taking in different parts of a financial organization or the financial sector more broadly. This could entail, among other things, revising the provisions of Gramm-Leach-Bliley Act that currently limit the ability of consolidated supervisors to monitor and address risks at functionally regulated subsidiaries within a financial organization and specifying that consolidated supervisors of financial firms have clear authority to monitor and address safety and soundness concerns in all parts of an organization.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. There are two separate, but related, questions to answer in thinking about regulation of large, complex financial institutions. The first pertains to the substantive regulatory approaches to be adopted, the second to how those regulatory tasks will be allocated to specific regulatory agencies. As to the former question, in considering possible changes to current arrangements, Congress should be guided by a few basic principles that should help shape a legislative program.

First, recent experience has shown that it is critical that all systemically important firms be subject to effective consolidated supervision. The lack of consolidated supervision can leave gaps in coverage that allow large financial firms to take actions that put themselves, other firms, and the entire financial sector at risk. To be fully effective, consolidated supervisors must have clear authority to monitor and address safety and soundness concerns in all parts of an organization. Accordingly, specific consideration should be given to modifying the limits currently placed on the ability of consolidated supervisors to monitor and address risks at an organization's functionally regulated subsidiaries.

Second, it is important to have a resolution regime that facilitates managing the failure of a systemically important financial firm in an orderly manner, including a mechanism to cover the costs of the resolution. In most cases, federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, this framework does not sufficiently protect the public's interest in ensuring the orderly resolution of nonbank financial institutions when a failure would pose substantial systemic risks.

With respect to the allocation of regulatory missions among agencies, one can imagine a range of institutional arrangements that could provide for the effective supervision of financial services firms. While models adopted in other countries can be useful in suggesting options, the breadth and complexity of the financial services industry in the United States suggests that the most workable arrangements will take account of the specific characteristics

of our industry. As previously indicated, we suggest that Congress consider charging an agency with an explicit financial stability mission, including such tasks as assessing and, if necessary, curtailing systemic risks across the U.S. financial system. While establishment of such an authority would not be a panacea, this mission could usefully complement the focus of safety and soundness supervisors of individual firms.

Q.3. If there are institutions that are too big to fail, how do we identify that? How do we define the circumstance where a single company is so systemically significant to the rest of our financial circumstances and our economy that we must not allow it to fail?

A.3. Identifying whether a given institution's failure is likely to impose systemic risks on the U.S. financial system and our overall economy depends on specific economic and market conditions, and requires substantial judgment by policymakers. That said, several key principles should guide policymaking in this area.

No firm should be considered too big to fail in the sense that existing stockholders cannot lose their entire investment, existing senior management and boards of directors cannot be replaced, and over time the organization cannot be wound down or sold in whole or in part. In addition, from the point of view of maintaining financial stability, it is critical that such a wind down occur in an orderly manner, the reason for our recommendation for improved resolution procedures for systemically financial firms. Still, even without improved procedures, it is important to try to resolve the firm in an orderly manner without guaranteeing the longer-term existence of any individual firm.

The core concern of policymakers should be whether the failure of the firm would likely have contagion, or knock-on, effects on other key financial institutions and markets, and ultimately on the real economy. Such interdependencies can be direct, such as through deposit and loan relationships, or indirect, such as through concentrations in similar types of assets. Interdependencies can extend to broader financial markets and can also be transmitted through payment and settlement systems. The failure of the firm and other interconnected firms might affect the real economy through a sharp reduction in the supply of credit, or rapid declines in the prices of key financial and nonfinancial assets. Of course, contagion effects are typically more likely in the case of a very large institution than with a smaller institution. However, size is not the only criterion for determining whether a firm is potentially systemic. A firm may have systemic importance if it is critical to the functioning of key markets or critical payment and settlement systems.

Q.4. We need to have a better idea of what this notion of too big to fail is—what it means in different aspects of our industry and what our proper response to it should be. How should the federal government approach large, multinational, and systemically significant companies?

A.4. As we have seen in the current financial crisis, large, complex, interconnected financial firms pose significant challenges to supervisors. Policymakers have strong incentives to prevent the failure of such firms, particularly in a crisis, because of the risks that a

failure would pose to the financial system and the broader economy. However, the belief of market participants that a particular firm will receive special government assistance if it becomes troubled has many undesirable effects. It reduces market discipline and encourages excessive risk-taking by the firm. It also provides an incentive for firms to grow in size and complexity, 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 such firms can involve the commitment of substantial public resources, as we have seen recently, with the potential for taxpayer losses.

In the midst of this crisis, given the highly fragile state of financial markets and the global economy, government assistance to avoid the failures of major financial institutions was deemed necessary to avoid a further serious destabilization of the financial system, with adverse consequences for the broader economy. Looking to the future, however, it is imperative that policymakers address this issue by better supervising systemically critical firms to prevent excessive risk-taking and by strengthening the resilience of the financial system to minimize the consequences when a large firm must be unwound.

Achieving more effective supervision of large and complex financial firms will require, at a minimum, the following actions. First, supervisors need to move vigorously to address the capital, liquidity, and risk management weaknesses at major financial institutions that have been revealed by the crisis. Second, the government must ensure a robust framework—both in law and practice—for consolidated supervision of all systemically important financial firms. Third, the Congress should put in place improved tools to allow the authorities to resolve systemically important nonbank financial firms in an orderly manner, including a mechanism to cover the costs of the resolution. Improved resolution procedures for these firms would help reduce the too-big-to-fail problem by narrowing the range of circumstances that might be expected to prompt government intervention to keep a firm operating.

Q.5. What does "fail" mean? In the context of AIG, we are talking about whether we should have allowed an orderly Chapter 11 bankruptcy proceeding to proceed. Is that failure?

A.5. As a general matter, a company is considered to have "failed" if it no longer has the capacity to fund itself and meet its obligations, is insolvent (that is its obligations to others exceed its assets), or other conditions exist that permit a governmental authority, a court or stakeholders of the company to put the firm into liquidation or place the company into a conservatorship, receivership, or similar custodial arrangement. Under the Federal Deposit Insurance Act (FDIA), for example, a conservator or receiver may be appointed for an insured depository institution if any of a number of grounds exist. See 12 U.S.C. §1821(c)(5). Such grounds include that the institution is in an unsafe or unsound condition to transact business, or the institution has incurred or is likely to incur losses that deplete all or substantially all of its capital and there is no reasonable prospect for the institution to become adequately capitalized without federal assistance.

In the fall of 2008, American International Group, Inc. (AIG) faced severe liquidity pressures that threatened to force it imminently into bankruptcy. As Chairman Bernanke has testified, the Federal Reserve and the Treasury determined that AIG's bankruptcy under the conditions then prevailing would have posed unacceptable risks to the global financial system and to the economy. Such an event could have resulted in the seizure of its insurance subsidiaries by their regulators—leaving policyholders facing considerable uncertainty about the status of their claims—and resulted in substantial losses by the many banks, investment banks, state and local government entities, and workers that had exposures to AIG. The Federal Reserve and Treasury also believed that the risks posed to the financial system as a whole far outstripped the direct effects of a default by AIG on its obligations. For example, the resulting losses on AIG commercial paper would have exacerbated the problems then facing money market mutual funds. The failure of the firm in the middle of a financial crisis also likely would have substantially increased the pressures on large commercial and investment banks and could have caused policyholders and creditors to pull back from the insurance industry more broadly.

The AIG case provides strong support for a broad policy agenda that would address both systemic risk and the problems caused by firms that may be viewed as being too big, or too interconnected, to fail, particularly in times of more generalized financial stress. A key aspect of such an agenda includes development of appropriate resolution procedures for potentially systemic financial firms that would allow the government to resolve such a firm in an orderly manner and in a way that mitigates the potential for systemic shocks. As discussed in my testimony, other important measures that would help address the current too-big-to-fail problem include ensuring that all systemically important financial firms are subject to an effective regime for consolidated prudential supervision and vesting a government authority with more direct responsibility for monitoring and regulation of potential systemic risks in the financial system.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL FROM DANIEL K. TARULLO

Q.1. Two approaches to systemic risk seem to be identified: (1) monitoring institutions and taking steps to reduce the size/activities of institutions that approach a "too large to fail" or "too systemically important to fail" or (2) impose an additional regulator and additional rules and market discipline on institutions that are considered systemically important.

Which approach do you endorse? If you support approach one how you would limit institution size and how would you identify new areas creating systemic importance?

If you support approach two how would you identify systemically important institutions and what new regulations and market discipline would you recommend?

A.1. As we have seen in the current financial crisis, large, complex, interconnected financial firms pose significant challenges to supervisors. In the current environment, market participants recognize

that policymakers have strong incentives to prevent the failure of such firms because of the risks such a failure would pose to the financial system and the broader economy. A number of undesirable consequences can ensue: a reduction in market discipline, the encouragement of excessive risk-taking by the firm, an artificial incentive for firms to grow in size and complexity in order to be perceived as too big to fail, and an unlevel playing field with smaller firms that are not regarded as having implicit government support. Moreover, of course, government rescues of such firms can be very costly to taxpayers.

The nature and scope of this problem suggests that multiple policy instruments may be necessary to contain it. Firms whose failure would pose a systemic risk should be subject to especially close supervisory oversight of their risk-taking, risk management, and financial condition, and should be held to high capital and liquidity standards. As I emphasized in my testimony, the government must ensure a robust framework—both in law and practice—for consolidated supervision of all systemically important financial firms. In addition, it is important to provide a mechanism for resolving systemically important nonbank financial firm in an orderly manner.

A systemic risk authority that would be charged with assessing and, if necessary, curtailing systemic risks across the entire U.S. financial system could complement firm-specific consolidated supervision. Such an authority would focus particularly on the systemic connections and potential risks of systemically important financial institutions.

Whatever the nature of reforms that are eventually adopted, it may well be necessary at some point to identify those firms and other market participants whose failure would be likely to impose systemic effects. Identifying such firms is a very complex task that would inevitably depend on the specific circumstances of a given situation and requires substantial judgment by policymakers. That being said, several key principles should guide policymaking in this area.

No firm should be considered too big to fail in the sense that existing stockholders cannot lose their entire investment, existing senior management and boards of directors cannot be replaced, and over time the organization cannot be wound down or sold in an orderly way either in whole or in part, which is why we have recommended that Congress create an orderly resolution procedure for systemically important financial firms. The core concern of policymakers should be whether the failure of the firm would be likely to have contagion, or knock-on, effects on other key financial institutions and markets and ultimately on the real economy. Of course, contagion effects are typically more likely in the case of a very large institution than with a smaller institution. However, size is not the only criterion for determining whether a firm is potentially systemic. A firm may have systemic importance if it is critical to the functioning of key markets or critical payment and settlement systems.

Q.2. Please identify all regulatory or legal barriers to the comprehensive sharing of information among regulators including insurance regulators, banking regulators, and investment banking regulators. Please share the steps that you are taking to improve

the flow of communication among regulators within the current legislative environment.

A.2. In general, there are few formal regulatory or legal barriers to sharing bank supervisory information among regulators, and such sharing is done routinely. Like other federal banking regulators, the Board's regulations generally prohibit the disclosure of confidential supervisory information (such as examination reports and ratings, and other supervisory correspondence) and other confidential information relating to supervised financial institutions without the Board's consent. See 12 C.F.R. §261, Subpart C. These regulations, however, expressly permit designated Board and Reserve Bank staff to make this information available to other Federal banking supervisors on request. 12 C.F.R. §261.20(c).. As a practical matter, federal banking regulators have access to a database that contains examination reports for regulated institutions, including commercial banks, bank holding companies, branches of foreign banks, and other entities, and can view examination material relevant to their supervisory responsibility. State banking supervisors also have access to this database for entities they regulate. State banking supervisors may also obtain other information on request if they have direct supervisory authority over the institution or if they have entered into an information sharing agreement with their regional Federal Reserve Bank and the information concerns an institution that has acquired or applied to acquire a financial institution subject to the state regulator's jurisdiction. *Id.* at 261.20(d).

The Board has entered into specific sharing agreements with a number of state and federal regulators, including most state insurance regulators, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Office of Foreign Asset Control (OFAC), and the Financial Crimes Enforcement Network (FinCEN), authorizing sharing of information of common regulatory and supervisory interest. We frequently review these agreements to see whether it would be appropriate to broaden the scope of these agreements to permit the release of additional information without compromising the examination process.

Other supervisory or regulatory bodies may request access to the Board's confidential information about a financial institution by directing a request to the Board's general counsel. Financial supervisors also may use this process to request access to information that is not covered by one of the regulatory provisions or agreements discussed above. Normally such requests are granted subject to agreement on the part of the regulatory body to maintain the confidentiality of the information, so long as the requester bas identified a legitimate basis for its interest in the information.

Because the Federal Reserve is responsible for the supervision of all bank holding companies and financial holding companies on a consolidated basis, it is critical that the Federal Reserve also have timely access to the confidential supervisory information of other bank supervisors or functional regulators relating to the bank, securities, or insurance subsidiaries of such holding companies. Indeed, the Gramm-Leach-Bliley Act (GLBA) provides that the Federal Reserve must rely to the fullest extent possible on the reports of examinations prepared by the Office of the Comptroller of the

Currency, the Federal Deposit Insurance Corporation, the SEC, and the state insurance authorities for the national bank, state nonmember bank, broker-dealer, and insurance company subsidiaries of a bank holding company. The GLBA also places certain limits on the Federal Reserve's ability to examine or obtain reports from functionally regulated subsidiaries of a bank holding company.

Consistent with these provisions, the Federal Reserve has worked with other regulators to ensure the proper flow of information to the Federal Reserve through information sharing arrangements and other mechanisms similar to those described above. However, the restrictions in current law still can present challenges to timely and effective consolidated supervision in light of, among other things, differences in supervisory models—for example, between those favored by bank supervisors and those used by regulators of insurance and securities subsidiaries—and differences in supervisory timetables, resources, and priorities. In its review of the U.S. financial architecture, we hope that the Congress will consider revising the provisions of Gramm-Leach-Bliley Act to help ensure that consolidated supervisors have the necessary tools and authorities to monitor and address safety and soundness concerns in all parts of an organization.

Q.3. What delayed the issuance of regulations under the Home Ownership Equity Protection Act for more than 10 years? Was the Federal Reserve receiving outside pressure not to write these rules? Is it necessary for Congress to implement target timelines for agencies to draft and implement rules and regulations as they pertain to consumer protections?

