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# ESTABLISHING A FRAMEWORK FOR SYSTEMIC RISK REGULATION

## HEARING

BEFORE THE

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

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING A FRAMEWORK FOR SYSTEMIC RISK REGULATION

JULY 23, 2009

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# ESTABLISHING A FRAMEWORK FOR SYSTEMIC RISK REGULATION

**THURSDAY, JULY 23, 2009**

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

The Committee met at 9:37 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. I will make some opening comments, turn to Senator Shelby for his, and then we will invite our very distinguished witnesses to join us at the witness table, and I will in advance apologize to them if we interrupt your testimony once the 12th Member arrives here, to go back into executive calendar to deal with this legislation.

So let us shift gears, if we can now, to the hearing, and that is, as I mentioned earlier, a hearing to establish a framework for systemic risk regulation. Let me just share some thoughts, if I can. And, again, we have had a lot of discussion about this subject matter over the last number of months. We have had some 40 hearings in this Committee since January, not all of it on this subject matter, but the bulk of the hearings have been on this whole issue of how do we modernize our financial regulatory structure not only to address the problems that have brought us to this point, but also how do we create that architecture for the 21st century that will allow us to move forward with innovation and creativity that has been the hallmark of our financial services sector, and yet once again restore that credibility of safety and soundness that has been the hallmark, I think, of our financial services sector for so many years, and yet collapsed, in the views of many, over the last number of years, resulting in the economic problems that so many of our fellow citizens are facing, with joblessness, with house foreclosures, retirement accounts being wiped out, and all of the ancillary problems that our economy is suffering through.

Systemic risk is going to be an important factor in all of this, and I cannot begin to express my gratitude to my fellow Members here because, unlike other matters that the Congress is dealing with, my sense is on this subject matter this is not one that has any ideology, that I can sense, to it at all. What all of us want is to figure out what works best, what makes sense for us here—not that we are going to solve every future problem. I think we make a mistake if we are sort of promising what we cannot deliver on. There will be future problems, and we are not going to solve every one of them. But if we look back a bit and see where the gaps have been, either, one, where there was no authority or, two, where there was authority but it was not being exercised, then how we fill those gaps in a way that makes sense I think will be a major contribution.

And I want to particularly thank Senator Shelby, the former Chairman of this Committee, the Ranking Member now. We have had a lot of conversations together. We do not have a bill ready at all. There has been a lot of talk at this point. But I get a sense among my colleagues, as I have discussed the subject matter with them, that we share a lot of common views about this, and that is a good place to begin. It does not mean we are going to agree on every answer we have, but I sense that the overwhelming majority of us here are committed to that goal of establishing what makes sound and solid regulatory process.

The economic crisis introduced a new term in our national vocabulary: "systemic risk." Not words we use much. I do not recall using those words at all back over the years. It is the idea that in an interconnected global economy, it is easy for some people's problems to become everybody's problems, and that is what systemic risk is. The failures that destroyed some of our Nation's most prestigious financial institutions also devastated the economic security of millions of working Americans who did nothing wrong and never heard of these institutions that collapsed and put them at great risk. Jobs, homes, and retirement security were gone in a flash because Wall Street greed in some cases, regulatory neglect in others, resulted in these problems.

After years of focusing on short-term profits while ignoring long-term risk, a number of companies, giants of the financial industry, found themselves in very serious trouble. Some, as we know, tragically, failed. Some were sold under duress. And an untold number only survived because of Government intervention—loans, guarantees, direct injections of capital.

Taxpayers had no choice but to step in—and that is my strong view—assuming billions of risk and saved companies because our system was not set up to withstand their failure. Their efforts saved our economy from catastrophe, but real damage remains, as we all are painfully aware. Investors who lost billions were scared to invest. Credit markets dried up, with no one willing to make loans. Businesses could not make payrolls. Employees were laid off and families could not get mortgages or loans to buy an automobile, even.

Wall Street's failures have hit Main Street, as we all know, across our Nation, and it will take years, perhaps decades, to undo the damage that a stronger regulatory system I think could have prevented. And while many Americans understand why we had to take extraordinary measures this time, it does not mean that they are not angry, because they are. It does not mean they are not worried, and they certainly are that. And it does not mean they do not expect us to fix the problems that allowed this to happen.

First and foremost, we need someone looking at the whole economy for the next big problem with the authority to do something about it. The Administration has a bold proposal to modernize our financial regulatory system. It would give the Federal Reserve new authority to identify, regulate, and supervise all financial companies considered to be systemically important. It would establish a council of regulators to serve in a sole advisory role. And it would provide a framework for companies to fail, if they must fail, in a way that does not jeopardize the entire financial system.

It is a thoughtful proposal, but the devil, obviously, we all know, is in the details, and I expect changes to be made in this proposal.

I share my colleagues' concerns about giving the Fed additional authority to regulate systemic risk. The Fed has not done a perfect job, to put it mildly, with the responsibilities it already has. This new authority could compromise the independence the Fed needs to carry out effective monetary policy. Additionally, systemic risk regulation involves too broad of a range of issues, in my view, for any one regulator to be able to oversee. And so I am especially interested to hear from our witnesses this morning on your ideas and how we might get this right.

Many of you have suggested a council with real authority that would effectively use the combined knowledge of all of the regulatory agencies. As President Obama has said, when we rebuild our economy, we must ensure that its foundation rests on a rock, not on sand. And today we continue our work to lay the cornerstones of that foundation—strong, smart, effective regulation that protects working families without hindering growth, innovation, and creativity that has been, again, the hallmark, as I said earlier, of our financial services sector.

With that, let me turn to Senator Shelby, and then I will introduce our first panel.

**STATEMENT OF SENATOR RICHARD C. SHELBY**

Senator SHELBY. Thank you, Mr. Chairman.

At the core of the Administration's financial regulatory reform proposal is the concept of systemic risk. The President believes that it can be regulated and that the Fed should be the regulator. But as we begin to consider how to address systemic risk, my main concern is that while there appears to be a growing consensus on the need for a systemic risk regulator, there is no agreement on how to define systemic risk, let alone how to manage it.

I believe that it would be legislative malfeasance to simply tell a particular regulator to manage all financial risk without having reached some consensus on what systemic risk is and whether it can be regulated at all. Should we reach such a consensus, I believe we then must be very careful not to give our markets a false sense of security that could actually exacerbate our "too-big-to-fail" problem. If market participants believe that they no longer have to closely monitor risk presented by financial institutions, the stage will be set for our next economic crisis.

If we can decide what systemic risk is and that it is something that should and can be regulated, I believe our next question should be: Who should regulate it?

Unfortunately, I believe the Administration's proposal largely places the Federal Reserve in charge of regulating systemic risk. It would grant the Fed, as I understand the white paper, authority to regulate any bank, securities firm, insurer, investment fund, or any other type of financial institution that the Fed deems a systemic risk. The Fed would be able to regulate any aspect of these firms, even over the objections of other regulators. In effect, the Fed would become a regulator giant of unprecedented size and scope.

I believe that expanding the Fed's power in this manner could be very dangerous. The mixing of monetary policy and bank regulation has proven to be a formula for taxpayer-funded bailouts and poor monetary policy decisions. Giving the Fed ultimate responsibility for the regulation of systemically important firms will provide further incentives for the Fed to hide its regulatory failures by bailing out troubled firms.