A.3. In responding, I will briefly report the history of the Federal Reserve's rulemakings under the Home Ownership and Equity Protection Act (HOEPA). Although I did not join the Board until January 2009, I support the action taken by Chairman Bernanke and the Board in 2007 to propose stronger HOEPA rules to address practices in the subprime mortgage market. I should note, however, that in my private academic capacity I believed that the Board should have acted well before it did.

HOEPA, which defines a class of high-cost mortgage loans that are subject to restrictions and special disclosures, was enacted in 1994 as an amendment to the Truth in Lending Act. In March 1995, the Federal Reserve published rules to implement HOEPA, which are contained in the Board's Regulation Z. HOEPA also gives the Board responsibility for prohibiting acts or practices in connection with mortgage loans that the Board finds to be unfair or deceptive. The statute further requires the Board to conduct public hearings periodically, to examine the home equity lending market and the adequacy of existing laws and regulations in protecting consumers, and low-income consumers in particular. Under this mandate, during the summer of 1997 the Board held a series of public hearings. In connection with the hearings, consumer representatives testified about abusive lending practices, while others testified that it was too soon after the statute's October 1995 implementation date to determine the effectiveness of the new law. The

Board made no changes to the HOEPA rules resulting from the 1997 hearings.

Over the next several years, the volume of home-equity lending increased significantly in the subprime mortgage market. With the increase in the number of subprime loans, there was increasing concern about a corresponding increase in the number of predatory loans. In response, during the summer of 2000 the Board held a series of public hearings focused on abusive lending practices and the need for additional rules. Those hearings were the basis for rulemaking under HOEPA that the Board initiated in December 2000 to expand HOEPA's protections.

The Board issued final revisions to the HOEPA rules in December 2001. These amendments lowered HOEPA's rate trigger for first-lien mortgage loans to extend HOEPA's protections to a larger number of high-cost loans. The 2001 final rules also strengthened HOEPA's prohibition on unaffordable lending by requiring that creditors generally document and verify consumers' ability to repay a high-cost HOEPA loan. In addition, the amendments addressed concerns that high-cost HOEPA loans were "packed" with credit life insurance or other similar products that increased the loan's cost without commensurate benefit to consumers. The Board also used the rulemaking authority in HOEPA that authorizes the Board to prohibit practices that are unfair, deceptive, or associated with abusive lending. Specifically, to address concerns about "loan flipping" the Board prohibited a HOEPA lender from refinancing one of its own loans with another HOEPA loan within the first year unless the new loan is in the borrower's interest. The December 2001 final rule addressed other issues as well.

As the subprime market continued to grow, concerns about "predatory lending" grew. During the summer of 2006, the Board conducted four public hearings throughout the country to gather information about the effectiveness of its HOEPA rules and the impact of the state predatory lending laws. By the end of 2006, it was apparent that the nation was experiencing an increase in delinquencies and defaults, particularly for subprime mortgages, in part as a result of lenders' relaxed underwriting practices, including qualifying borrowers based on discounted initial rates and the expanded use of "stated income" or "no doc" loans. In response, in March 2007, the Board and other federal financial regulatory agencies published proposed interagency guidance addressing certain risks and emerging issues relating to subprime mortgage lending practices, particularly adjustable-rate mortgages. The agencies finalized this guidance in June 2007.

Also in June 2007, the Board held a fifth hearing to consider ways in which the Board might use its HOEPA rulemaking authority to further curb abuses in the home mortgage market, including the subprime sector. This became the basis for the new HOEPA rules that the Board proposed in December 2007 and finalized in July 2008. Among other things, the Board's 2008 final rules adopt the same standard for subprime mortgage loans that the statute previously required for high cost HOEPA loans—a prohibition on making loans without regard to borrowers' ability to repay the loan from income and assets other than the home's value. The July 2008 final rule also requires creditors to verify the income and assets

they rely upon to determine borrowers' repayment ability for subprime loans. In addition, the final rules restrict creditors' use of prepayment penalties and require creditors to establish escrow accounts for property taxes and insurance. The rules also address deceptive mortgage advertisements, and unfair practices related to real estate appraisals and mortgage servicing.

We can certainly understand the desire of Congress to provide timelines for regulation development and implementation. This could be especially important to address a crisis situation. However, in the case of statutory provisions that require consumer disclosure for implementation, we hope that any statutory timelines would account for robust consumer testing in order to make the disclosures useful and effective. Consumer testing is an iterative process, so it can take some additional time, but we have found that it results in much clearer disclosures. Additionally, interagency rulemakings are also more time consuming. While they have the potential benefit of bringing different perspectives to bear on an issue, arriving at consensus is always more time consuming than when regulations are assigned to a single rule writer. Moreover, assigning rulewriting responsibility, to multiple agencies can result in diffused accountability, with no one agency clearly responsible for outcomes.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HUTCHISON FROM DANIEL K. TARULLO

Q.1. Will each of you commit to do everything within your power to prevent performing loans from being called by lenders? Please outline the actions you plan to take.

A.1. The Federal Reserve's survey of senior loan officers at banks has indicated that banks have been tightening standards for both new commercial and industrial loans and new consumer loans since the beginning of 2008, although the net percentage of banks that have tightened standards in both categories has diminished a bit in recent months. We also are aware of reports that some banking organizations have declined to renew or extend new credit to borrowers that had performed on previously provided credit, or have exercised their rights to lower the amount of credit available to performing customers under existing lines of credit, such as home equity lines of credit. There is a variety of factors that potentially could influence a banking organization's decision to not renew or extend credit to a currently performing borrower, or reduce the amount of credit available to such a borrower. Many of these factors may be unique to the individual transaction, customer or banking organization involved. However, other more general factors also may be involved.

For example, due to the ongoing turmoil in the financial markets, many credit and securitization markets have experienced substantial disruptions in the past year and a half, which have limited the ability of banking organizations to find outlets for their loans and obtain the financing to support new lending activities. In addition, losses on mortgage-related and other assets reduced the capital position of many banking organizations, which also weakened their ability to make or renew loans. The Federal Reserve, working in

conjunction with the Treasury Department, has taken a number of important steps to help restore the flow of credit to households and businesses. For example, the Term Asset-Backed Securities Leading Facility (TALF), which began operations in March 2009, is designed to restart the securitization markets for several types of consumer and commercial credit. In addition, the recently completed Supervisory Capital Assessment Program was designed to ensure that the largest banking organizations have the capital necessary to fulfill their critical credit intermediation functions even in seriously adverse economic conditions.

Besides these actions, we continue to actively work with banking organizations to encourage them to continue lending prudently to creditworthy borrowers and work constructively with troubled customers in a manner consistent with safety and soundness. I note that, in some instances, it may be appropriate from a safety and soundness perspective for a banking organization to review the creditworthiness of an existing borrower, even if the borrower is current on an existing loan from the institution. For example, the collateral supporting repayment of the loan may have declined in value.

However, we are very cognizant of the need to ensure that banking organizations do not make credit decisions that are not supported by a fair and sound analysis of creditworthiness, particularly in the current economic environment. Striking the right balance between credit availability and safety and soundness is difficult, but vitally important. The Federal Reserve has long-standing policies and procedures in place to promote sound risk identification and management practices at regulated institutions that also support bank lending, the credit intermediation process, and working with borrowers. For example, guidance issued as long ago as 1991, during the commercial real estate crisis that began in the late 1980s, specifically instructs examiners to ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers.[1] The 1991 guidance also states that examiners are to "ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance."

This emphasis on achieving an appropriate balance between credit availability and safety and soundness continues today. To the extent that institutions have experienced losses, hold less capital, and are operating in a more risk-sensitive environment, supervisors expect banks to employ appropriate risk-management practices to ensure their viability. At the same time, it is important that supervisors remain balanced and not place unreasonable or artificial constraints on lenders that could hamper credit availability.

As part of our effort to help stimulate appropriate bank lending, the Federal Reserve and the other federal banking agencies issued a statement in November 2008 to encourage banks to meet the needs of creditworthy borrowers.[2] The statement was issued to encourage bank lending in a manner consistent with safety and

[1] "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," (November 1991).

[2] "Interagency Statement on Meeting the Needs of Credit Worthy Borrowers," (November 2008).

soundness—specifically, by taking a balanced approach in assessing borrowers' ability to repay and making realistic assessments of collateral valuations. This guidance has been reviewed and discussed with examination staff within the Federal Reserve System.

Earlier, in April 2007, the federal financial institutions regulatory agencies issued a statement encouraging financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans.[3] The statement noted that "prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term interest of both the financial institution and the borrower." The statement also noted that "the agencies will not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems." It further stated that, "existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties." This guidance has also been reviewed by examiners within the Federal Reserve System.

More generally, we have directed our examiners to be mindful of the pro-cyclical effects of excessive credit tightening and to encourage banks to make economically viable loans, provided such lending is based on realistic asset valuations and a balanced assessment of borrowers' repayment capacities. Banks are also expected to work constructively with troubled borrowers and not unnecessarily call loans or foreclose on collateral. Across the Federal Reserve System, we have implemented training and outreach to underscore these objectives.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SCOTT M. POLAKOFF

Q.1. *Consumer Protection Regulation*—Some have advocated that consumer protection and prudential supervision should be divorced, and that a separate consumer protection regulation regime should be created. They state that one source of the financial crisis emanated from the lack of consumer protection in the underwriting of loans in the originate-to-distribute space.

What are the merits of maintaining it in the same agency? Alternatively, what is the best argument each of you can make for a new consumer protection agency?

A.1. The key advantage of creating a separate agency for consumer protection would be its single-focus on consumer protection. One hundred percent of its resources would be devoted to consumer protection, regulations and the balance and tension between both aspects is extraordinarily beneficial, policies, and enforcement. However, safety and soundness and consumer protection concerns are interconnected. For example, requiring that a lender responsibly consider a borrower's repayment ability has implications for both areas. Consequently, if consumer protection and prudential super-

[3] "Federal Regulators Encourage Institutions To Work With Mortgage Borrowers Who Are Unable To Make TheirPayments," (April 2007).

vision were separated, the new consumer protection agency would not be in a position to take into account the safety and soundness dimensions of consumer protection issues. Placing consumer compliance examination activities in a separate organization would reduce the effectiveness of both programs by removing the ability for regulators to evaluate an institution across both the safety and soundness and compliance functions. The same is true for rulemaking functions.

With respect to consumer protection regulation, some may argue that assigning one agency responsibility for writing all consumer protection regulations would speed the process. However, past experience indicates that providing one agency such exclusive responsibility does not guarantee this result. Moreover, such a strategy may weaken the outcome because it deprives other agencies of the opportunity to make contributions based on their considerable expertise.

Q.2. *Regulatory Gaps or Omissions*—During a recent hearing, the Committee has heard about massive regulatory gaps in the system. These gaps allowed unscrupulous actors like AIG to exploit the lack of regulatory oversight. Some of the counterparties that AIG did business with were institutions under your supervision.

Why didn't your risk management oversight of the AIG counterparties trigger further regulatory scrutiny? Was there a flawed assumption that AIG was adequately regulated, and therefore no further scrutiny was necessary?

A.2. OTS actions demonstrate that we had a progressive level of supervisory criticism of AIG's corporate governance. OTS criticisms addressed AIG's risk management, corporate oversight, and financial reporting. There was not a flawed assumption that AIG was adequately regulated. Instead, OTS did not recognize in time the extent of the liquidity risk to AIG of the "super senior" credit default swaps in AIG Financial Products' (AIGFP) portfolio. In hindsight, we focused too narrowly on the perceived creditworthiness of the underlying securities and did not sufficiently assess the susceptibility of highly illiquid, complex instruments to downgrades in the ratings of the company or the underlying securities, and to declines in the market value of the securities. No one predicted the amount of funds that would be required to meet collateral calls and cash demands on the credit default swap transactions.

Q.3. Was there dialogue between the banking regulators and the state insurance regulators? What about the SEC?

A.3. The OTS role in reaching out to insurance regulators (both domestic and foreign) was to obtain information regarding functionally regulated entities. This included information regarding examination efforts and results, requests for approval for transactions, market conduct activities and other items of a regulatory nature. In the U.S., state insurance departments conduct financial examinations of insurance companies every 3–5 years, depending on state law. In addition, regulatory approval is required for certain types of transactions or activities. OTS contact with state insurance regulators was done with the intent to identify issues with regulated insurance companies and to determine if regulatory actions were being taken. In addition, regulatory communications were

maintained in an informal way to ensure that the lines of communication remained open.

Annually, OTS hosted a supervisory conference that provided an opportunity for insurance (and banking) regulators to share information regarding the company. At each of the three annual conferences held, OTS provided general information regarding our examination approach, plans for our supervisory efforts and current concerns. Other regulators attending the sessions provided the same type of information and the session provided an opportunity to discuss these concerns.

Collateralized debt obligation (CDO) activities at AIG were housed in AIGFP, an unregulated entity. AIGFP is not a regulated insurance company or depository institution. State insurance departments did not have the legal authority to examine or regulate AIGFP activities. Therefore, OTS did not engage in discussions with state insurance departments regarding AIGFP. The types of activities engaged in, and the products sold, are not the types of activities that insurance structures typically engage in within regulated insurance company subsidiaries. Also, since AIGFP was not a regulated insurance company, OTS did not contact state regulators to discuss AIGFP or its activities. Upon the announcement of Federal Reserve intervention in the company, OTS engaged in many calls with regulators in the U.S. and abroad.

AIG did have a network of registered investment advisers, retail investment brokerage firms and mutual funds, all supervised by the SEC. OTS stayed abreast of AIG's compliance with SEC laws and regulations through a monthly regulatory issues report. OTS also interacted with an individual placed at AIG by the SEC and Department of Justice as an independent monitor in connection with the 2005 settlement regarding accounting irregularities. The independent monitor is still working within AIG, and he interacts directly with the Regulatory Group.

Q.4. If the credit default swap contracts at the heart of this problem had been traded on an exchange or cleared through a clearinghouse, with requirement for collateral and margin payments, what additional information would have been available? How would you have used it?

A.4. There is no centralized exchange or clearing house for credit default swap (CDS) transactions. Currently, CDS trade as a bilateral contract between two counterparties that are done on the over-the-counter (OTC) market. They are not traded on an exchange and there are no specific record-keeping requirements of who traded, how much, and when. As a result, the market is opaque, lacking the transparency that would be expected for a market of its size, complexity, and importance. The lack of transparency creates significant opportunity for manipulation and insider trading in the CDS market as well as in the regulated markets for securities. Also, the lack of transparency allows the CDS market to be largely immune to market discipline.

The creation of a central counterparty (CCP) would be an important first step in maintaining a fair, orderly, and efficient CDS market and thereby helping to mitigate systemic risk. It would help to reduce the counterparty risks inherent in CDS market. A

central clearing house could further reduce systemic risk by novating trades to the CCP, which means that two dealers would no longer be exposed to each others' credit risk. Other benefits would include reducing the risk of collateral flows by netting positions in similar instruments, and by netting all gains and losses across different instruments; helping to ensure that eligible trades are cleared and settled in a timely manner, thereby reducing the operational risks associated with significant volumes of unconfirmed and failed trades; helping to reduce the negative effects of misinformation and rumors; and serving as a source of records for CDS transactions. Furthermore, this would likely allow for much greater market discipline, increased transparency, enhanced liquidity, and improved price discovery.

The presence of an exchange with margin and daily position marking would have given regulators greater visibility into the dangerous concentration of posted collateral. Regulators could have had more time and flexibility to react through the firm's risk management and corporate governance units if a CDS exchange existed. Also, if a counterparty had failed to post required margin/collateral, its positions may have been liquidated sooner in the process.

We have learned there is a need for consistency and transparency in over-the-counter (OTC) CDS contracts. The complexity of CDS contracts masked risks and weaknesses. The OTS believes standardization and simplification of these products would provide more transparency to market participants and regulators. We believe many of these OTC contracts should be subject to exchange-traded oversight, with daily margining required. This kind of standardization and exchange-traded oversight can be accomplished when a single regulator is evaluating these products. Congress should consider legislation to bring such OTC derivative products under appropriate regulation.

Q.5. *Liquidity Management*—A problem confronting many financial institutions currently experiencing distress is the need to roll-over short-term sources of funding. Essentially these banks are facing a shortage of liquidity. I believe this difficulty is inherent in any system that funds long-term assets, such as mortgages, with short-term funds. Basically the harm from a decline in liquidity is amplified by a bank's level of "maturity-mismatch."

I would like to ask each of the witnesses, should regulators try to minimize the level of a bank's maturity-mismatch? And if so, what tools would a bank regulator use to do so?

A.5. Maturity mismatches are a significant supervisory concern from both a liquidity risk and interest rate risk standpoint. However, OTS does not believe that regulators should try to simply minimize the mismatch without consideration of different business models, portfolio structures, and mitigating factors. Furthermore, maturity mismatches are heavily affected by unknowns such as loan prepayments and deposit withdrawals which can have serious implications on an institution's cash needs and sources. The embedded optionality in some instruments can lead to a rapid shortening of stated maturities and can compromise the effectiveness of fol-

lowing a simple maturity gap measure in the management of liquidity risk.

Given the thrift industry's heavy reliance on longer-term mortgages and shorter-term funding, however, OTS has always placed a heavy emphasis on maturity-mismatch risk management and we are constantly exploring ways to improve our supervisory process in light of the ongoing crisis.

On an international basis, OTS is a member of the Basel Committee for Banking Supervision's Working Group on Liquidity which is currently seeking to identify a range of measures and metrics to better assess liquidity risk at regulated institutions. Metrics specifically dealing with maturity-mismatch are being considered as part of this work. On the domestic front, OTS's supervisory process has long stressed the need for OTS-regulated banks to identify and manage the maturity mismatch inherent in their operations; and OTS examiners routinely assess this aspect of a bank's operation during their on-site safety and soundness examinations.

From an off-sight monitoring perspective, OTS utilizes information from the Thrift Financial Report to identify institutions with a heavy reliance on short-term or volatile sources of funding. In addition, OTS is exploring ways to better lever the information it collects from institutions for interest rate risk purposes. Each quarter, OTS collects detailed interest rate data, re-pricing characteristics, and maturity information from most of its thrifts through a specialized reporting schedule called Consolidated Maturity and Rate (Schedule CMR). The CMR data is fed into a proprietary interest rate risk model called the Net Portfolio Value (NPV) Model. The NPV Model was created in 1991, in response to the industry's significant interest rate risk problems which were a major contributor to the savings and loan crisis. The NPV Model provides a quarterly analysis of an institution's interest rate risk profile and plays an integral role in the examination process.

Interest rate risk and "maturity-mismatch" risk are intimately related. Indeed, much of the same information that is used for interest rate risk purposes can also be used to provide a more structured view of liquidity risk and maturity mismatch. As a first step, OTS is using the model to generate individual Maturing Gap Reports for a large segment of the industry. This report provides a snapshot of a bank's current maturity-mismatch as well as how that mismatch changes under different interest rate stress scenarios.

Q.6. *Regulatory Conflict of Interest*—Federal Reserve Banks which conduct bank supervision are run by bank presidents that are chosen in part by bankers that they regulate.

Mr. Polakoff, does the fact that your agencies' funding stream is affected by how many institutions you are able to keep under your charters affect your ability to conduct supervision?

A.6. No it does not. The OTS conducts its supervisory function in a professional, consistent, and fair manner. Ensuring the safety and soundness of the institutions that we supervise is always paramount. Moreover, the use of assessments on the industry to fund the agency has many advantages. It permits the agency to develop

a budget that is based on the supervisory needs of the industry. The agency does not rely on the Congressional appropriations process and can assess the industry based on a number of factors including the number, size, and complexity of regulated institutions. Such a method of funding also provides the agency the ability to determine whether fees should be increased as a result of supervisory concerns.

This funding mechanism permits the agency to sustain itself financially. Funding an agency differently may lead to conflicts of interest with congress or any other entity that determines the budget necessary to run the agency. As a result, political pressure or matters outside the control of the agency may negatively affect the agency's ability to supervise its regulated institutions. An agency that must supervise institutions on a regular basis needs to have more control over its funding and budget than is possible through an appropriations process. Funding through assessments also eliminates the concern that taxpayers are responsible for paying for the running of the agency.

Q.7. *Too-Big-To-Fail*—Chairman Bair stated in her written testimony that "the most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of those institutions similar to that which exists for FDIC-insured banks. In short we need to end too big to fail." I would agree that we need to address the too-big-to-fail issue, both for banks and other financial institutions.

Could each of you tell us whether putting a new resolution regime in place would address this issue?

A.7. The events of the past year have put into stark focus the need to address whether a resolution regime is necessary for nonbank financial companies. Whatever resolution regime is adopted would address too big to fail issue but it may not bring it to a final conclusion. There currently exists a resolution mechanism for federally insured depository institutions and instances have arisen in which an insured institution has been found to be too big to fail. As the framers of the resolution develop the mechanism for nonbank financial companies, it will be important to establish whether there will be a circumstance in which such a company will not be allowed to fail or the circumstances under which it will be permitted. A resolution mechanism will make it less likely that a company will be determined to be too big to fail.

Q.8. How would we be able to convince the market that these systemically important institutions would not be protected by taxpayer resources as they had been in the past?

A.8. There are two ways that the market can be convinced that systemically important institutions will not be protected by taxpayer resources. The first is if they are permitted to fail and do not receive the benefit of taxpayer funds. The second is through the establishment of a resolution mechanism that provides for funding through assessments on the institutions that may be resolved. Even the second alternative would not preclude that the taxpayer might not ultimately pay for part of the resolution.

In the creation of the resolution mechanism, the funding of the entity and the process would need to be specifically addressed and communicated to the market.

Q.9. *Pro-Cyclicality*—I have some concerns about the pro-cyclical nature of our present system of accounting and bank capital regulation. Some commentators have endorsed a concept requiring banks to hold more capital when good conditions prevail, and then allow banks to temporarily hold less capital in order not to restrict access to credit during a downturn. Advocates of this system believe that counter-cyclical policies could reduce imbalances within financial markets and smooth the credit cycle itself.

What do you see as the costs and benefits of adopting a more counter-cyclical system of regulation?

A.9. Different proposals have been raised to achieve a more counter-cyclical system of capital regulation. One of the most promising ideas would mandate that banks build up an additional capital buffer during good times that would be available to draw upon in bad times, essentially a rainy day fund. In our view, such a fund would be an amount of allocated retained earnings that would be over and above the bank's minimum capital requirement. Initially, it would appear that for an individual bank, the cost of such a requirement would be a decreased level of available retained earnings: fewer funds would be available for dividends and share buybacks for example. The benefit would be that the rainy day fund might save the bank from failing (or threat of failure) when economic conditions deteriorate and therefore help the bank remain in sound condition so that it can continue lending. Systemically, a restriction on banks' retained earnings would act as a restraint on bank activity during high points in the economic cycle and could diminish share prices when times are good. It might also curtail some lending at high points in the economic cycle. However, the availability of those funds when conditions deteriorate ought to allow banks to continue lending at more reasonable levels even when economic conditions deteriorate.

Q.10. Do you see any circumstances under which your agencies would take a position on the merits of counter-cyclical regulatory policy?

A.10. Yes, we support the concept of a counter-cyclical policy. There are a variety of ideas as to how to achieve this including the concept we have outlined above. Together with the other Federal Banking Agencies we are participating in international Basel Committee efforts to consider various counter-cyclical proposals with the goal of having a uniform method, not only within the United States, but internationally as well—so as to create a more level competitive environment for U.S. Banks and a sound counter-cyclical proposal.

Q.11. *G20 Summit and International Coordination*—Many foreign officials and analysts have said that they believe the upcoming G20 summit will endorse a set of principles agreed to by both the Financial Stability Forum and the Basel Committee, in addition to other government entities. There have also been calls from some countries to heavily re-regulate the financial sector, pool national

sovereignty in key economic areas, and create powerful supranational regulatory institutions. (Examples are national bank resolution regimes, bank capital levels, and deposit insurance.) Your agencies are active participants in these international efforts.

What do you anticipate will be the result of the G20 summit?

A.11. At the conclusion of the G20 summit, several documents were issued by G20 working groups and by the Financial Stability Forum (now renamed the Financial Stability Board). These laid out principles for international cooperation between supervisors and stressed the importance of coordinated supervisory action. With its largest firms, OTS has for some years held annual college meetings to foster communication between regulators, and understands the value of cross-border cooperation. OTS believes that insofar as the agreements coming out of the G20 summit encourage greater international cooperation, supervision overall will be enhanced.

Q.12. Do you see any examples or areas where supranational regulation of financial services would be effective?

A.12. As a member of the Basel Committee, OTS has been involved in the past efforts of that body to set capital and other regulatory standards. We believe there is value in coordinating such standards at the international level, primarily for two reasons. First, such coordination is a vehicle for enshrining high quality standards. In a globally interconnected capital market, it is important that all players be subject to basic requirements. Second, common standards foster a level playing field for U.S. institutions that must compete internationally.

Q.13. How far do you see your agencies pushing for or against such supranational initiatives?

A.13. As indicated above, OTS supports active cooperation among supervisors and the setting of international regulatory standards, where appropriate. Ultimately, of course, authority must be commensurate with responsibility, and OTS would not be supportive of initiatives that would diminish its capacity to carry out its responsibility to preserve the safety and soundness of the institutions it regulates or the rights and protections of the customers they serve.

Q.14. *Effectiveness of Functional Regulation* [1]—Mr. Polakoff, in your testimony you point out that the OTS, as the holding company supervisor of AIG, relies on the specific functional regulators for information regarding regulated subsidiaries of AIG's holding company.

When did the OTS first learn of the problems related to AIG's securities lending program? Did any state insurance commissioner alert the OTS, as the holding company supervisor, of these problems?

A.14. Annually, the OTS hosted a supervisory conference that provided an opportunity for regulators (insurance and banking) to share information regarding the AIG. At each of the three annual conferences held, the OTS provided general information regarding our examination approach, plans for our supervisory efforts and

[1] Mr. Polakoff has been on leave from OTS since March 26, 2009, and will retire from the agency effective July 3, 2009. The answers to the Committee's supplemental questions were prepared by other OTS staff members.

current concerns. Other regulators attending the sessions provided the same type of information and the session provided an opportunity to discuss these concerns.

The OTS was first advised of potential financial problems in the AIG Securities Lending Program (SLP) during the OTS Annual AIG Supervisor's Conference on November 7, 2007, when the representative from the Texas Department of Insurance's (DOI) office raised the issue during the Supervisor's roundtable session. This representative stated the Texas DOI was looking into the exposure that the various Texas-based life companies had to the SLP and was seeking assurance from AIG that any market value losses would be covered by the corporate parent.

Subsequently, on November 27, 2007, the OTS met with Price Waterhouse Coopers (PwC) as part of its regular supervisory process. During this meeting the SLP exposure topic was raised and a discussion ensued. PwC advised that as of Q3 2007, the exposure to market value decline in the portfolio was $1.3 billion and expected to worsen in Q4. PwC further advised that AIG was planning to indemnify its subsidiary companies for losses up to $5 billion. This was verified in the year end 2007 regulatory financial statement filings (required by state insurance departments) by the AIG life insurance subsidiaries. The disclosure went on to cite AIG's indemnification agreement to reimburse losses of up to $5 billion for all (not each) of AIG's impacted subsidiaries.

Q.15. *Holding Company Regulation*—Mr. Polakoff, AIG's Financial Products subsidiary has been portrayed in the press as a renegade subsidiary that evaded regulation by operating from London. A closer examination reveals, however, that a majority of its employees and many of its officers were located in the United States.

Did the OTS have adequate authority to supervise AIG's Financial Products subsidiary? If not why did the OTS fail to inform Congress about this hole in its regulatory authority, especially since your agency had identified serious deficiencies in Financial Products' risk management processes since 2005? How was the Financial Products subsidiary able to amass such a large, unhedged position on credit default swaps (CDS)?