Rather than undertaking the politically painful task of resolving failed institutions, the Fed could take the easy way out and rescue them by using its lender-of-last-resort facilities or open market operations. Even worse, it could undertake these bailouts without having to obtain the approval of the Congress.

In our system of Government, elected officials should make decisions about fiscal policy and the use of taxpayers' dollars, not unelected central bankers. Handing over the public purse to an enhanced Fed is simply inconsistent with the principles of democratic Government.

Augmenting the Federal Reserve's authority also risks burdening it with more responsibility than one institution can reasonably be expected to handle. In fact, the Federal Reserve is already overburdened with its responsibility for monetary policy, the payment system, consumer protection, and bank supervision. I believe anointing the Fed as the systemic risk regulator will make what has proven to be a bad bank regulator even worse.

Let us not forget that it was the Fed that pushed for the adoption of the flawed Basel II Capital Accords right here in this Committee which would have drained our banking system of capital. It was the Fed that failed to adequately supervise Citigroup and Bank of America, setting the stage for bailouts in excess of $400 billion there. It was the Fed that failed to adopt mortgage underwriting guidelines until well after this crisis was underway.

Yes, it was the Fed that said there was no need to regulate derivatives right here in this Committee. It was also the Fed that lobbied to become the regulator of financial holding companies as part of Gramm-Leach-Bliley. The Fed won that fight and got the additional authority it sought. Ten years later, however, it is clear that the Fed has proven that it is incapable of handling that responsibility.

Ultimately, I believe if we are able to reach some sort of agreement on systemic risk and whether it can be managed, I strongly believe that we should consider every possible alternative to the Fed as a systemic risk regulator.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator, and we are still missing one, I think. Is it one? One. We need 12. If I have a colleague that can count 12, I am willing to move ahead on that.

[Laughter.]

Chairman DODD. After all, this is Washington, you know. We will wait for the 12th to arrive.

Let me invite Sheila Bair and Mary Schapiro and Dan Tarullo to join us at the witness table, and let me briefly introduce the people who hardly need an introduction. They have been before this Committee on numerous occasions, and we thank them.

Sheila Bair, as we all know, is our Chair of the Federal Deposit Insurance Corporation, served as Assistant Secretary at the Treasury, has an extensive background in banking finance, and, of course, many of us up here have known her over the years when she was legal counsel to Bob Dole and did a great job in that capacity as well, so very familiar with the Senate as an institution.

Mary Schapiro is the new Chair of the Securities and Exchange Commission, and prior to her appointment this year, she served as the CEO of the Financial Industry Regulatory Authority, or FINRA, also served as a Commissioner of the SEC during Ronald Reagan's administration, President Bush 41, and the Clinton administration.

Dan Tarullo—I will finish this and then turn to our executive session—is the new member of the Board of Governors of the Federal Reserve System and, again, a familiar figure to many of us up here, having served in public life on numerous occasions in the past, including Assistant Secretary of State for Economic and Business Affairs, before he served as Chief Counsel for Employment Policy on the staff of our good friend Senator Ted Kennedy as well, and taught at Georgetown University Law Center, worked in the Clinton administration. So we thank you, Dan for your service, as we do yours, Mary, and Sheila Bair.

[Whereupon, at 9:49 a.m., the Committee proceeded to other business and reconvened at 9:52 a.m.]

Chairman DODD. We will now go back to our witnesses. You have been introduced, and, Sheila, we will begin with you. All statements, supporting data, materials, and the like that you think would be valuable for our Committee as we consider modernization of the Federal regulatory structure, of course, will be included in the record. That is also true, of course, of all of our colleagues here as well.

We would like you, if you could, to try to keep those remarks to 5 or 7 minutes so we can get to the questions as quickly as possible. 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, I appreciate you holding this hearing. The issues under discussion today approach in importance those before the Congress in the wake of the Great Depression. We are emerging from a credit crisis that has wreaked havoc on our economy. Homes have been lost; jobs have been lost. Retirement and investment accounts have plummeted in value.

The proposals put forth by the Administration to address the causes of this crisis are thoughtful and comprehensive. However, these are very complex issues that can be addressed in a number of different ways.

It is clear that one of the causes of our current economic crisis is significant regulatory gaps within the financial system. Differences in the regulation of capital, leverage, complex financial instruments, and consumer protection provided an environment in which regulatory arbitrage became rampant. Reforms are urgently needed to close these regulatory gaps.

At the same time, we must recognize that much of the risk in the system involved financial firms that were already subject to extensive regulation. One of the lessons of the past several years is that regulation alone is not sufficient to control risk taking within a dynamic and complex financial system. Robust and credible mechanisms to ensure that market participants will actively monitor and control risk taking must be in place.

We must find ways to impose greater market discipline on systemically important institutions. In a properly functioning market economy, there will be winners and losers, and when firms—through their own mismanagement and excessive risk taking—are no longer viable, they should fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the incentive to monitor the actions of similarly situated firms and allocate resources to the most efficient providers. Unfortunately, the actions taken during the past year have reinforced the idea that some financial organizations are too-big-to-fail.

The notion of "too-big-to-fail" creates a vicious circle that needs to be broken. Large firms are able to raise huge amounts of debt and equity and are given access to the credit markets at favorable terms without sufficient consideration of the firms' risk profile. Investors and creditors believe their exposure is minimal since they also believe the Government will not allow these firms to fail. The large firms leverage these funds and become even larger, which makes investors and creditors more complacent and more likely to extend credit and funds without fear of losses. "Too-big-to-fail" must end.

Today, shareholders and creditors of large financial firms rationally have every incentive to take excessive risk. They enjoy all the upside. But their downside is capped at their investment, and with "too-big-to-fail," the Government even backstops that.

For senior managers, the incentives are even more skewed. Paid in large part through stock options, senior managers have an even bigger economic stake in going for broke because their upside is so much bigger than any possible loss. And, once again, with "too-big-to-fail" the Government takes the downside.

To end "too-big-to-fail," we need a solution that uses a practical, effective, and highly credible mechanism for the orderly resolution of these institutions similar to that which exists for the FDIC-insured banks. When the FDIC closes a bank, shareholders and creditors take the first loss. When we call for a resolution mechanism, we are not talking about propping up the failed firm and its management. We are talking about a process where the failed bank is closed, where the shareholders and creditors typically suffer severe losses, and where management is replaced and the assets of the failed institution are sold off. This process is harsh, but it quickly reallocates assets back into the private sector and into the hands of better management. It also sends a strong message to the market that investors and creditors will face losses when an institution fails.

So-called "open bank assistance," which puts the interests of shareholders and creditors before that of the Government, should be prohibited. Make no mistake. I support the actions the regulators have collectively taken to stabilize the financial system. Lacking an effective resolution mechanism, we did what we had to do. But going forward, open bank assistance by any Government entity should be allowed only upon invoking the extraordinary systemic risk procedures, and even then, the standards should be tightened to prohibit assistance to prop up any individual firm.

Moreover, whatever systemwide support is provided should be based on a specific finding that such support would be least costly to the Government as a whole. In addition, potentially systemic institutions should be subject to assessments that provide disincentives for complexity and high-risk behavior. I am very pleased that yesterday the President expressed support for the idea of an assessment. Funds raised through this assessment should be kept in reserve to provide working capital for the resolution of large financial organizations to further insulate taxpayers from loss.

Without a new comprehensive resolution regime, we will be forced to repeat the costly *ad hoc* responses of the past year. In addition to a credible resolution process, there is a need to improve the structure for the supervision of systemically important institutions and create a framework that proactively identifies issues that pose risk to the financial system.