A.15. AIG became a savings and loan holding company in 2000. At that time. the OTS's supervision focused primarily on the impact of the holding company enterprise on the subsidiary savings association. With the passage of Gramm-Leach-Bliley, and not long before AIG became a savings and loan holding company, the OTS recognized that large corporate enterprises, made up of a number of different companies or legal entities, were changing the way they operated and needed to be supervised. These companies, commonly called conglomerates, began operating differently and in a more integrated fashion as compared to traditional holding companies. These conglomerates required a more enterprise-wide review of their operations. Consistent with changing business practices and how conglomerates were managed at that time, in late 2003 the OTS embraced a more enterprise-wide approach to supervising conglomerates. This approach aligned well with core supervisory principles adopted by the Basel Committee and with requirements implemented in 2005 by European Union (EU) regulators that re-

quired supplemental regulatory supervision at the conglomerate level. The OTS was recognized as an equivalent regulator for the purpose of AIG consolidated supervision within the EU, a process that was finalized with a determination of equivalence by AIG's French regulator, Commission Bancaire.

AIG Financial Products' (AIGFP) CDS portfolio was largely originated in the 2003 to 2005 period and was facilitated by AIG's full and unconditional guarantee (extended to all AIGFP transactions since its creation), which enabled AIGFP to assume the AAA rating for market transactions and counterparty negotiations. AIGFP made the decision to stop origination of these derivatives in December 2005 based on the general observation that underwriting standards for mortgages backing securities were declining. At the time the decision was made, however, AIGFP already had $80 billion of CDS commitments. This activity stopped before the OTS targeted examination which commenced March 6, 2006.

The OTS actions demonstrate a progressive level of supervisory criticism of AIG's corporate governance. The OTS criticisms addressed AIG's risk management, corporate oversight, and financial reporting. There was not a flawed assumption that AIG was adequately regulated. Instead, the OTS did not fully recognize the extent of the liquidity risk to AIG of the "super senior" credit default swaps in AIGFP's portfolio or the profound systemic impact of a nonregulated financial product. There was a narrow focus on the perceived creditworthiness of the underlying securities rather than an assessment of the susceptibility of highly illiquid, complex instruments to downgrades in the public ratings of the company or the underlying securities, and to declines in the market value of the securities. No one predicted the amount of funds that would be required to meet collateral calls and cash demands on the credit default swap transactions.

CDS are financial products that are not regulated by any authority and impose serious challenges to the ability to supervise this risk proactively without any prudential derivatives regulator or standard market regulation. There is a need to fill the regulatory gaps the CDS market has exposed. There is a need for consistency and transparency in CDS contracts. The complexity of CDS contracts masked risks and weaknesses in the program that led to one type of CDS performing extremely poorly. The current regulatory means of measuring off-balance sheet risks do not fully capture the inherent risks of CDS. The OTS believes standardization of CDS contracts would provide more transparency to market participants and regulators.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM SCOTT M. POLAKOFF

Q.1. It is clear that our current regulatory structure is in need of reform. At my subcommittee hearing on risk management, March 18, 2009, GAO pointed out that regulators often did not move swiftly enough to address problems they had identified in the risk management systems of large, complex financial institutions.

Chair Bair's written testimony for today's hearing put it very well: " . . . the success of any effort at reform will ultimately rely

on the willingness of regulators to use their authorities more effectively and aggressively."

My questions may be difficult, but please answer the following:

- If this lack of action is a persistent problem among the regulators, to what extent will changing the structure of our regulatory system really get at the issue?
- Along with changing the regulatory structure, how can Congress best ensure that regulators have clear responsibilities and authorities, and that they are accountable for exercising them "effectively and aggressively"?

A.1. A change in the structure of the regulatory system alone will not achieve success. While Congress should focus on ensuring that all participants in the financial markets are subject to the same set of regulations, the regulatory agencies must adapt using the lessons learned from the financial crisis to improve regulatory oversight. OTS conducts internal failed bank reviews for thrifts that fail and has identified numerous lessons learned from recent financial institution failures. The agency has revised its policies and procedures to correct gaps in regulatory oversight. OTS has also been proactive in improving the timeliness of formal and informal enforcement action.

Q.2. How do we overcome the problem that in the boom times no one wants to be the one stepping in to tell firms they have to limit their concentrations of risk or not trade certain risky products? What thought has been put into overcoming this problem for regulators overseeing the firms? Is this an issue that can be addressed through regulatory restructure efforts?

A.2. OTS believes that the best way to improve the regulatory oversight of financial activities is to ensure that all entities that provide specific financial services are subject to the same level of regulatory requirements and scrutiny. For example, there is no justification for mortgage brokers not to be bound by the same laws and rules as banks. A market where unregulated or under-regulated entities can compete alongside regulated entities offering complex loans or other financial products to consumers provides a disincentive to protect the consumer. Any regulatory restructure effort must ensure that all entities engaging in financial services are subject to the same laws and regulations.

In addition, the business models of community banks versus that of commercial banks are fundamentally different. Maintaining and strengthening a federal regulatory structure that provides oversight of these two types of business models is essential. Under this structure, the regulatory agencies will need to continue to coordinate regulatory oversight to ensure they apply consistent standards for common products and services.

Q.3. As Mr. Tarullo and Mrs. Bair noted in their testimony, some financial institution failures emanated from institutions that were under federal regulation. While I agree that we need additional oversight over and information on unregulated financial institutions, I think we need to understand why so many regulated firms failed.

Why is it the case that so many regulated entities failed, and many still remain struggling, if our regulators in fact stand as a safety net to rein in dangerous amounts of risk-taking?

A.3. While undesirable, failures are inevitable in a dynamic and competitive market. The housing downturn and resulting economic strain highlights that even traditionally lower-risk lending activities can become higher-risk when products evolve and there is insufficient regulatory oversight covering the entire market. There is no way to predict with absolute certainty how economic factors will combine to cause stress. For example, in late 2007, financial institutions faced severe erosion of liquidity due to secondary markets not functioning.

This problem compounded for financial institutions engaged in mortgage banking who found they could not sell loans from their warehouse, nor could they rely on secondary sources of liquidity to support the influx of loans on their balance sheets. While the ideal goal of the regulatory structure is to limit and prevent failures, it also serves as a safety net to manage failures with no losses to insured depositors and minimal cost to the deposit insurance fund.

Q.4. While we know that certain hedge funds, for example, have failed, have any of them contributed to systemic risk?

A.4. Hedge funds are unregulated entities that are considered impermissible investments for thrifts. As such, OTS has no direct knowledge of hedge fund failures or how they have specifically contributed to systemic risk. Anecdotally, however, we understand that many of these entities were highly exposed to sub-prime loans through their investment in private label securities backed by subprime or Alt-A loan collateral, and they were working with higher levels of leverage than were commercial banks and savings institutions. As defaults on these loans began to rise, the value of those securities fell, losses mounted and capital levels declined. As this occurred, margin calls increased and creditors began cutting these firms off or stopped rolling over lines of credit. Faced with greater collateral requirements, creditors demanding lower levels of leverage, eroding capital, and dimming prospects on their investments, these firms often perceived the sale of these unwanted assets as the best option. The glut of these securities coming to the market and the lack of private sector buyers likely further depressed prices.

Q.5. Given that some of the federal banking regulators have examiners on-site at banks, how did they not identify some of these problems we are facing today?

A.5. The problem was not a lack of identifying risk areas, but in understanding and predicting the severity of the economic downturn and its resulting impact on entire asset classes, regardless of risk. The magnitude and severity of the economic downturn was unprecedented. The confluence of events leading to the financial crisis extends beyond signals that bank examiners alone could identify or correct. OTS believes it is important for Congress to establish a systemic risk regulator that will work with the federal bank regulatory agencies to identify systemic risks and how they affect individual regulated entities.

There is evidence in reports of examination and other supervisory documents that examiners identified several of the problems we are facing, particularly the concentrations of assets. There was no way to predict how rapidly the market would reverse and housing prices would decline. The agency has taken steps to improve its regulatory oversight through the lessons learned during this economic cycle. For its part, OTS has strengthened its regulatory oversight, including the timeliness of enforcement actions and monitoring practices to ensure timely corrective action.

Q.6. There have been many thrifts that failed under the watch of the OTS this year. While not all thrift or bank failures can or should be stopped, the regulators need to be vigilant and aware of the risks within these financial institutions. Given the convergence within the financial services industries, and that many financial institutions offer many similar products, what is distinct about thrifts? Other than holding a certain proportion of mortgages on their balance sheets, do they not look a lot like other financial institutions?

A.6. In recent years, financial institutions of all types have begun offering many of the same products and services to consumers and other customers. It is hard for customers to distinguish one type of financial institution from another. This is especially true of insured depository institutions. Despite the similarities, savings associations have statutory limitations on the assets they may have or in the activities in which they may engage. They still must have 65 percent of their assets in housing related loans, as defined. As a result, savings associations are not permitted to diversify to the same extent as are national banks or state chartered banks. Within the confines of the statute, savings associations have begun to engage in more small business and commercial real estate lending in order to diversify their activities, particularly in times of stress in the mortgage market.

Savings associations are the insured depositories that touch the consumer. They are local community banks providing services that families and communities need and value. Many of the institutions supervised by the OTS are in the mutual form of ownership and are small. While many savings associations offer a variety of lending and deposit products and they are competitors in communities nationwide, they generally are retail, customer driven community banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM SCOTT M. POLAKOFF

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of federal and state functional regulation for large, interconnected, and large firms like AIG?

A.1. There have been positive results of the convergence of financial services providers. Consumers and customers seeking financial products have benefited from products and services that are more varied and specifically targeted to meet their needs. At the same time, the regulatory oversight framework has not kept pace with the developments in all areas of the companies offering these products and services. If a systemic risk regulator had existed, it may not have filled in all of the gaps, but such a regulator would have looked at the entire organization with a view to identifying concerns in all areas of the company and would have identified how the operations of one line of business or business unit would affect the company as a whole. A systemic risk regulator with access to information about all aspects of a company's operations would be responsible for evaluating the overall condition and performance of the entity and the impact a possible failure would have on the rest of the market. Such a broad overview would enable the systemic regulator to work with the functional regulators to ensure that the risks of products and the interrelationships of the businesses are understood and monitored.

The establishment of a systemic risk regulator need not eliminate functional regulators for the affiliated entities in a structure. Functional regulators are necessary to supervise the day to day activities of the entities and provide input on the entities and activities to the systemic risk regulator. Working together with the functional regulators and putting data and developments into a broader context would provide the ability to identify and close gaps in regulation and oversight. In order to benefit from having a framework with a systemic risk regulator and functional regulation of the actual activities and products, information sharing arrangements among the regulators must be established.

Further, the systemic risk regulator would need access to information regarding nonsystemically important institutions in order to monitor trends, but would not regulate or supervise those entities.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. A number of proposals to change the financial services regulatory framework have been issued in the past year. Some of these proposals would establish a new framework for financial services regulation and others would make changes by merging existing regulatory agencies. The proposals of recent months all have identified the supervision of conglomerates as a key element to be addressed in any restructuring. There are pros and cons to each of the proposals for supervision of conglomerates. Three recommenda-

tions represent different perspectives on how to accomplish the goals.

The example of the single consolidated regulator similar to the Financial Services Authority has been highlighted by its proponents as a solution to the regulation of large conglomerates that offer a variety of products and services through a number of affiliates. Because the single regulator model using a principles based approach to regulation and supervision has been in place in the UK since 1997, the benefits and negative aspects of this type of regulatory framework can be viewed from the perspective of actual practice.

A single regulator, instead of functional regulators for different substantive businesses, coupled with a principles based approach to regulation was not successful in avoiding a financial crisis in the UK. The causes of the crisis in the UK are similar to those identified as causes in the U.S., and elsewhere, and the FSA model for supervision did not fully eliminate the gaps in regulation or mitigate other risk factors that lead to the crisis. Several factors may have contributed to the shortcomings in the FSA model. The most frequently cited factor was principles based regulation. Critics of this framework have identified the lack of close supervision and enforcement over conglomerates, their component companies and other financial services companies. The FSA employed a system that did not adequately require ongoing supervision or account for changes in the risk profiles of the entities involved. Finally, in an effort to streamline the framework and eliminate regulatory overlap, important roles were not fulfilled.

The Group of 30 issued a report on January 15, 2009, that included a number of recommendations for financial stability. The recommendations presented in the report respond to the same factors that have become the focus of the causes of the current crisis. The first core recommendation is that gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated, the second is that the quality and effectiveness of prudential regulation and supervision must be improved, the third is that institutional policies and standards must be strengthened, with particular emphasis on standards of governance, risk management, capital and liquidity and finally, financial markets and products must be more transparent with better aligned risk and prudential incentives.

The first core recommendation is one about which there is little disagreement. The elimination of gaps and weakness in the coverage of prudential regulation and supervision is an important goal in a number of areas. Whether it is the unregulated participants in the mortgage origination process, hedge funds or creators and sellers of complex financial instruments changing the regulatory framework to include those entities is a priority for a number of groups making recommendations for change. The benefits of the adaptation of the current system are evident and the core principles proposed by the Group of 30 are common themes in addressing supervision of conglomerates.

A final proposal is the Treasury Blueprint that was issued in March 2008. That document was a top to bottom review of the current regulatory framework, with result that financial institutions

would be regulated by a market stability regulator, a prudential regulator and/or a business conduct regulator. In addition, an optional federal charter would be created for insurance companies, a regulator for payment systems would be established, and a corporate finance regulator would be created. This approach to regulation would move toward the idea that supervision should be product driven and not institution driven. The framework proposed would not use the positive features in the current system, but a systemic regulator would be created.

Q.3. If there are institutions that are too big to fail, how do we identify that? How do we define the circumstance where a single company is so systemically significant to the rest of our financial circumstances and our economy that we must not allow it to fail?

A.3. Establishing the criteria by which financial institutions or other companies are identified as too big to fail is not easy. Establishing a test with which to judge whether an entity is of a size that makes it too big to fail, or the business is sufficiently interconnected, requires looking at a number of factors, including the business as a whole. The threshold is not simply one of size. The degree of integration of the company with the financial system also is a consideration. A company does not need to be a bank, an insurance company or a securities company to be systemically important. As we have seen in recent months, manufacturing companies as well as financial services conglomerates are viewed differently because of the impact that the failure would have on the economy as a whole. The identification of companies that are systemically important should be decided after a subjective analysis of the facts and circumstances of the company and not just based on the size of the entity.