The new structure, featuring a strong oversight council, should address such issues as the industry's excessive leverage, inadequate capital, and overreliance on short-term funding. A council of regulators will provide the necessary perspective and expertise to view our financial system holistically. A wide range of views makes it more likely we will capture the next problems before they happen. As with the FDIC Board, a systemic risk council can act quickly and efficiently in a crisis.

The combination of the unequivocal prospect of an orderly closing, a stronger supervisory structure, and a council that anticipates and mitigates risks that are developing both within and outside the regulated financial sector will go a long way to assuring that the problems of the last several years are not repeated and that any problems that do arise can be handled without cost to the taxpayer.

Thank you very much.

Chairman DODD. Thank you very much, Chairman Bair.

Chairman Schapiro.

## STATEMENT OF MARY L. SCHAPIRO, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Thank you. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am very pleased to be here today with my colleagues from the Fed and FDIC.

There are many lessons to be learned from the recent financial crisis, and a key one is that we as regulators need to identify, monitor, and reduce systemic risk before they threaten the stability of the financial system.

However, in our efforts to minimize the potential for institutional failures to threaten the system, we must take care not to unintentionally facilitate the growth of large, interconnected institutions whose failure might later pose even greater systemic risk.

To best address these risks, I believe we must rely on two lines of defense. First, there is traditional oversight and regulation. This includes enhancing existing regulations, filling gaps, increasing transparency, and strengthening enforcement to prevent systemic risks from developing. And, second, we should establish a workable macroprudential regulatory framework and resolution regime that can identify, reduce, and unwind systemic risks if they do develop.

Closing regulatory gaps is an important part of reducing systemic risk. If financial participants realize they can achieve the same economic ends with fewer costs by flocking to a regulatory gap, they will do so quickly, often with size and leverage. We have seen this time and again, most recently with over-the-counter derivatives, instruments through which major institutions engage in enormous, virtually unregulated trading in synthetic versions of other, often highly regulated financial products. We can do much to reduce systemic risk if we close these gaps and ensure that similar products are regulated similarly.

In addition to filling gaps, we need to ensure greater transparency of risk. Transparency helps reduce systemic risk by enabling market participants to better allocate capital and giving regulators more information about risks that are building in the financial system. Transparency has been utterly lacking in the world of unregulated over-the-counter derivatives, hedge funds, and dark pools. Additionally, we need to recognize the importance that vigorous enforcement plays in sending a strong message to market participants.

As a second line of defense, I believe there is a need to establish a framework for macroprudential oversight, a key element of the Administration's financial regulatory plan. Within that framework, I believe the most appropriate approach consists of a single systemic risk regulator and a very strong council.

In terms of a systemic risk regulator, I agree there needs to be a governmental entity responsible for monitoring our financial markets for systemwide risks. This role could be performed by the Federal Reserve or by a new entity specifically designed for this task. The systemic risk regulator should have access to information across the financial markets about institutions that pose significant risk. And it should be able to monitor whether institutions are maintaining appropriate capital levels, and it should have clear delegated authority from the council to respond quickly in extraordinary circumstances. Most importantly, the systemic risk regulator should serve as a second set of eyes upon those institutions whose failure might put the system at risk.

At the same time, I agree with the Administration that the systemic risk regulator must be combined with a newly created council, but I believe that any council must be strengthened well beyond the framework set forth in the Administration's white paper. The council should have authority to identify institutions, practices, and markets that create potential systemic risks and to set standards for liquidity, capital, and other risk management practices at systemically important institutions. This hybrid approach can help minimize systemic risk in a number of ways.

First, a council would bring different perspectives to the identification of risks that individual regulators might miss or consider too small to warrant attention.

Second, the members on the council would have experience regulating different types and sizes of institutions so that the council would be more likely to ensure that risk-based capital and leverage requirements do not unintentionally foster greater systemic risk.

And, third, the council would include multiple agencies, thereby significantly reducing potential conflicts of interest and regulatory capture.

Finally, the council would monitor the growth and development of financial institutions to prevent the creation of institutions that are either too-big-to-fail or too-big-to-succeed.

At most times, I would expect the council and systemic risk regulator to work with and through primary regulators who are experts on the products and activities of their regulated entities. The systemic risk regulator, however, can provide a second layer of review over the activities, capital, and risk management procedures of systemically important institutions as a backstop to ensure that no red flags are missed.

To ensure that authority is checked and decisions are not arbitrary, the council would remain the place where general policy is set, and if differences remain between the council and the primary regulator, the more stringent standards should apply.

For example, on questions of capital, the new systemic risk framework should only be in a position to raise standards for regulatory capital for these institutions, not lower them. This will reduce the ability of any single regulator to compete with other regulators by lowering standards, driving a race to the bottom.

And, finally, the Government needs a credible resolution mechanism for unwinding systemically important institutions. Currently, banks and broker-dealers are subject to resolution processes, but no corresponding resolution process exists for the holding companies of systemically significant financial institutions.

I believe we have an opportunity to create a regulatory framework that will help prevent the type of systemic risk that created havoc in our financial system, and I believe we can create a credible regulatory regime that will help restore investor confidence.

I look forward to working with you to address these issues and doing all we can to foster a safer, dynamic, and more nimble financial system. Thank you.

Chairman DODD. Thank you very much, Chairwoman Schapiro. Dan Tarullo, welcome to the Committee once again.

**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. My prepared statement sets forth in some detail the positions of the Federal Reserve on a number of the proposals that have been brought before you, so I thought I would use these introductory remarks to offer a few more general points.

First, I think the title you have given this hearing captures the task well, "Establishing a Framework for Systemic Risk Regulation." The task is not to enact one piece of legislation or to establish one overarching systemic risk regulator and then to move on. The shortcomings of our regulatory system were too widespread, the failure of risk management at financial firms too pervasive, and the absence of market discipline too apparent to believe that there was a single cause of, much less a single solution for, the financial crisis. We need a broad agenda of basic changes at our regulatory agencies and in financial firms, and a sustained effort to embed market discipline in financial markets.

Second, the "too-big-to-fail" problem looms large on the agenda. Therein lies the importance of proposals to ensure that the systemically important institutions are subject to supervision, to promote capital and other kinds of rules that will apply more stringently because the systemic importance of an institution increases, and to establish a resolution mechanism that makes the prospect of losses for creditors real, even at the largest of financial institutions.

But "too-big-to-fail," for all its importance, was not the only problem left unaddressed for too long. The increasingly tightly wound connection between lending and capital markets, including the explosive growth of the shadow banking system, was not dealt with as leverage built up throughout the financial system. That is why there are also proposals before you pertaining to derivatives, money market funds, ratings agencies, mortgage products, procyclical regulations, and a host of other issues involving every financial regulator.

Third, in keeping with my first point on a broad agenda for change, let me say a few words about the Federal Reserve. Even before my confirmation, I had begun conversations with many of you on the question of how to ensure that the shortcomings of the past would be rectified and the right institutional structure for rigorous and efficient regulation put in place, particularly in light of the need for a new emphasis on systemic risk. This colloquy has continued through the prior hearing your Committee conducted and in subsequent conversations that I have had with many of you.

My colleagues and I have thought a good deal about this question and are moving forward with a series of changes to achieve these ends. For example, we are instituting closer coordination and supervision of the largest holding companies, with an emphasis on horizontal reviews that simultaneously examine multiple institutions.