The factors used to make the determination might include: the risks presented by the other parties with which the company and its affiliates do business; liquidity risks, capital positions; interrelationships of the affiliates; relationships of the affiliates with nonaffiliated companies; and the prevalence of the product mix in the market.

Q.4. We need to have a better idea of what this notion of too big to fail is—what it means in different aspects of our industry and what our proper response to it should be. How should the federal government approach large, multinational, and systemically significant companies?

A.4. The array of lessons learned from the crisis will be debated for years. One lesson is that some institutions have grown so large and become so essential to the economic well-being of the nation that they must be regulated in a new way. The establishment of a systemic risk regulator is an essential outcome of any initiative to modernize bank supervision and regulation. OTS endorses the establishment of a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose a risk to financial stability. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies including, but not limited to, companies involved in banking, securities, and insurance.

For systemically important institutions, the systemic risk regulator should supplement, not supplant, the holding company regulator and the primary federal bank supervisor. A systemic regulator should have the authority and resources to supervise institutions and companies during a crisis situation. The regulator should have ready access to funding sources that would provide the capability to resolve problems at these institutions, including providing liquidity when needed.

Given the events of the past year, it is essential that such a regulator have the ability to act as a receiver and to provide an orderly resolution to companies. Efficiently resolving a systemically important institution in a measured, well-managed manner is an important element in restructuring the regulatory framework. 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. The continued ability of banks and other entities in the United States to compete in today's global financial services marketplace is critical. The systemic risk regulator would be charged with coordinating the supervision of conglomerates that have international operations. Safety and soundness standards, including capital adequacy and other factors, should be as comparable as possible for entities that have multinational businesses.

Q.5. What does "fail" mean? In the context of AIG, we are talking about whether we should have allowed an orderly Chapter 11 bankruptcy proceeding to proceed. Is that failure?

A.5. In the context of AIG, OTS views the financial failure of a company as occurring when it can no longer repay its liabilities or satisfy other obligations from its liquid financial resources. OTS is not in a position to state whether AIG should have proceeded to a Chapter 11 bankruptcy. As stated in the March 18, 2009, testimony on Lessons Learned in Risk Management Oversight at Federal Financial Regulators and the March 19, 2009, testimony on Modernizing Bank Supervision and Regulation, OTS endorses establishing a systemic risk regulator with broad regulatory and monitoring authority of companies whose failure or activities could pose a risk to financial stability. Such a regulator should be able to access funds, which would present options to resolve problems at these institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL FROM SCOTT M. POLAKOFF

Q.1. Two approaches to systemic risk seem to be identified: (1) monitoring institutions and taking steps to reduce the size/activities of institutions that approach a "too large to fail" or "too systemically important to fail" or (2) impose an additional regulator and additional rules and market discipline on institutions that are considered systemically important.

Which approach do you endorse? If you support approach one how you would limit institution size and how would you identify new areas creating systemic importance?

If you support approach two how would you identify systemically important institutions and what new regulations and market discipline would you recommend?

A.1. OTS endorses the establishment of a systemic risk regulator with broad authority, including regular monitoring, over companies that if, due to the size or interconnected nature of their activities, their actions or their failure would pose a risk to the financial stability of the country. Such a regulator should be able to access funds, which would present options to resolve problems at these institutions. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies including, but not limited to, companies involved in banking, securities, and insurance.

Any systemic regulator should have all of the authority necessary to supervise institutions and companies especially in a crisis situation, but this regulator would be in addition to the functional regulator. The systemic risk regulator would not have supervisory authority over nonsystemically important banks. However, the systemic risk regulator would need access to data regarding the health and activities of these institutions for purposes of monitoring trends and other matters influencing monetary policy.

In addition, the systemic risk regulator would be charged with coordination of supervision of conglomerates that have international operations. The safety and soundness standards including capital adequacy and other measurable factors should be as comparable as possible for entities that have multinational businesses. The ability of banks and other entities in the United States to compete in today's global financial services market place is critical.

The identification of systemically important entities would be accomplished by looking at those entities whose business is so interconnected with the financial services market that its failure would have a severe impact on the market generally. Any systemic risk regulator would have broad authority to monitor the market and products and services offered by a systemically important entity or that dominate the market. Important additional regulations would include additional requirements for transparency regarding the entity and the products. Further, such a regulator would have the authority to require additional capital commensurate with the risks of the activities of the entity and would monitor liquidity with the risks of the activities of the entity. Finally, such a regulator would have authority to impose a prompt corrective action regime on the entities it regulates.

Q.2. Please identify all regulatory or legal barriers to the comprehensive sharing of information among regulators including insurance regulators, banking regulators, and investment banking regulators. Please share the steps that you are taking to improve the flow of communication among regulators within the current legislative environment.

A.2. The most significant barrier to disclosure is that if a regulator discloses confidential supervisory information to another regulator, the disclosure could lead to further, unintended disclosure to other persons. Disclosure to another regulator raises two significant risks: the risk that information shared with the other regulator will

not be maintained confidential by that regulator, or that legal privileges that apply to the information will be waived by sharing.

The regulator in receipt of the information may not maintain confidentiality of the information because the regulator is required by law to disclose the information in certain circumstances or because the regulator determines that it is appropriate to do so. For example, most regulators in the United States or abroad may be required to disclose confidential information that they received from another supervisor in response to a subpoena related to litigation in which the regulator may or may not be a party. While the regulator may seek to protect the confidentiality of the information that it received, the court overseeing the litigation may require disclosure. In addition, the U.S. Congress and other legislative bodies may require a regulator to disclose confidential information received by that regulator from another regulator. Moreover, if a regulator receives information from another regulator that indicates that a crime may have been committed, the regulator in receipt of the information may provide the information to a prosecutor. Other laws may require or permit a regulator in receipt of confidential information to disclose the information, for example, to an authority responsible for enforcement of anti-trust laws. These laws mean that the regulator that provides the information can no longer control disclosure of it because the regulator in receipt of the information cannot guarantee that it will not disclose the information further.

With respect to waiver of privileges through disclosure to another regulator, legislation provides only partial protection against the risk that legal privileges that apply to the information will be waived by sharing. When privileged information is shared among covered U.S. federal agencies, privileges are not waived. 12 U.S.C. §1821(t). This statutory protection does not, however, extend to state regulators (*i.e.,* insurance regulators) or foreign regulators.

To reduce these risks, OTS has information-sharing arrangements with all but one state insurance regulator, 16 foreign bank regulators, and one foreign insurance regulator. (Some of these foreign bank regulators may also regulate investment banking or insurance.) OTS is in the process of negotiating information-sharing arrangements with approximately 20 additional foreign regulators.

OTS also shares information with regulators with which it does not have an information-sharing arrangement on a case-by-case basis, subject to an agreement to maintain confidentiality and compliance with other legal requirements. See 12 U.S.C. §§1817(a)(2)(C), 1818(v), 3109(b); 12 C.F.R. §510.5.

In terms of practical steps to ensure a robust flow of communication, OTS, as part of its supervisory planning, identifies foreign and functional regulators responsible for major affiliates of its thrifts and maintains regular contact with them. This interaction includes phone and e-mail communication relating to current supervisory matters, as well as exchanging reports of examination and other supervisory documentation as appropriate. With its largest holding companies, OTS sponsors an annual supervisory conference to which U.S. and foreign regulators are invited to discuss group-wide supervisory issues.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HUTCHISON FROM SCOTT M. POLAKOFF

Q.1. Will each of you commit to do everything within your power to prevent performing loans from being called by lenders? Please outline the actions you plan to take.

A.1. OTS is encouraging financial institutions to develop effective loan modification programs in lieu of calling loans, whether they are performing or delinquent. OTS and OCC are working jointly to produce a quarterly Mortgage Metrics Report that analyzes mortgage servicing data and also provides data on the affordability and sustainability of loan modifications. The 2008 fourth quarter report revealed that delinquencies were still rising, but financial institutions were also increasing efforts aimed at home retention, including loan modifications or payment plans.

The first quarter 2009 data continued to show increases in seriously delinquent prime mortgages and a jump in the number of foreclosures in process across all risk categories as a variety of moratoria on foreclosures expired during the first quarter of 2009. A positive development is the significant increase in the number of modifications made by servicers. In addition to the increase in the overall numbers of modifications, servicers also implemented a higher percentage of modifications that reduced monthly payments than in previous quarters. Modifications with lower payments continued to show fewer delinquencies each month following modification than those that left payments unchanged or increased payments. Therefore, even in the midst of an overall worsening of conditions in mortgage performance, there is a strong industry response in the form of increased modifications. The OTS will continue to monitor the types of home retention actions implemented by servicers in efforts to stem home foreclosure actions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOSEPH A. SMITH, JR.

Q.1. *Consumer Protection Regulation*—Some have advocated that consumer protection and prudential supervision should be divorced, and that a separate consumer protection regulation regime should be created. They state that one source of the financial crisis emanated from the lack of consumer protection in the underwriting of loans in the originate-to-distribute space.

What are the merits of maintaining it in the same agency? Alternatively, what is the best argument each of you can make for a new consumer protection agency?

A.1. CSBS believes safety and soundness and consumer protection should be maintained for the benefit of the system. While CSBS recognizes there is a tension between consumer protection and safety and soundness supervision, we believe these two forms of supervision strengthen the other. Consumer protection is integral to the safety and soundness of consumer protections. The health of a financial institution ultimately is connected to the health of its customers. If consumers lack confidence in their institution or are unable to maintain their economic responsibilities, the institution will undoubtedly suffer. Similarly, safety and soundness of our institutions is vital to consumer protection. Consumers are protected if

the institutions upon which they rely are operated in a safe and sound manner. Consumer complaints have often spurred investigations or even enforcement actions against institutions or financial service providers operating in an unsafe and unsound manner.

States have observed that federal regulators, without the checks and balances of more locally responsive state regulators or state law enforcement, do not always give fair weight to consumer issues or lack the local perspective to understand consumer issues fully. CSBS considers this a weakness of the current system that would be exacerbated by creating a consumer protection agency.

Further, federal preemption of state law and state law enforcement by the OCC and the OTS has resulted in less responsive consumer protections and institutions that are much less responsive to the needs of consumers in our states.

CSBS is currently reviewing and developing robust policy positions upon the administration's proposed financial regulatory reform plan. Our initial thoughts, however, are pleased the administration has recognized the vital role states play in preserving consumer protection. We agree that federal standards should be applicable to all financial entities, and must be a floor, allowing state authorities to impose more stringent statutes or regulations if necessary to protect the citizens of our states. CSBS is also pleased the administration's plan would allow for state authorities to enforce all applicable law—state and federal—on those financial entities operating within our state, regardless of charter type.

Q.2. *Regulatory Gaps or Omissions*—During a recent hearing, the Committee has heard about massive regulatory gaps in the system. These gaps allowed unscrupulous actors like AIG to exploit the lack of regulatory oversight. Some of the counterparties that AIG did business with were institutions under your supervision.

Why didn't your risk management oversight of the AIG counterparties trigger further regulatory scrutiny? Was there a flawed assumption that AIG was adequately regulated, and therefore no further scrutiny was necessary?

Was there dialogue between the banking regulators and the state insurance regulators? What about the SEC?

If the credit default swap contracts at the heart of this problem had been traded on an exchange or cleared through a clearinghouse, with requirement for collateral and margin payments, what additional information would have been available? How would you have used it?

A.2. CSBS believes this is a question best answered by the Federal Reserve and the OCC. However, we believe this provides an example of why consolidated supervision would greatly weaken our system of financial oversight. Institutions have become so complex in size and scope, that no single regulator is capable of supervising their activities. It would be imprudent to lessen the number of supervisors. Instead, Congress should devise a system which draws upon the strength, expertise, and knowledge of all financial regulators.

Q.3. *Liquidity Management*—A problem confronting many financial institutions currently experiencing distress is the need to roll-over short-term sources of funding. Essentially these banks are facing a

shortage of liquidity. I believe this difficulty is inherent in any system that funds long-term assets, such as mortgages, with short-term funds. Basically the harm from a decline in liquidity is amplified by a bank's level of "maturity-mismatch."

I would like to ask each of the witnesses, should regulators try to minimize the level of a bank's maturity-mismatch? And if so, what tools would a bank regulator use to do so?

A.3. While banks tend to have an inherent maturity-mismatch, greater access to diversified funding has mitigated this risk. Beyond traditional retail deposits, banks can access brokered deposits, public entity deposits, and secured borrowings from the FHLB. Since a bank essentially bids or negotiates for these funds, they can structure the term of the funding to meet their asset and liability management objectives.

In the current environment, the FDIC's strict interpretation of the brokered deposit rule has unnecessarily led banks to face a liquidity challenge. Under the FDIC's rules, when a bank falls below "well capitalized" they must apply for a waiver from the FDIC to continue to accept brokered deposits. The FDIC has been overly conservative in granting these waivers or allowing institutions to reduce their dependency on brokered deposits over time, denying an institution access to this market. Our December 2008 letter to the FDIC on this topic is attached.

Q.4. *Regulatory Conflict of Interest*—Federal Reserve Banks which conduct bank supervision are run by bank presidents that are chosen in part by bankers that they regulate.

Mr. Tarullo, do you see the potential for any conflicts of interest in the structural characteristics of the Fed's bank supervisory authorities?

Mr. Dugan and Mr. Polakoff does the fact that your agencies' funding stream is affected by how many institutions you are able to keep under your charters affect your ability to conduct supervision?

A.4. I believe these questions are best answered by the Federal Reserve, the OCC, and the OTS.

Q.5. *Too-Big-To-Fail*—Chairman Bair stated in her written testimony that "the most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of those institutions similar to that which exists for FDIC-insured banks. In short we need to end too big to fail." I would agree that we need to address the too-big-to-fail issue, both for banks and other financial institutions.

Could each of you tell us whether putting a new resolution regime in place would address this issue?

How would we be able to convince the market that these systemically important institutions would not be protected by taxpayer resources as they had been in the past?

A.5. CSBS strongly agrees with Chairman Bair that we must end "too big to fail." Our current crisis has shown that our regulatory structure was incapable of effectively managing and regulating the nation's largest institutions and their affiliates.

Further, CSBS believes a regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk. The federal government, perhaps through the FDIC, must have regulatory tools in place to manage the orderly failure of the largest financial institutions regardless of their size and complexity. The FDIC's testimony effectively outlines the checks and balances provided by a regulator with resolution authority and capability.

Part of this process must be to prevent institutions from becoming "too big to fail" in the first place. Some methods to limit the size of institutions would be to charge institutions additional assessments based on size and complexity, which would be, in practice, a "too big to fail" premium. In a February 2009 article published in Financial Times, Nassim Nicholas Taleb, author of *The Black Swan,* discusses a few options we should avoid. Basically, Taleb argues we should no longer provide incentives without disincentives. The nation's largest institutions were incentivized to take risks and engage in complex financial transactions. But once the economy collapsed, these institutions were not held accountable for their failure. Instead, the U.S. taxpayers have further rewarded these institutions by propping them up and preventing their failure. Accountability must become a fundamental part of the American financial system, regardless of an institution's size.

Q.6. *Pro-Cyclicality*—I have some concerns about the pro-cyclical nature of our present system of accounting and bank capital regulation. Some commentators have endorsed a concept requiring banks to hold more capital when good conditions prevail, and then allow banks to temporarily hold less capital in order not to restrict access to credit during a downturn. Advocates of this system believe that counter-cyclical policies could reduce imbalances within financial markets and smooth the credit cycle itself.

What do you see as the costs and benefits of adopting a more counter-cyclical system of regulation?

Do you see any circumstances under which your agencies would take a position on the merits of counter-cyclical regulatory policy?

A.6. Our legislative and regulatory efforts should be counter-cyclical. In order to have an effective counter-cyclical regulatory regime, we must have the will and political support to demand higher capital standards and reduce risk-taking when the economy is strong and companies are reporting record profits. We must also address accounting rules and their impact on the depository institutions, recognizing that we need these firms to originate and hold longer-term, illiquid assets. We must also permit and encourage these institutions to build reserves for losses over time. Similarly, the FDIC must be given the mandate to build upon their reserves over time and not be subject to a cap. This will allow the FDIC to reduce deposit insurance premiums in times of economic stress.

A successful financial system is one that survives market booms and busts without collapsing. The key to ensuring our system can survive these normal market cycles is to maintain and strengthen the diversity of our industry and our system of supervision. Diversity provides strength, stability, and necessary checks-and-balances to regulatory power.

Consolidation of the industry or financial supervision could ultimately produce a financial system of only mega-banks, or the behemoth institutions that are now being propped up and sustained by taxpayer bailouts. An industry of only these types of institutions would not be resilient. Therefore, Congress must ensure this consolidation does not take place by strengthening our current system and preventing supervisory consolidation.

Q.7. *G20 Summit and International Coordination*—Many foreign officials and analysts have said that they believe the upcoming G20 summit will endorse a set of principles agreed to by both the Financial Stability Forum and the Basel Committee, in addition to other government entities. There have also been calls from some countries to heavily re-regulate the financial sector, pool national sovereignty in key economic areas, and create powerful supranational regulatory institutions. (Examples are national bank resolution regimes, bank capital levels, and deposit insurance.) Your agencies are active participants in these international efforts.

What do you anticipate will be the result of the G20 summit?

Do you see any examples or areas where supranational regulation of financial services would be effective?

How far do you see your agencies pushing for or against such supranational initiatives?

A.7. This question is obviously targeted to the federal financial agencies. However, while our supervisory structure will continue to evolve, CSBS does not believe international influences or the global marketplace should solely determine the design of regulatory initiatives in the United States. CSBS believes it is because of our unique dual banking system, not in spite of it, that the United States boasts some of the most successful institutions in the world. U.S. banks are required to hold high capital standards compared to their international counterparts. U.S. banks maintain the highest tier 1 leverage capital ratios but still generate the highest average return on equity. The capital levels of U.S. institutions have resulted in high safety and soundness standards. In turn, these standards have attracted capital investments worldwide because investors are confident in the strength of the U.S. system.

Viability of the global marketplace and the international competitiveness of our financial institutions are important goals. However, our first priority as regulators must be the competitiveness between and among domestic banks operating within the United States. It is vital that regulatory restructuring does not adversely affect the financial system in the U.S. by putting banks at a competitive disadvantage with larger, more complex institutions. The diversity of financial institutions in the U.S. banking system has greatly contributed to our economic success.

CSBS believes our supervisory structure should continue to evolve as necessary and prudent to accommodate our institutions that operate globally as well as domestically.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM JOSEPH A. SMITH, JR.

Q.1. It is clear that our current regulatory structure is in need of reform. At my subcommittee hearing on risk management, March

18, 2009, GAO pointed out that regulators often did not move swiftly enough to address problems they had identified in the risk management systems of large, complex financial institutions.

Chairman Bair's written testimony for today's hearing put it very well: " . . . the success of any effort at reform will ultimately rely on the willingness of regulators to use their authorities more effectively and aggressively."

My questions may be difficult, but please answer the following:

- If this lack of action is a persistent problem among the regulators, to what extent will changing the structure of our regulatory system really get at the issue?
- Along with changing the regulatory structure, how can Congress best ensure that regulators have clear responsibilities and authorities, and that they are accountable for exercising them "effectively and aggressively"?

A.1. First of all, CSBS agrees completely with Chairman Bair. In fact, in a letter to the Government Accountability Office (GAO) in December 2008, CSBS Executive Vice President John Ryan wrote, "While there are clearly gaps in our regulatory system and the system is undeniably complex, CSBS has observed that the greater failing of the system has been one of insufficient political and regulatory will, primarily at the federal level." Perhaps the resilience of our financial system during previous crises gave policymakers and regulators a false sense of security and a greater willingness to defer to powerful interests in the financial industry who assured them that all was well.

From the state perspective, it is clear that the nation's largest and most influential financial institutions have themselves been major contributors to our regulatory system's failure to prevent the current economic collapse. All too often, it appeared as though legislation and regulation facilitated the business models and viability of our largest institutions, instead of promoting the strength of consumers or encouraging a diverse financial industry.

CSBS believes consolidating supervisory authority will only exacerbate this problem. Regulatory capture by a variety of interests would become more likely with a consolidated supervisory structure. The states attempted to check the unhealthy evolution of the mortgage market and it was the states and the FDIC that were a check on the flawed assumptions of the Basel II capital accord. These checks should be enhanced by regulatory restructuring, not eliminated.

To best ensure that regulators exercise their authorities "effectively and aggressively," I encourage Congress to preserve and enhance the system of checks and balances amongst regulators and to forge a new era of cooperative federalism. It serves the best interest of our economy, our financial services industry, and our consumers that the states continue to have a role in financial regulation. States provide an important system of checks and balances to financial oversight, are able to identify emerging trends and practices before our federal counterparts, and have often exhibited a willingness to act on these trends when our federal colleagues did not.

Therefore, CSBS urges Congress to implement a recommendation made by the Congressional Oversight Panel in their "Special Report on Regulatory Reform" to eliminate federal preemption of the application of state consumer protection laws. To preserve a responsive system, states must be able to continue to produce innovative solutions and regulations to provide consumer protection.

Further, the federal government would best serve our economy and our consumers by advancing a new era of cooperative federalism. The SAFE Act enacted by Congress requiring licensure and registration of mortgage loan originators through NMLS provides a mode for achieving systemic goals of high regulatory standards and a nationwide regulatory roadmap and network, while preserving state authority for innovation and enforcement. The SAFE Act sets expectations for greater state-to-state and state-to-federal regulatory coordination.

Congress should complete this process by enacting a federal predatory lending standard as outlined in H.R. 1728, the Mortgage Reform and Anti-Predatory Lending Act. However, a static legislative solution would not keep pace of market innovation. Therefore, any federal standard must be a floor for all lenders that does not stifle a state's authority to protect its citizens through state legislation that builds upon the federal standard. States should also be allowed to enforce-in cooperation with federal regulators-both state and federal predatory lending laws for institutions that act within their state.

Finally, rule writing authority by the federal banking agencies should be coordinated through the FFIEC. Better state/federal coordination and effective lending standards is needed if we are to establish rules that are appropriately written and applied to financial services providers. While the biggest institutions are federally chartered, the vast majority of institutions are state chartered and regulated. Also, the states have a breadth of experience in regulating the entire financial services industry, not just banks. Unlike our federal counterparts, my state supervisory colleagues and I oversee all financial service providers, including banks, thrifts, credit unions, mortgage banks, and mortgage brokers.

Q.2. How do we overcome the problem that in the boom times no one wants to be the one stepping in to tell firms they have to limit their concentrations of risk or not trade certain risky products?

What thought has been put into overcoming this problem for regulators overseeing the firms?

Is this an issue that can be addressed through regulatory restructure efforts?

A.2. Our legislative and regulatory efforts must be counter-cyclical. A successful financial system is one that survives market booms and busts without collapsing. The key to ensuring our system can survive these normal market cycles is to maintain and strengthen the diversity of our industry and our system of supervision. Diversity provides strength, stability, and necessary checks-and-balances to regulatory power.

Consolidation of the industry or financial supervision could ultimately product a financial system of only mega-banks, or the behemoth institutions that are now being propped up and sustained by

taxpayer bailouts. An industry of only these types of institutions would not be resilient. Therefore, Congress must ensure this consolidation does not take place by strengthening our current system and preventing supervisory consolidation.

Q.3. As Mr. Tarullo and Mrs. Bair noted in their testimony, some financial institution failures emanated from institutions that were under federal regulation. While I agree that we need additional oversight over and information on unregulated financial institutions, I think we need to understand why so many regulated firms failed.

Why is it the case that so many regulated entities failed, and many still remain struggling, if our regulators in fact stand as a safety net to rein in dangerous amounts of risk-taking?

While we know that certain hedge funds, for example, have failed, have any of them contributed to systemic risk?

Given that some of the federal banking regulators have examiners on-site at banks, how did they not identify some of these problems we are facing today?

A.3. To begin, the seeming correlation between federal supervision and success now appears to be unwarranted and should be better understood. The failures we have seen are divided between institutions that are suffering because of an extreme business cycle, and others that had more fundamental flaws that precipitated the downturn. In a healthy and functional economy, financial oversight must allow for some failures. In a competitive marketplace, some institutions will cease to be feasible. Our supervisory structure must be able to resolve failures. Ultimately, more damage is done to the financial system if toxic institutions are allowed to remain in business, instead of allowed to fail. Propping up these institutions can create lax discipline and risky practices as management relies upon the government to support them if their business models become untenable.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOSEPH A. SMITH, JR.

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of federal and state functional regulation for large, interconnected, and large firms like AIG?

A.1. The current economic crisis has shown that our financial regulatory structure in the United States was incapable of effectively managing and regulating the nation's largest institutions, such as AIG.

Institutions, such as AIG, that provide financial services similar to those provided by a bank, should be subject to the same oversight that supervises banks.

CSBS believes the solution, however, is not to expand the federal government bureaucracy by creating a new super regulator. In-

stead, we should enhance coordination and cooperation among federal and state regulators. We believe regulators must pool their resources and expertise to better identify and manage systemic risk. The Federal Financial Institutions Examination Council (FFIEC) provides a vehicle for working toward this goal of seamless federal and state cooperative supervision.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. Each of the models discussed would result in further consolidation of the financial industry, and would create institutions that would be inherently too big to fail. If we allowed our financial industry to consolidate to only a handful of institutions, the nation and the global economy would be reliant upon those institutions to remain functioning. CSBS believes all financial institutions must be allowed to fail if they become insolvent. Currently, our system of financial supervision is inadequate to effective supervise the nation's largest institutions and to resolve them in the event of their failure.

More importantly, however, consolidation of the industry would destroy the community banking system within the United States. The U.S. has over 8,000 viable insured depository institutions to serve the people of this nation. The diversity of our industry has enabled our economy to continue despite the current recession. Community and regional banks have continued to make credit available to qualified borrowers throughout the recession and have prevented the complete collapse of our economy.

Q.3. If there are institutions that are too big to fail, how do we identify that? How do we define the circumstance where a single company is so systemically significant to the rest of our financial circumstances and our economy that we must not allow it to fail?

A.3. A specific definition for "too big to fail" will be difficult for Congress to establish. Monetary thresholds will eventually become insufficient as the market rebounds and works around any asset-size restrictions, just as institutions have avoided deposit caps for years now. Some characteristics of an institution that is "too big to fail" include being so large that the institution's regulator is unable to provide comprehensive supervision of the institution's lines of business or subsidiaries. An institution is also "too big to fail" if a sudden collapse of the institution would have a devastating impact upon separate market segments.

Q.4. We need to have a better idea of what this notion of too big to fail is—what it means in different aspects of our industry and what our proper response to it should be. How should the federal

government approach large, multinational, and systemically significant companies?

A.4. The federal government should utilize methods to prevent companies from growing too big to fail, either through incentives and disincentives (such as higher regulatory fees and assessments for higher amounts of assets or engaging in certain lines of business), denying certain business mergers or acquisitions that allow a company to become "systemic," or through establishing anti-trust laws that prevent the creation of financial monopolies. Congress should also grant the Federal Deposit Insurance Corporation (FDIC) resolution authority over all financial firms, regardless of their size or complexity. This authority will help instill market discipline to these systemic institutions by providing a method to close any institution that becomes insolvent. Finally, Congress should consider establishing a bifurcated system of supervision designed to meet the needs not only of the nation's largest and most complex institutions, but also the needs of the smallest community banks.

Q.5. What does "fail" mean? In the context of AIG, we are talking about whether we should have allowed an orderly Chapter 11 bankruptcy proceeding to proceed. Is that failure?

A.5. CSBS believes failures and resolutions take on a variety of forms based upon the type of institution and its impact upon the financial system as a whole. In the context of AIG, an orderly Chapter 11 bankruptcy would have been considered a failure.

But it is more important that we do not create an entire system of financial supervision that is tailored only to our nation's largest and most complex institutions. It is our belief the greatest strength of our unique financial structure is the diversity of the financial industry. The U.S. banking system is comprised of thousands of financial institutions of vastly different sizes. Therefore, legislative and regulatory decisions that alter our financial regulatory structure or financial incentives should be carefully considered against how those decisions affect the competitive landscape for institutions of all sizes.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL FROM JOSEPH A. SMITH, JR.

Q.1. Two approaches to systemic risk seem to be identified: (1) monitoring institutions and taking steps to reduce the size/activities of institutions that approach a "too large to fail" or "too systemically important to fail" or (2) impose an additional regulator and additional rules and market discipline on institutions that are considered systemically important.