In addition, building on our experience with the SCAP process that drew so successfully upon the analytic and financial capacities of the nonsupervisory divisions of the Board, we will create a quantitative surveillance program that will use a variety of data sources to identify developing strains and imbalances affecting individual firms and large institutions as a group. This program will be distinct from the activities of the on-site examiners, so as to provide an independent perspective on the financial condition of the institutions.

Fourth and finally, I would note that there are many possible ways to organize or to reorganize the financial regulatory structure. Many are plausible, but as experience around the world suggests, none is perfect. There will be disadvantages, as well as advantages, to even good ideas.

One criterion, though, that I suggest you keep in mind as you consider various institutional alternatives is the basic principle of accountability. Collective bodies of regulators can serve many useful purposes: examining latent problems, coordinating a response to new problems, recommending new action to plug regulatory gaps, and scrutinizing proposals for significant regulatory initiatives from all participating agencies.

When it comes to specific regulations or programs or implementation, though, collective bodies often diffuse responsibility and attenuate the lines of accountability, to which I know this Committee has paid so much attention. Achieving an effective mix of collective process and agency responsibility with an eye toward relevant institutional incentives will be critical to successful reform.

Thank you very much, Mr. Chairman. I would be happy to answer any questions.

Chairman DODD. Thank you very much, Dan. We appreciate your testimony and your involvement with the Committee, as well.

I will ask the Clerk to put on—why don't you put on 6 minutes and try and keep an eye on that. We have got a lot of participation here this morning and I want to make sure we get around to people. I have asked the staff to make sure you give me a very accurate account of the arrival of Members in terms of the order in which they will be asked to address the questions to our panel.

Let me begin with you, Governor Tarullo, if I can. I suspect a lot of the questions I am going to raise for you, you are going to hear variations of these same kind of questions, I suspect that sort of a theme will emerge here.

You testified that the Administration's proposal to give the Fed systemic risk supervision is incremental. It builds on the robust authority which you already have under the Bank Holding Company Act, and you also detail your plan for a new surveillance program, which you mentioned here, for large complex financial organizations that will look at emerging risks to the system as a whole.

Now, obviously, we are not speaking about you, because obviously you are new to this, but given the Federal Reserve's history and record on this as an institution as we look back, why should we in this Congress have any confidence in the Federal Reserve, other than what is being said today, and I appreciate what is being said today, but given the history of the Federal Reserve, you can argue that this authority has already existed. We don't need new authority. It has been there. Under the Bank Holding Company Act, you have had that authority for a long, long time. Certainly all the powers are there, the personnel, the resources to do a job, and yet there was an abysmal failure when it came to these institutions.

So why at this juncture, and I raise this with you, why should this Committee or the Congress have any heightened degree of confidence that the Federal Reserve, having failed in that function, given the authority for years, should now be granted expanded authority in that same area?

Mr. TARULLO. Well, Senator, let me say a couple of things about that. First, as you know, in my prior capacity, I had a fairly broad-based set of criticisms about the Fed and the regulatory system as a whole. I continue to believe that when the final history of the financial crisis is written, there is going to be a lot of blame to go around to regulatory agencies and private institutions. This was not a single failing. This was a broad-based failing at home and, as we have seen, internationally as well. Let me be clear. I think that includes an inadequate or flawed approach to supervision at the banking agencies, including the Fed.

Second, I will say that I think that history shifts. History shifts and the relative positions of agencies shift over time. I remember when I was in law school studying this set of issues that the Federal Reserve was regarded as the most aggressive of the regulatory agencies and the other agencies were regarded as somewhat more accommodating. So I think there is a rhythm that goes with the times, with the leadership of an agency, and with the general orientation of public policy.

So, since I have gotten to the Fed—actually before that, since I began having conversations with you and other Members of the Committee—what I have been trying to determine is the degree to which the capacity and the resources are present to do what is in some sense the same job that should have been done better. But to be honest, in some sense, it is a different job because I don't think anybody actually was focused on the systemic part of the problem as much as they ought to have been. It was a more siloed approach to regulation.

And that is why I also think some changes should be made in prevailing law so that it is clear that the supervisor of the holding companies has authority to do examinations of functionally regulated subsidiaries when it is necessary. Those sorts of things need to move forward. But, I think more fundamentally, what has to be done is the kind of thing I mentioned a moment ago, which is to put in place a system within the agency that has its own kind of cross-checks, drawing upon the substantial resources of the agency. There are substantial resources in the research and monetary affairs parts of the Board to provide exactly the kinds of information that will enhance supervision.

And that is, I think, the task which someone is going to have to perform, Senator, and it is either going to be done by the Federal Reserve or another agency. It has got to be done somewhere. My belief is, based upon my 6 months' experience at the Fed, that under Chairman Bernanke's leadership, it can be done. But I don't think anyone should underestimate the task and I would just second something you said in your introductory remarks. I hope people are not expecting that anything that the Fed or the SEC or the FDIC or anybody else does is going to eliminate all potential for systemic risk. That is just not going to happen. And I think we have got to keep that in mind.

Let me just say one final thing. The Administration's proposal and other proposals vary in how much authority they really mean to invest in a particular agency. Back at our March hearing, you and I talked back and forth a good bit about the different possible functions of a systemic risk regulator. With the possible exception of some of the proposals for the council as they have been described, most proposals don't talk about a systemic risk regulator. They talk about allocating a particular set of responsibilities to particular agencies or collective groups, and I think that is probably the way it should be.

I really don't think you need or want so much responsibility, as well as authority, lodged in any one agency to say, you have responsibility for figuring out anywhere in the financial system there is a problem and you have authority to do whatever you think is necessary.

Chairman DODD. Well, let me—thank you for that. Let me, Sheila, quickly turn to you for two quick questions and let me play the devil's advocate, in a sense, in this, as well. And again, I am still sort of agnostic on this, although I am sort of leaning toward the council approach, but let me take the side of the argument that the Administration opposes and raise it with you. I will give my best shot here in giving their side of the argument.

This is a new idea we are fooling around with, a council here, agencies that don't necessarily have the kind of expertise and background of the Federal Reserve. You are going to spread this out among a bunch of different agencies so no one is really in control or authority. The Federal Reserve has the experience. Yes, they have done a bad job of this over the years, but historically, they have the capacity, the knowledge, and so forth to do this. We know about the Fed. You are asking me to create something that is altogether new and it may not function well at all to handle the issue of systemic risk, a very important issue.

Why should I take a leap of faith in something here creating a whole new entity that may include the Fed, but is going to have the problem of spreading out the responsibility in such a way that you will never figure out who is really running the shop? In a sense, systemic risk will be suffering terribly. Despite the fact you have given it a nice name, hired a bunch of nice people, it really will not make the kind of decisions that you need to have with a single regulator with the experience the Fed has to do the job. Why is that not a bad idea?

Ms. BAIR. Obviously, we disagree with that. We think a council needs real teeth and rule-making authority. It needs to have some real authorities to be highly effective in monitoring for systemic risk and taking action to address it. The more eyes you have looking at this from different perspectives, the better. Clearly the FDIC has a different perspective from the SEC or the CFTC or the Federal Reserve. So I think bringing those multiple perspectives together is going to strengthen the entity, not weaken it.