Which approach do you endorse? If you support approach one how you would limit institution size and how would you identify new areas creating systemic importance?

If you support approach two how would you identify systemically important institutions and what new regulations and market discipline would you recommend?

A.1. CSBS endorses the first approach monitor institutions and take steps to reduce the size and activities of institutions that approach either "too large to fail" or "too systemically important to

fail." Our current crisis has shown that our regulatory structure was incapable of effectively managing and regulating the nation's largest institutions. CSBS believes the solution, however, is not to expand the federal government bureaucracy by creating a new super regulator, or granting those authorities to a single existing agency. Instead, we should enhance coordination and cooperation among the federal government and the states to identify systemic importance and mitigate its risk. We believe regulators must pool resources and expertise to better manage systemic risk. The FFIEC provides a vehicle for working towards this goal of seamless federal and state cooperative supervision.

Further, CSBS believes a regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk. The federal government, perhaps through the FDIC, must have regulatory tools in place to manage the orderly failure of the largest financial institutions regardless of their size and complexity.

Part of this process must be to prevent institutions from becoming "too big to fail" in the first place. Some methods to limit the size of institutions would be to charge institutions additional assessments based on size and complexity, which would be, in practice, a "too big to fail" premium. In a February 2009 article published in Financial Times, Nassim Nicholas Taleb, author of *The Black Swan,* discusses a few options we should avoid. Basically, Taleb argues we should no longer provide incentives without disincentives. The nation's largest institutions were incentivized to take risks and engage in complex financial transactions. But once the economy collapsed, these institutions were not held accountable for their failure. Instead, the U.S. taxpayers have further rewarded these institutions by propping them up and preventing their failure. Accountability must become a fundamental part of the American financial system, regardless of an institution's size.

Q.2. Please identify all regulatory or legal barriers to the comprehensive sharing of information among regulators including insurance regulators, banking regulators, and investment banking regulators. Please share the steps that you are taking to improve the flow of communication among regulators within the current legislative environment.

A.2. Regulatory and legal barriers exist at every level of state and federal government. These barriers can be cultural, regulatory, or legal in nature.

Despite the hurdles, state and federal authorities have made some progress towards enhancing coordination. Since Congress added full state representation to the FFIEC in 2006, federal regulators are working more closely with state authorities to develop processes and guidelines to protect consumers and prohibit certain acts or practices that are either systemically unsafe or harmful to consumers.

The states, working through CSBS and the American Association of Residential Mortgage Regulators (AARMR), have made tremendous strides towards enhancing coordination and cooperation among the states and with our federal counterparts.

The model for cooperative federalism among state and federal authorities is the CSBS-AARMR Nationwide Mortgage Licensing System (NMLS) and the SAFE Act enacted last year. In 2003, CSBS and AARMR began a very bold initiative to identify and track mortgage entities and originators through a database of licensing and registration. In January 2008, NMLS was successfully launched with seven inaugural participating states. Today, 25 states plus the District of Columbia and Puerto Rico are using NMLS. The hard work and dedication of the states was recognized by Congress as you enacted the Housing and Economic Recovery Act of 2008 (HERA). Title V of HERA, known as the SAFE Act, is designed to increase mortgage loan originator professionalism and accountability, enhance consumer protection, and reduce fraud by requiring all mortgage loan originators be licensed or registered through NMLS.

Combined, NMLS and the SAFE Act create a seamless system of accountability, interconnectedness, control, and tracking that has long been absent in the supervision of the mortgage market. Please see the Appendix of my written testimony for a comprehensive list of state initiatives to enhance coordination of financial supervision.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM GEORGE REYNOLDS

Q.1. *Consumer Protection Regulation*—Some have advocated that consumer protection and prudential supervision should be divorced, and that a separate consumer protection regulation regime should be created. They state that one source of the financial crisis emanated from the lack of consumer protection in the underwriting of loans in the originate-to-distribute space.

What are the merits of maintaining it in the same agency? Alternatively, what is the best argument each of you can make for a new consumer protection agency?

A.1. A separate consumer protection regulation regime would not recognize state law. State legislators and regulators are in the first and best position to identify trends and abusive practices. One regulator for consumer protection eliminates the dual oversight that is made possible by state and federal laws and regulations. It would also inhibit coordination and cooperation between regulators or worse, provide a gap in regulation and oversight by the state regulatory system.

The Treasury *Blueprint for a Modernized Financial Regulatory Structure,* presented in March 2008, suggests the creation of a business conduct regulator to conduct regulation across all types of financial firms. The business conduct regulator would include key aspects of consumer protection, including rule writing for disclosures and business practices. This structure proposes to eliminate gaps in oversight and provide effective consumer and investor protections.

The proposed business conduct regulator at the federal level would be separate and distinct from the suggested prudential regu-

lator. NASCUS[1] believes such a system would curtail, not enhance, consumer protections.

The Treasury *Blueprint* would create a new federal bureaucracy, taking away most supervisory, enforcement and rule making authority from the states and federalizing those authorities in a new business conduct regulator.

Much of the focus of attention of the OCC, OTS and NCUA has been on seeking preemption from state consumer protection laws. An example of this is the preemption efforts undertaken by these agencies regarding the Georgia Fair Lending Act (GFLA). It is vital that consumer protection statutes adopted at the state level apply consistently to all financial institutions regardless of charter type.

Q.2. *Regulatory Gaps or Omissions*—During a recent hearing, the Committee has heard about massive regulatory gaps in the system. These gaps allowed unscrupulous actors like AIG to exploit the lack of regulatory oversight. Some of the counterparties that AIG did business with were institutions under your supervision.

Why didn't your risk management oversight of the AIG counterparties trigger further regulatory scrutiny? Was there a flawed assumption that AIG was adequately regulated, and therefore no further scrutiny was necessary?

A.2. NASCUS members do not have regulatory oversight of AIG. The answers provided by NASCUS focus on issues related to our expertise regulating state credit unions and issues concerning the state credit union system.

Q.3. Was there dialogue between the banking regulators and the state insurance regulators? What about the SEC?

A.3. This question does not apply to state credit union regulators. The answers provided by NASCUS focus on issues related to our expertise regulating state credit unions and issues concerning the state credit union system.

Q.4. If the credit default swap contracts at the heart of this problem had been traded on an exchange or cleared through a clearinghouse, with requirement for collateral and margin payments, what additional information would have been available? How would you have used it?

A.4. Credit unions did not and currently do not engage in credit default swap contracts to the best of our knowledge.

Q.5. *Liquidity Management*—A problem confronting many financial institutions currently experiencing distress is the need to roll-over short-term sources of funding. Essentially these banks are facing a shortage of liquidity. I believe this difficulty is inherent in any system that funds long-term assets, such as mortgages, with short-term funds. Basically the harm from a decline in liquidity is amplified by a bank's level of "maturity-mismatch."

I would like to ask each of the witnesses, should regulators try to minimize the level of a bank's maturity-mismatch? And if so, what tools would a bank regulator use to do so?

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[1] NASCUS is the professional association of state credit union regulatory agencies that charter, examine and supervise the nation's 3,100 state-chartered credit unions. The NASCUS , mission is to enhance state credit union supervision and advocate for a safe and sound credit union system.

A.5. Most credit unions supervised by state regulators have strong core liquidity funding in the form of member deposits. Unlike other financial institutions which use brokered funding, Internet deposit funding and other noncore funding, these practices are rare in credit unions.

Many credit unions' liquidity position would be favorably impacted if they had access to supplemental capital. Supplemental capital would bolster the safety and soundness of credit unions and provide further stability in this unpredictable market. It would also provide an additional layer of protection to the NCUSIF thereby maintaining credit unions' independence from the federal government and taxpayers.

Credit union access to supplemental capital is more important than ever given the impact of losses in the corporate system on federally insured natural-person credit unions. Stabilizing the corporate credit union system requires natural-person federally insured credit unions to write off their existing one percent deposit in the NCUSIF, as well as an assessment of a premium to return NCUSIF's equity ratio to 1.3 percent. Additionally, credit unions with capital investments in the retail corporate credit union could be forced to write-down as much as another $2 billion in corporate capital. This will impact the bottom line of many credit unions, and supplemental capital could have helped their financial position in addressing this issue.

State regulators are committed to taking every feasible step to protect credit union safety and safety and soundness—we must afford the nation's credit unions with the opportunity to protect and grow liquidity as well as the tools to react to unusual market conditions. The NASCUS Board of Directors and NASCUS state regulators urge you to enact legislation allowing supplemental capital.

Q.6. *Too-Big-To-Fail*—Chairman Bair stated in her written testimony that "the most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of those institutions similar to that which exists for FDIC-insured banks. In short we need to end too big to fail." I would agree that we need to address the too-big-to-fail issue, both for banks and other financial institutions.

Could each of you tell us whether putting a new resolution regime in place would address this issue?

A.6. While relatively few credit unions fall into the category of "too big to fail," with the exception perhaps of some of the larger corporate credit unions, I believe as a general rule that if an institution is too big to fail, then perhaps it is also too large to exist. Perhaps the answer is to functionally separate and decouple the risk areas of a "too big to fail" organization so that a component area can have the market discipline of potential failure, without impairing the entire organization. Financial institutions backed by federal deposit insurance need to have increased expectations of risk control and risk management.

Q.7. How would we be able to convince the market that these systemically important institutions would not be protected by taxpayer resources as they had been in the past?

A.7. Again this area has relatively little application to state-chartered credit unions. But the most effective message can be conveyed to the marketplace by clearly indicating that these riskier decoupled operations will not be supported by taxpayer resources and then following through by letting these entities enter bankruptcy or fail without government intervention.

Q.8. *Pro-Cyclicality*—I have some concerns about the pro-cyclical nature of our present system of accounting and bank capital regulation. Some commentators have endorsed a concept requiring banks to hold more capital when good conditions prevail, and then allow banks to temporarily hold less capital in order not to restrict access to credit during a downturn. Advocates of this system believe that counter-cyclical policies could reduce imbalances within financial markets and smooth the credit cycle itself.

What do you see as the costs and benefits of adopting a more counter-cyclical system of regulation?

Do you see any circumstances under which your agencies would take a position on the merits of counter-cyclical regulatory policy?

A.8. Perhaps the most needed measure relative to a counter-cyclical system of regulation is the need to increase deposit insurance premiums during periods of heightened earnings, as opposed to the current practice of basing these assessment on deposit insurance losses. Financial institutions end up with high assessments typically at the same time that their capital and earnings are under pressure due to asset quality concerns. The deposit insurance funds need to be built up during the good times and banks and credit unions need to be able to have lower assessments during periods of economic uncertainty.

It would also be wise to review examination processes to see where greater emphasis can be placed on developing counter-cyclical processes and procedures. This will always be a challenge during periods of economic expansion, where financial institutions are experiencing low levels of nonperforming loans and loan losses, strong capital and robust earnings. Under these circumstances supervisors are subject to being accused by financial institutions and policy makers as impeding economic progress and credit availability. It would be beneficial to take a stronger and more aggressive posture regarding concentration risk and funding and asset/liability management risk during periods of economic expansion.

Q.9. *G20 Summit and International Coordination*—Many foreign officials and analysts have said that they believe the upcoming G20 summit will endorse a set of principles agreed to by both the Financial Stability Forum and the Basel Committee, in addition to other government entities. There have also been calls from some countries to heavily re-regulate the financial sector, pool national sovereignty in key economic areas, and create powerful supranational regulatory institutions. (Examples are national bank resolution regimes, bank capital levels, and deposit insurance.) Your agencies are active participants in these international efforts.

What do you anticipate will be the result of the G20 summit?

Do you see any examples or areas where supranational regulation of financial services would be effective?

How far do you see your agencies pushing for or against such supranational initiatives?

A.9. To ensure a comprehensive regulatory system for credit unions, Congress should consider the current dual chartering system as a regulatory model. Dual chartering and the value offered to consumers by the state and federal systems provide the components that make a comprehensive regulatory system. Dual chartering also reduces the likelihood of gaps in financial regulation because there are two interested regulators. Often, states are in the first and best position to identify current trends that need to be regulated and this structure allows the party with the most information to act to curtail a situation before it becomes problematic. Dual chartering should continue. This system provides accountability and the needed structure for effective and aggressive regulatory enforcement.

The dual chartering system has provided comprehensive regulation for 140 years. Dual chartering remains viable in the financial marketplace because of the distinct benefits provided by each charter, state and federal. This system allows each financial institution to select the charter that benefits its members or consumers the most. Ideally, for any system, the best elements of each charter should be recognized and enhanced to allow for competition in the marketplace so that everyone benefits. In addition, the dual chartering system allows for the checks and balances between state and federal government necessary for comprehensive regulation. Any regulatory system should recognize the value of the dual chartering system and how it contributes to a comprehensive regulatory structure. Regulators should evaluate products and services based on safety and soundness and consumer protection criterion. This will maintain the public's confidence.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM GEORGE REYNOLDS

Q.1. It is clear that our current regulatory structure is in need of reform. At my subcommittee hearing on risk management, March 18, 2009, GAO pointed out that regulators often did not move swiftly enough to address problems they had identified in the risk management systems of large, complex financial institutions.

Chair Bair's written testimony for today's hearing put it very well: " . . . the success of any effort at reform will ultimately rely on the willingness of regulators to use their authorities more effectively and aggressively."

My questions may be difficult, but please answer the following: If this lack of action is a persistent problem among the regulators, to what extent will changing the structure of our regulatory system really get at the issue?

A.1. We do not perceive that lack of action is a problem among the state credit union regulators. In fact, the authority given to state regulators by state legislatures allows state regulators to move quickly to mitigate problems and address risk in their state-char-

tered credit unions. NASCUS[1] believes that the dual chartering structure which allows for both a strong state and federal regulator is an effective regulatory structure for credit unions.

State and federal credit union regulators regularly exchange information about the credit unions they supervise; it is a cooperative relationship. The Federal Credit Union Act (FCUA) provides that "examinations conducted by State regulatory agencies shall be utilized by the Board for such purposes to the maximum extent feasible."[2] Further, Congress has recognized and affirmed the distinct roles played by state and federal regulatory agencies in the FCUA by providing a system of consultation and cooperation between state and federal regulators.[3] It is important that all statutes and regulations written in the future include provisions that require consultation and cooperation between state and federal credit union regulators to prevent regulatory and legal barriers to the comprehensive information sharing. This cooperation helps regulators identify and act on issues before they become a problem.