You are talking about tremendous regulatory power being invested in whatever this entity is going to be, and I think in terms of checks and balances, it is also helpful to have multiple views being expressed and coming to a consensus. We do a lot of this informally now, but there is no forcing mechanism. There are a lot of discussions now about OTC derivatives and trying to harmonize capital and margining standards. But having a formalized group with a head who is charged with dealing with those kinds of crosscutting issues, harmonizing standards to make sure there is no regulatory arbitrage, and making sure risk throughout the system is being appropriated addressed, I think is extremely important.

I think we have a bit of a middle ground in terms of institution regulation. We would not advocate the Federal Reserve losing its consolidated supervisory authorities now. They do that. They are the reservoir for that expertise. To the extent that there are other systemic institutions that are not under that prudential framework, we think the council should be able to make a determination regarding the consolidated supervision of those entities. But, it would be fine for the Federal Reserve to be the regulator for those systemic institutions.

The kind of power that is contemplated in the U.S. Treasury White Paper, that we think, frankly, is needed, is much better vested in a council of regulators who I do believe can work together. The FDIC Board has three different agencies represented. We make decisions very quickly.

Chairman DODD. Thank you very much. I was going to ask you—I will wait for another round on the Consumer Financial Product Safety Agency idea. I will delay that for later.

Let me turn to Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Governor Tarullo, in your testimony, you appear to fully endorse the Obama administration's regulatory reform proposal. I am curious to know if you arrived at this position as a member of the Board of Governors after conducting an independent assessment of the plan, which I hope is the case. Otherwise, it would call into question the so-called "independence" of the Fed. Could you provide the Committee with the data and analysis that you used to make the determination that the Obama plan was the optimal approach?

Mr. TARULLO. Well, Senator, I actually wouldn't say that the Board's position is an endorsement of the Administration's plan. I think what you saw in my prepared testimony which reflects the position of the Board, is a sense that the Administration is moving in the right direction on these key components, that there are obviously lots of details, many of which, by the way, we don't know and didn't know based on the white paper and are only beginning to find out as they send up legislation to you.

Senator SHELBY. What about our legislation? They want to send it up, but don't you think we should be preparing our own legislation?

Mr. TARULLO. Absolutely. All I am saying is we couldn't figure out in some cases exactly what one of their proposals meant, which is why the testimony is phrased in such a way as to agree with the concept of needing to have every systemically important institution supervised and needing to have a resolution mechanism.

As you probably saw, the Fed is certainly not endorsing the proposal of the Administration to create the new consumer agency. It is not opposing it, either.

Senator SHELBY. Let me get into that a little bit. Safety and soundness regulation, very important here. In your testimony, you state there are synergies between the monetary policy and systemic risk regulation. In order to capture these synergies, you argue that the Fed should become a systemic risk regulator, as I understand it. Yesterday, Chairman Bernanke testified that he believed there are synergies between prudential bank regulation and consumer protection. This argues in favor of establishing one consolidated bank regulator.

Do you agree with Chairman Bernanke that there are synergies between prudential supervision and consumer protection, and if so, do you believe that the Obama administration's call for a separate consumer protection agency would undermine the safety and soundness regulation that we have?

Mr. TARULLO. Senator, as I said in my introductory comments, there are multiple ways to organize or to reorganize financial services regulation. Many times you have got competing ideas, each of which has merits and each of which has some demerits.

With respect to the consumer protection issue, the Administration has made a proposal which I think a lot of people have some sympathy with because it focuses on consumer protection. We say we are going to give one agency the exclusive authority to regulate on consumer matters and thus they will be 100 percent devoted to doing that.

My testimony is meant only to suggest that there are some things that would be lost by doing that as well as some things that would be gained, and what the Chairman, I think, was suggesting yesterday is that there is a synergy or interaction between prudential regulation and consumer protection regulation, at least if they are both being done well. That synergy is both in the substance of things—that is, having some sense of what makes an effective consumer protection regulation because you know the way in which the institutions operate—but also in the practical sense that as you have one corps of examiners, there is a certain economy of scope in having them looking at the multiple sets of issues within the same organization.

So, I definitely think there are synergies. There are some benefits that go back and forth. If you take consumer protection away and put it in another agency, you probably lose some of those. I guess the Administration's position would be, yes, but you gain some things along the way.

Senator SHELBY. Chairman Bair, the Obama administration's proposal, as I understand it, would have regulators designate certain firms as systemically important. You alluded to that earlier. These firms would be classified as Tier 1 Financial Holding Companies and would be subject to a separate regulatory regime.

If some firms are designated as systemically important, would this signal to market participants that the Government will not allow these firms to fail? And if so, how would this worsen our "too-big-to-fail" problem?

Ms. BAIR. We do have concerns about formally designating certain institutions as a special class. At the same time, we recognize there may be very large interconnected financial entities out there that are not yet subject to Federal consolidated supervision. I think almost all of them already are subject to Federal consolidated supervision as a result of the crisis. But, some type of formal designation, I think, you would need to think hard about for just the reasons you expressed.

Any recognition of an institution as being systemic, though, should be a stigmatizing designation, not something that is favorable. This is why we do feel so strongly that a robust resolution mechanism—for very large financial organizations needs to be combined with any type of new supervisory entity or to even recognize whether some institutions may be systemic.

Senator SHELBY. Governor, I want to get back on the consumer protection. I have just got a second. There was testimony here last week on that, that this would change the whole model from a classical approach to consumer protection to a behavioral approach. Have you done some work in that area? Have you looked at that closely yet?

Mr. TARULLO. Senator, I have to be honest. I am not altogether sure what that refers to. I can only tell you—again, based on what I have learned since I have been at the Fed—the way in which the division there does consumer protection and generates proposals is one that has a fairly important behavioral orientation, up to and including the fact that there is extensive consumer testing done before regulations are presented to the Board to make sure, for example, that if what you are trying to do is disclose terms of a consumer contract, that the kind of terms you are disclosing will actually mean something to a consumer and be useful to them.

So in that sense, it is not just a top–down inquiry—how would the rational person think—but you actually try to determine how real people really do think.

Senator SHELBY. It would put a lot of power in bureaucrats, would it not?

Mr. TARULLO. To create a——

Senator SHELBY. No, if we created something like they proposed, which I hope we won't, it would put a lot of power in the bureaucrats.

Mr. TARULLO. Well, it depends, Senator. I mean, obviously, it depends on the mandate and the scope. That is obviously to be determined by all of you. I think that people at the Fed would agree strongly with the proposition that there needs to be good, solid consumer protection in the financial services area. Obviously, we also think that should be done in a well-organized fashion with due process for everyone involved.

Senator SHELBY. Thank you.

Chairman DODD. Thank you very much, and I just point out that it was, as Jim Bunning has pointed out on countless occasions and others have, we gave the Fed the authority in 1994 to deal with consumer protection. It took them 14 years to finally promulgate a single regulation in the area, so I appreciate the concern about consumer protection.

Senator Reed.

Senator REED. Thank you, Mr. Chairman. Thank you, Chairman Bair, Chairman Schapiro, and Governor Tarullo.

I will start with Chairman Bair, but this is a general question for everyone. As I understand the proposals by the White House, the OTS would be eliminated, so effectively all Financial Holding Company regulation would be lodged under the Federal Reserve, that there would, in fact, be at least a review and perhaps the elimination of the Unitary Savings and Loan Holding Company Act. Those institutions would be Financial Holding Companies under the Federal Reserve.

So direct regulation after this legislation by the Fed would comprise most of, if not all of, the systemic institutions, save perhaps some insurance companies that might be outside, and we have to deal with that, and some very large hedge funds or maybe not so large hedge funds but operating very recklessly.

So with that framework, what does the council—how does the council relate now to a regulator that has full direct authority, and in fact in the proposal would eliminate the functional—the deference to functional regulators, so that the Fed, I think, could look through every part of the institution? What role does the council play there in that reality, or should play?

Ms. BAIR. I think there are still issues across markets. Even when functions within the holding company are individually regulated, there will still be some practices and products that other nonsystemic institutions may be doing. Mortgage originations are a prime example. You had a lot of very small third-party mortgage brokers originating some pretty bad mortgages that were being funded through multiple sources, including nonregulated finance companies, Wall Street firms, *et cetera.*

So I think that there is plenty of opportunity for risk to be assessed across the system by any entity in terms of products and practices. Even within large holding companies, there will be reservoirs of expertise. There will be expertise in investment banks and broker-dealers from the SEC. There will be expertise regarding State-chartered and nationally chartered banks from the new prudential OCC–OTS regulator and the FDIC.

I think in particular, capital standards—applying them across the board, making sure that there are no opportunities for arbitrage going forward—is a very major issue. I think OTC derivatives, some derivatives, are going to be traded on exchanges. Some are going to be traded through central counterparties. Others are still going to be done by OTC derivative market makers. Seeing how margining and capital across the system affects incentives, and whether we can all get together to incentivize more standardized trading, are all interagency matters that I think cry out for coordination across agency rule making. I actually see a lot for the council to do, even preserving the Fed's authority to be an institutional regulator for major holding companies.

Senator REED. Just specifically, would the council, in your view, designate the Tier 1 or the entities——

Ms. BAIR. That is tremendous power, to say to an institution, whether you want to be regulated or not, we are going to designate you as Tier 1. I do think that that power is needed, but I think it is better to be exercised by a council where there would be a diversity of views and some checks and balances.

Senator REED. And the council would formally begin the resolution process?

Ms. BAIR. I think we could discuss that. We have been talking about that a lot internally. I think, certainly for systemic institutions or institutions where the resolution might have systemic impact, that might be a role for the council. On the other hand, to the extent resolution will involve potential at least short-term assistance, I think the current approach, what we call the three keys now, the FDIC, the Fed, the Treasury, in consultation with the President, might be another model to look at. Those are the three entities that actually have to put the money on the table, so to speak, to deal with the situation. That is the way the system works now. If you rely on that system, though, we think the systemic risk exception, as I indicated in my testimony, should be tightened so it is harder, much harder to provide assistance, at least to individual institutions.

Senator REED. Let me ask Chairman Schapiro, and I do want Governor Tarullo to comment, too.

Ms. SCHAPIRO. Thank you. I really agree very much with what Sheila has said. I think a council is really critical to bring a diversity of views about the financial markets to the deliberations of all the regulators and this diversity of views really does need to reach across equity markets, futures and derivatives markets, the banking institutions, the clearance and settlement systems, and across a huge variety of different products. And if we don't bring the diverse perspectives together, we run the risk of any one regulator not appreciating a risk that is developing or not understanding the risk that may impact other financial institutions for which that regulator doesn't have direct responsibility.

So I think both the ability to designate the institutions that need to be subject to additional risk-type regulation and establish capital standards, liquidity requirements, other risk management procedures for those institutions, in conjunction with the primary regulators, is a very important backstop.

Senator REED. Governor Tarullo, you have 40 seconds. This is the lightning round.

[Laughter.]

Mr. TARULLO. So, Senator, I think it depends a lot on how you structure things. I guess one model—maybe this is what Sheila and Mary are talking about—has the council basically as the rule-making entity for things that are systemically important, the designation of the Tier 1, the capital rules, I assume deposit insurance premiums to the degree that they are affecting the system, as well, and money market fund regulation.

And then the question for you, for everybody, is going to be, do you want a system in which each major regulation that has systemic importance—as Chairman Schapiro said, something that will affect regulated entities of the other regulators—do you want that done formally in a council by a vote of some sort, or do you want it to be done through a lot of scrutiny, a lot of discussion, perhaps bringing in outsiders as well as—those people outside from the Government or from the Congress as well as from the agencies to ask the hard questions—to require the agency that has responsibility and accountability for that regulation to defend it, to make it a better regulation, but then ultimately to itself have the responsibility to implement it.

And I think that is the choice, and that is what I was alluding to earlier in terms of the tradeoff. Do you get the incentives right?

Senator REED. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Reed.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and I thank each of you for your testimony.

Chairman Bair, I very much, as you know, support your outlook as it relates to the resolution issue, and I am surprised at the Administration's proposal and wanting to continue to support companies that fail, much like is being done with TARP, and I hope that that will evolve. But let me just ask you this: On the issue of systemic risk, if there had been a resolution mechanism in place, would that not have actually—even though there was risk in the market, would that not have actually reduced the risk to some degree? In other words, if you had the appropriate ability to deal with a Lehman Brothers or an AIG, would that actually have reduced the risk to the system in the first place?

Ms. BAIR. I think it would have, for two reasons. One, if it had already been in place for some time, I think we would have had better market discipline across the system. Second, when the problems hit—and we will always have cycles, hopefully never as severe as this one, but we will always have cycles—there would have been a consistent statutory mechanism in place that could be applied to all of these institutions which would have reduced market uncertainty about who was going to be next and who was going to win and who was going to lose.

So I absolutely think it would have reduced risk in the system going into this crisis if we had had such a resolution mechanism in place.

Senator CORKER. I think that is really a big point. I think that is something that—you know, we are looking at creating something new, and I know we will debate that, and we may come up with the right solution. But the fact of the matter is if we had just had effective market disciplines in the first place where there were not entities that were too-big-to-fail, they could actually fail, the risk itself would have been less, and I think that is an important point.

Let me ask you another question. I have served on several public company boards, and certainly not the size of the companies we are talking about here, but I have been before lots of them, and each of the board members typically are respected individuals that have a focus on their own companies, and I respect people in that position very much. But is there something we should be thinking about as it relates to boards? My guess is most board members show up, really do not know, excuse the language, squat about what is going on inside the company. It is a nice social event. It is just the way boards are set up, and most CEOs like it that way.

Chairman DODD. Is this an admission on your part?

Senator CORKER. No, no, no. I was very——

[Laughter.]

Senator CORKER. I was not serving on highly social boards, but, you know, it is a fact. I mean, let us face it. The board members really, as good as they are, the respected individual, they have their own companies. They have their own fish to fry in many cases. They really do not know what is happening inside these companies, and the greatest regulation would just be knowing that people are on these boards and they actually understand what is happening inside the company.

Again, I know most CEOs do not like that much, but I wonder if you might respond, both Mary and Sheila, to that—excuse me, Chairman and Chairman, to that.

Ms. SCHAPIRO. "Mary" is just fine.

I actually think governance is an enormous issue here, and I do not think it is by malintention or neglect that so many of these institutions got into so much trouble. But I do think we have serious examples of boards that were not paying close enough attention or did not actually understand the business the company was in.

I think from the perspective of the SEC, there are a couple things we want to do about that coming directly out of the financial crisis. One is we have proposed some new rules that require much greater disclosure in the proxy when shareholders get to vote about a board member's qualifications to serve on that particular board and a risk committee or a compensation committee or other committee that might require particular expertise. So we can encourage boards to nominate people to sit on their boards who actually bring that value to the company.