State regulators play an important role in protecting the safety and soundness of the state credit union system. It is imperative that any regulatory structure preserve state regulators role in overseeing and writing regulations for state credit unions. In addition, it is critical that state regulators and National Credit Union Administration (NCUA) have parity and comparable systemic risk authority with the Federal Deposit Insurance Corporation (FDIC).

Q.2. Along with changing the regulatory structure, how can Congress best ensure that regulators have clear responsibilities and authorities, and that they are accountable for exercising them "effectively and aggressively"?

A.2. To ensure a comprehensive regulatory system, Congress should consider the current dual chartering system as a regulatory model. Dual chartering and the value offered to consumers by the state and federal systems provide the components that make a comprehensive regulatory system. Dual chartering also reduces the likelihood of gaps in financial regulation because there are two interested regulators. Often, states are in the first and best position to identify current trends that need to be regulated and this structure allows the party with the most information to act to curtail a situation before it becomes problematic. Dual chartering should continue. This system provides accountability and the needed structure for effective and aggressive regulatory enforcement.

The dual chartering system has provided comprehensive regulation for 140 years. Dual chartering remains viable in the financial marketplace because of the distinct benefits provided by each charter, state and federal. This system allows each financial institution to select the charter that benefits its members or consumers the most. Ideally, for any system, the best elements of each charter should be recognized and enhanced to allow for competition in the

[1] NASCUS is the professional association of state credit union regulatory agencies that charter, examine and supervise the nation's 3,100 state-chartered credit unions. The NASCUS mission is to enhance state credit union supervision and advocate for a safe and sound credit union system.

[2] 12 U.S. Code §1781(b)(1).

[3] The "Consultation and Cooperation With State Credit Union Supervisors" provision contained in The Federal Credit Union Act, 12 U.S. Code §1757a(e) and 12 U.S. Code §1790d(l).

marketplace so that everyone benefits. In addition, the dual chartering system allows for the checks and balances between state and federal government necessary for comprehensive regulation. Any regulatory system should recognize the value of the dual chartering system and how it contributes to a comprehensive regulatory structure. Regulators should evaluate products and services based on safety and soundness and consumer protection criterion. This will maintain the public's confidence.

Q.3. How do we overcome the problem that in the boom times no one wants to be the one stepping in to tell firms they have to limit their concentrations of risk or not trade certain risky products?

What thought has been put into overcoming this problem for regulators overseeing the firms?

Is this an issue that can be addressed through regulatory restructure efforts?

A.3. The current credit union regulatory structure appropriately provides state credit union regulators rulemaking and enforcement authority. This authority helps state regulators respond to problems and trends at state-chartered credit unions and it places them in a position to help state credit unions manage risks on their balance sheets.

It is sometimes difficult, particularly during a period of economic expansion to motivate financial institutions to reduce concentration risk when institutions are strongly capitalized and have robust earnings. This is, nevertheless, the appropriate role of a regulator and it is not really a factor that can be addressed through regulatory restructuring. It can only be impacted by having effective, experienced and well trained examiners that are supported in consistent manner by experienced supervisory management.

Q.4. As Mr. Tarullo and Mrs. Bair noted in their testimony, some financial institution failures emanated from institutions that were under federal regulation. While I agree that we need additional oversight over and information on unregulated financial institutions, I think we need to understand why so many regulated firms failed.

Why is it the case that so many regulated entities failed, and many still remain struggling, if our regulators in fact stand as a safety net to rein in dangerous amounts of risk-taking?

A.4. The current economic crisis and resulting destabilization of portions of the financial services system has revealed certain gaps and lapses in overall regulatory oversight. Currently, state and federal regulators are assessing those lapses, identifying gaps, and working diligently to address weaknesses in the system. As part of this process, it is also important to recognize regulatory oversight that worked, whether preventing failure, or identifying undue risk in a manner that allowed for an orderly unwinding of a going concern.

To the extent that regulators miscalculated a calibration of acceptable risk, as opposed to undue risk, it may be safe to conclude that undue reliance was placed on underlying market assumptions that failed upon severe market dislocation.

Q.5. While we know that certain hedge funds, for example, have failed, have any of them contributed to systemic risk?

A.5. NASCUS members do not regulate hedge funds. The answers provided by NASCUS focus solely on issues related to our expertise regulating state credit unions and issues concerning the state credit union system.

Q.6. Given that some of the federal banking regulators have examiners on-site at banks, how did they not identify some of these problems we are facing today?

A.6. Given NASCUS members regulatory scope, this question does not apply. The answers provided by NASCUS focus solely on issues related to our expertise regulating state credit unions and issues concerning the state credit union system.

NASCUS background: The NASCUS,[4] mission is to enhance state credit union supervision and advocate for a safe and sound credit union system. NASCUS represents the interests of state agencies before Congress and is the liaison to federal agencies, including the National Credit Union Administration (NCUA). NCUA is the chartering authority for federal credit unions and the administrator of the National Credit Union Share Insurance Fund (NCUSIF), the insurer of most state-chartered credit unions.

Credit unions in this country are structured in three tiers. The first tier consists of 8,088 natural-person credit unions[5] that provide services to consumer members. Approximately 3,100 of these institutions are state-chartered credit unions and are regulated by state regulatory agencies. There are 27[6] retail corporate credit unions, which provide investment, liquidity and payment system services to credit unions; corporate credit unions do not serve consumers. The final tier of the credit union system is a federal wholesale corporate that acts as a liquidity and payment systems provider to the corporate system and indirectly to the consumer credit unions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM GEORGE REYNOLDS

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of federal and state functional regulation for large, interconnected, and large firms like AIG?

A.1. NASCUS[1] members do not have oversight responsibilities for AIG. The answers provided by NASCUS focus on issues related to our expertise regulating state credit unions and issues concerning

[4] NASCUS is the professional association of state credit union regulatory agencies that charter, examine and supervise the nation's 3,100 state-chartered credit unions.

[5] Credit Union Report, Year-End 2008, Credit Union National Association.

[6] There are 14 state-chartered retail corporate credit unions and 13 federally chartered corporate credit unions.

[1] NASCUS is the professional association of state credit union regulatory agencies that charter, examine and supervise the nation's 3,100 state-chartered credit unions.

the state credit union system. Although NASCUS does not have specific comments related to AIG, the following views on systemic risk are provided for your consideration.

It is important that systemic risk that is outside of the normal supervisory focus of financial institution regulators be monitored and controlled, but it is also imperative that the systemic risk process not interfere or add additional regulatory burden to financial institutions that are already supervised by their chartering authorities (state and federal) and their deposit insurers.

Regarding systemic risk, NASCUS believes that systemic risk and concentration risk can be mitigated through state and federal regulation cooperation. Regardless of which approach is selected to mitigate systemic risk, it presents all regulators with challenges, even those without direct jurisdiction over the entity representing the risk. By drawing on the expertise of many regulatory agencies, state and federal regulators could improve their ability to detect and address situations before they achieve critical mass.

State regulators play an important role in mitigating systemic risk in the state credit union system. Congress provides and affirms this distinct role in the Federal Credit Union Act (FCUA) by providing a system of "consultation and cooperation" between state and federal regulators.[2] It is imperative that any regulatory structure preserve state regulators role in overseeing and writing regulations for state credit unions. In addition, it is critical that state regulators and NCUA have parity and comparable systemic risk authority with the Federal Deposit Insurance Corporation (FDIC). NASCUS would be concerned about systemic risk regulation that introduces a new layer of regulation for credit unions or proposes to consolidate regulators and state and federal credit union charters.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. The Treasury *Blueprint for a Modernized Financial Regulatory Structure,* presented in March 2008, suggests an objectives-based approach to address market failures. NASCUS opposes this approach because it does not recognize the supervisory, enforcement and rule-making authority of the states. The suggested prudential financial regulator usurps the role of the National Credit Union Administration (NCUA) and it eliminates the National Credit Union Share Insurance Fund (NCUSIF), a fund that federally insured credit unions recapitalized in 1985 by depositing one percent of their shares into the Share Insurance Fund.

[2] The Consultation and Cooperation With State Credit Union Supervisors provision contained in The Federal Credit Union Act, 12 U.S. Code §1757a(e) and 12 U.S. Code §1790d(l).

The *Blueprint* would eliminate the credit union dual chartering system, a system that is based on the important foundation of competition and choice between state and federal charters.

Disruption of the current dual chartering structure would have various negative impacts. It would diminish state and federal regulator cooperation, tip the balance of power between states and the federal government and minimize the economic benefit and enhanced consumer protections available to states through state-chartered institutions. State legislators and regulators would no longer determine what is appropriate for a state-chartered institution.

Q.3. If there are institutions that are too big to fail, how do we identify that? How do we define the circumstance where a single company is so systemically significant to the rest of our financial circumstances and our economy that we must not allow it to fail?

A.3. While relatively few credit unions fall into the category of "too big to fail," with the exception of perhaps some of the larger corporate credit unions, I believe as a general rule that if an institution is "too big to fail," then perhaps it is also too large to exist. Perhaps the answer is to functionally separate and decouple the risk areas of a "too big to fail" organization so that a component area can have the market discipline of potential failure, without impairing the entire organization. Financial institutions backed by federal deposit insurance need to have increased expectations of risk control and risk management.

Clearly it is important to take steps to reduce systemic risk and lessen the impact of "too big to fail." Many of the credit unions that I supervise in Georgia would argue that the result of having these large institutions with systemic risk is that when problems arise, they get passed on to smaller credit unions through increased deposit insurance assessments.

Q.4. We need to have a better idea of what this notion of too big to fail is—what it means in different aspects of our industry and what our proper response to it should be. How should the federal government approach large, multinational, and systemically significant companies?

A.4. See response to previous question above.

Q.5. What does "fail" mean? In the context of AIG, we are talking about whether we should have allowed an orderly Chapter 11 bankruptcy proceeding to proceed. Is that failure?

A.5. While AIG does not directly relate to the state-chartered credit unions supervised by NASCUS state regulators, my general view as a financial services regulator is that institutions which become insolvent should face market based solutions; either bankruptcy or some type of corporate reorganization. Seeking government based solutions under these circumstances encourages excessive risk taking and creates moral hazard.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KOHL FROM GEORGE REYNOLDS

Q.1. Two approaches to systemic risk seem to be identified: (1) monitoring institutions and taking steps to reduce the size/activi-

ties of institutions that approach a "too large to fail" or "too systemically important to fail" or (2) impose an additional regulator and additional rules and market discipline on institutions that are considered systemically important.

Which approach do you endorse? If you support approach one how you would limit institution size and how would you identify new areas creating systemic importance?

If you support approach two how would you identify systemically important institutions and what new regulations and market discipline would you recommend?

A.1. NASCUS[1] believes that systemic risk can be mitigated through state and federal regulator cooperation. Regardless of which approach is selected to mitigate systemic risk, it presents all regulators with challenges, even those without direct jurisdiction over the entity representing the risk. By drawing on the expertise of many regulatory agencies, state and federal regulators could improve their ability to detect and address situations before they achieve critical mass.

State regulators play an important role mitigating systemic risk in the state credit union system. It is imperative that any regulatory structure preserve state regulators role in overseeing and writing regulations for state credit unions. In addition, it is critical that state regulators and National Credit Union Administration (NCUA) have parity and comparable systemic risk authority with the Federal Deposit Insurance Corporation (FDIC).

Systemic risk mitigation should recognize and utilize both state and federal credit union regulators and draw on their combined regulatory expertise. NASCUS would be concerned about a systemic risk regulation that introduces a new layer of regulation for credit unions or proposes to consolidate regulators and state and federal credit union charters.

Q.2. Please identify all regulatory or legal barriers to the comprehensive sharing of information among regulators including insurance regulators, banking regulators, and investment banking regulators. Please share the steps that you are taking to improve the flow of communication among regulators within the current legislative environment.

A.2. NASCUS does not believe that any regulatory or legal barriers to the comprehensive sharing of information between state and federal credit union regulators are insurmountable. Cooperation exists between state and federal credit union regulators and they regularly exchange information about the credit unions they supervise; it is a cooperative relationship. The Federal Credit Union Act (FCUA) provides that "examinations conducted by State regulatory agencies shall be utilized by the [NCUA] Board for such purposes to the maximum extent feasible."[2] Further, Congress has recognized and affirmed the distinct roles played by state and federal regulatory agencies in the FCUA by providing a system of consulta-

[1] NASCUS is the professional association of state credit union regulatory agencies that charter, examine and supervise the nation's 3,100 state-chartered credit unions. The NASCUS mission is to enhance state credit union supervision and advocate for a safe and sound credit union system.

[2] 12 U.S. Code §1781(b)(1).

tion and cooperation between state and federal regulators.[3] It is important that all statutes and regulations written in the future include provisions that require consultation and cooperation between state and federal credit union regulators to prevent barriers that could impede comprehensive information sharing.

There are processes established for comprehensive information sharing. Two examples come to mind: State regulators signed both a memorandum of understanding with the Financial Crimes Enforcement Network and a Document of Cooperation with the NCUA to facilitate the critical information sharing necessary for regulatory compliance.

The memorandum of understanding sets forth procedures for the exchange of information between the Financial Crimes Enforcement Network (FinCEN), a bureau within the U.S. Department of the Treasury and state financial regulatory agencies. Information exchange is intended to assist FinCEN in fulfilling its role as administrator of the Bank Secrecy Act and it assists state agencies in fulfilling their role as the financial institution supervisor. It fulfills the collective goal of the parties to enhance communication and coordination that help financial institutions identify and deter terrorist activities.

The Document of Cooperation is the formal agreement between NASCUS, on behalf of state regulatory agencies and the NCUA, the federal credit union regulator and administrator of the National Share Insurance Fund. The purpose of the document is to show the alliance between state and federal regulators to work with the common goal of providing solid credit union examination and supervision.

Both of these documents illustrate the respect and mutual cooperation that exists between state and federal credit union regulators.

[3] The Consultation and Cooperation With State Credit Union Supervisors provision contained in The Federal Credit Union Act, 12 U.S. Code §1757a(e) and 12 U.S. Code §1790d(l).