I think the second big problem is with compensation schemes. To the extent that compensation schemes in some of these institutions really incentivize excessive risk taking, holding boards accountable through better disclosure of compensation schemes and the link between compensation programs and risk taking I think will help shareholders do a better job of holding the boards accountable for how they are utilizing compensation.

Senator CORKER. Thank you.

Ms. BAIR. Yes, I think that the direction the SEC is going is great and much needed. Our own focus with regulated banks, obviously, where our examiners identify weaknesses in management, we look to the bank's board of directors. We want to make sure the board has people who understand banking and can oversee management, but also really their primary responsibility is to make sure that the management knows how to run the bank and will run the bank in a safe and sound manner.

So we have put a focus on this, and I believe the Federal Reserve has as well at the holding company level. We want real boards. We want people who are experienced, who know what is going on in their company, who understand the derivative positions and the risks they are taking and how their compensation structures impact risk-taking behavior.

Senator CORKER. I know the first question any board member, a potential board member is asked, the first question they ask the company is: How much insurance do you have? Right? I mean, you know, "I want to be able to be on this board, but I do not want any liability, and if the insurance is not enough, I am not coming on." And I just think that is something that we ought to consider as we move ahead, again, not—without any disrespect to the individuals themselves.

So I think if the resolution had been in place, the risk would have been less. If we had boards that somehow had some stake in the game or some different relationship, that would reduce risk. So let me move back to the notion of a systemic regulator, which I know we will debate, but what powers, Mr. Tarullo, if Company A was engaging in buying one side of a risk in a major way, unintelligently, what would the power of the systemic regulator be to stop that action?

Mr. TARULLO. Well, Senator, again, it depends on how Congress would choose to define a systemic risk regulator. If you are asking could the Federal Reserve deal with it, it would depend, of course, on whether it was a supervised institution or not, because if it is not a supervised institution, we have no authority over them.

Senator CORKER. I am talking about—forget all the—just tell me, I mean, at the end of the day, if you are going to give a systemic regulator the ability to do something, if they saw something that was creating a risk, what power would it be given? I think we would all like to understand. What exactly would they do in that case?

Mr. TARULLO. So, I think here it is important to draw this distinction. Right now, if we have a supervised institution, there is a set of rules and supervisory expectations. There are rules on leverage, rules on capital, rules on liquidity. They are supposed to be conforming to those, and if they are conforming to those, there should be a containment of the kind of risks you are talking about.

The backup effort there is supervisory examination, which goes beyond the rules, and if that works well, it identifies these things, and then allows the supervisor to give guidance to the firm to say we think you ought to be moving away from this practice or it creates certain risks.

But I think your question raises an important point, which is—let us just assume the Administration's proposal on Tier 1 FHCs was enacted—there would still be a substantial universe of firms out there which would not be regulated by the Fed, which might be engaging in the kind of practices you are talking about. Even if no one firm is systemically important, in the aggregate a practice engaged in by a lot of firms can still create problems. So you would have to ask who would be able to regulate that.

Senator CORKER. My time is up. I think that answer was really interesting, Mr. Chairman, from this standpoint: Nothing—I mean, the answer is nothing. So the notion of having a single person, a single entity overseeing so they can act swiftly is not even relevant, because there would be no power. Again, if it is all conversation, looking, regulation, those things can be done by a group. And I just think that is worthy of hearing one of the Governors saying, no action. So——

Mr. TARULLO. Senator, could I just—just slightly amend or add to what I said. It is important to look to see what those rules are that prevail. The rules on leverage, the rules on capital, the rules on liquidity are themselves supposed to be based upon concepts of risk, and I believe they are based upon concepts of risk, which should contain these kinds of risks I mentioned. I think that if you set the rules properly, you have gotten a fair way down the line to containing risks within those institutions.

What I was saying before about the backup supervisory examination authority is there can still be practices that arise that somehow are evading the rules or are not falling under the rules, and then you need to determine whether it is an unsafe and unsound practice and make a judgment about that.

So, I do not think anybody should promise to you that as soon as any firm starts doing anything dangerous that some regulator is going to see it and be able to stop it. It is going to have to evolve over time. If the rules are set right, you should be containing a good bit of that to begin with.

Chairman DODD. Thank you very much.

Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

All of you have talked about regulatory gaps and systemic risk in all of this. Mr. Tarullo, one of the points that you made was on accountability, you have got to be able—you cannot diffuse the responsibility. Later on, you talked about silos and that, and I do not want to put words in your mouth, but you were opposed to one agency that could determine the problem and determine the solution to the problem. And I may be wrong in what I heard in that, but that is what I thought I heard.

You know, we are at a point where we know there are regulatory failures, and I think there is an opportunity to fix that. I think that is what the President put forth with this proposal. But shouldn't we push for further consolidation to stop the gaps, to allow ourselves to really focus and have that accountability that you talked in one of your main points, more consolidation than even here.

Mr. TARULLO. Senator, I keep referring to my prior life, but it turns out to have been relevant for this job, which I guess is a good thing. I spent a good bit of time as an academic looking at the different ways in which countries structured their regulatory systems, and there are some countries—the U.K. and Japan notable among them—that have tried fundamentally to consolidate all financial regulation in a single entity.

I do not think there is any denying that there are some advantages to that. You do get some of the cross-pollination of views. You do balance your incentives to foster the system but protect, for example, the deposit insurance fund. You get a lot of those incentives.

I think, though, that many people in those countries would also say there are downsides to that as well. The advent of the crisis in the U.K. suggested to a lot of people that that model was not a fail-safe either.

I should say the Fed does not have a position on more consolidation, less consolidation. But just as a kind of policy observation, I think there would be gains to trying to get more focus and consolidation so that you have some sense of who is accountable for what. But I think most of us—and I suspect all three of us at the table here—would also agree that some measure of redundancy is actually not a bad thing; that is, sometimes, you want accountability, but sometimes it is not the worst thing in the world to have multiple pairs of eyes, and even somewhat overlapping authorities.

Senator TESTER. I would agree with that, but then what happens with the instrument that is developed that has no regulation and falls in those gaps that we talked about and then everybody says it was——

Mr. TARULLO. I think that is a very good point, and so I think the question for you will be: In the architecture that you all may choose to legislate, do you provide that somewhere there is going to be a residual or default authority to address the unanticipated?

Senator TESTER. OK. Chairman Bair, the Administration proposes factoring in a firm's size and leverage and the impact its failure would have on the financial system and the economy when determining if a firm is systemically important. It is kind of a two-edged sword once again, but if the firm size is—and the metrics are developed around that—and we can talk about what those metrics might be, and we might if we have time. But wouldn't that provide—from a safety standpoint, wouldn't that provide a competitive advantage for those bigger banks versus the community banks if, in fact, their size and leverage determined them to be—they cannot fail, so we are going to make sure that they do not through the regulation?

Ms. BAIR. Well, we think any designation of "systemic" should be a bad thing, not a good thing. That is one of the reasons why we suggest there should be a special resolution regime to resolve large, interconnected firms. It is the same as the regime that applies to small banks. Also, they should have to pay assessments to prefund a reserve that could provide working capital if they have to be resolved.

We are not sure you need a special Tier 1 category. We think the assessment, for instance, could apply to any firm that could be systemic, perhaps based on some dollar threshold or some other criteria that could be used as a means of the first cut of who should pay the assessment. But you are right, if you have any kind of systemic determination, without a robust resolution authority—and, again, we think assessments for a prefunded reserve would be helpful as well—it is going to be viewed as a reward. It is going to reinforce "too-big-to-fail," not end it, and you want to end it.

Senator TESTER. So I am not tracking as a consumer. How would you stop it from being a reward and not——

Ms. BAIR. You would need a resolution mechanism that works. So if they become nonviable, if they could not exist without Government support, the Government would not support them. They would close them. They would impose losses on their shareholders and creditors. The management would be gone, and they would be sold off. That is what we do with——

Senator TESTER. So too big——

Ms. BAIR. ——smaller banks.

Senator TESTER. Excuse me, but "too-big-to-fail" would go away?

Ms. BAIR. Well, I hope so. I certainly hope so. I think that should be the policy goal. Right now it was a doctrine that fed into lax market discipline that contributed to this crisis. I think the problem is even worse now because, lacking an adequate resolution mechanism, we have had to step in and provide a lot of open bank assistance.

Senator TESTER. And I have heard from other participants, and I would just like to get your perspective. They would go away by increased regulation——

Ms. BAIR. No. I think "too-big-to-fail" would be addressed by increased supervision combined with increased market discipline, which we think you can get through a resolution mechanism.

Senator TESTER. Thank you.

Thank you very much.

Senator JOHNSON. Senator Johanns.

Senator JOHANNS. Let me just say this has been just a very, very interesting discussion. I appreciate you being here. I will tell you what I said a few weeks back, maybe a couple months back. I tend to favor the council. The idea of the Federal Reserve I think is just fraught with a lot of problems, so at least today that is where I am thinking about this.

But the discussion today has really raised, I think—in my mind at least—some very important fundamental questions. It seems to me if you have a council, Chairman Bair, I would tend to agree with you that the council would designate who is classified as somebody who would fit within this. But that raises the issue: How broad is that power? Which probably brings us back to even a more fundamental question of what are we meaning by systemic risk.

Is that an institution that is so entangled with the overall economy that if they go down, it could literally shake the economy or bring the economy down? Is that what we are thinking about here?

Ms. BAIR. I think you are, and I think it should be a very high standard. I also believe through more robust regulation, higher standards for large, complex entities, a robust resolution mechanism, as well as an assessment mechanism, that you will provide disincentives for institutions to become that large and complex as opposed to now where all the incentives are to become so big that they can basically blackmail us because of a disorderly resolution. This is one of the things that we lack, a statutory scheme that allows the Government the powers it needs to provide a resolution on an orderly basis. It rewards them for being very large and complex.

Senator JOHANNS. So under that analysis, very, very clearly you could have a large banking operation fall within that. But you could also have a very large insurance company fall within that.

Ms. BAIR. You could. That is right.

Senator JOHANNS. You could have a very large power generating company fall within that. What if I somehow have the wealth and capital access to start buying power generation, and all of a sudden, someday you kind of look up and I own 60 percent of it. Now, that is a huge risk to the economy. If I go under, power generation is at risk. Is that what we are talking about?

Ms. BAIR. No. I think we are talking about financial intermediaries. There are things that need to be addressed with respect to financial intermediaries such as the reliance on short-term liabilities to fund themselves as well as the creditors, and the borrowers, who are dependent on financial intermediaries for continuing credit flows. So there are things that are different about financial intermediaries that make it more difficult to go through the standard bankruptcy process, which can be uncertain. You cannot plan for it. The Government cannot plan for it. They cannot control the timing for it, and it can be very protracted and take years. And the banking process is focused on maximizing returns for creditors as opposed to our resolution mechanism, which is designed to protect insured depositors, but also to make sure there is a seamless transition so there are no disruptions, especially for insured depositors, but also for borrowers. Through that process, through the combination of the supervisory process plus our legal authorities for resolution, we are able to plan for these failures and deal with them in advance. And I would assume that this would be the same situation you would have—as Senator Reed pointed out, with the Federal Reserve that virtually regulates almost every financial holding company already. Certainly if you do away with the thrift charter, that would be the case.

I would also say that I really do not think a very large plain-vanilla property and casualty insurer would be systemic. I think AIG got into trouble because it deviated from its bread-and-butter property and casualty insurance and went into very high-risk, unregulated activities. But if you penalize institutions for being systemically significant, you will reinforce incentives to stick to your knitting, stick to more basic lower-risk activities as opposed to getting into the higher-risk endeavors that can create systemic risk for us all, as we have seen.

Senator JOHANNS. Chairman Schapiro, do you agree with that?

Ms. SCHAPIRO. I do agree with that. I think if you have an adequate resolution mechanism that the marketplace understands will, in fact, be used, it can cancel out effectively the competitive advantage that might be perceived to exist for an institution that is systemically important and, therefore, the Government will not let it fail. If people understand in the marketplace the institutions will be unwound, they will be permitted to fail, then they should not have that competitive advantage that "too-big-to-fail" would give them.

I also think that a council will be much better equipped to make an expert judgment across the many different types of financial institutions that we have in this country about which ones are systemically significant and important.

Senator JOHANNS. Governor, what are your thoughts?

Mr. TARULLO. Senator, I guess I basically agree, but maybe with a couple of qualifications. I think that the resolution mechanism is an important component of any program to address "too-big-to-fail." But as with each of the other components, I do not think we should look at it as a panacea. This is not something that we have done before. It is something we think needs to be done. And I agree with Senator Corker's earlier observation that if it had been in place before, it would have reduced risk. But note, he did not say eliminate the risk and eliminate the problem, and I agree with that.

I think you are going to need a good, sound resolution mechanism. I think you are going to need other mechanisms to enhance market discipline as well—the capital structure of the firm, for example. And I think you are also going to need sound, transparent regulations because I do not think going forward we can rely on any one instrument. We are going to have to rely on a set of instruments to try to contain this problem.

Senator JOHANNS. My time has expired, but if I could just offer this thought: I think the Chairman is absolutely right. I do not notice any political agenda here. I do not think it is a partisan sort of thing we are trying to come to grips with. My hope is that as we start working through this and putting pen to paper, the Administration will look at this from the standpoint of there are a lot of ways of dealing with this problem and preventing what happened and avoid locking down on just a single approach, like it has got to be the Federal Reserve or it cannot be anything, because I do think you can come at this from a number of different angles. But having said that, I will again reiterate I am hoping at some point we can move beyond the "who manages this" and resolve that issue, because there are some very, very important issues about who does this apply to. What are the unintended consequences of trying to define that? And I think that is where you really get into where the rubber meets the road here, is how you structure this in a way that makes sense, that deals with the problem, without going off on a cul-de-sac that really is not where we want to be today.

Thank you, Mr. Chairman.

Chairman DODD. Well, let me just say—and I appreciate my friend and colleague's comments, because he is on track and I agree with him. And my sense is with the Administration as well that this is a dynamic process. They are sending up ideas and proposals to us, and that is as they should do, I suspect. But my sense of it is as well that I do not get a locked down view on this.

So I think we are still very much in that dynamic process of thinking through these ideas, and you are absolutely correct, we are spending a lot of time on the who. But Bob Corker raised, I think, an important question that I have raised any number of times. It is not just the who but what. What powers? Just identifying who is going to be a systemic risk is an important question, but what powers are you going to give them is an equally important question, if you are going to give them any powers at all, in a sense.

So I think there are a lot of really important issues, and, again, I am very optimistic about the process that we have in place here for arriving at some of these answers. So I thank my colleague very much for his observation on that.

Senator Bennet of Colorado.

Senator BENNET. Thank you, Mr. Chairman. I want to pick up right where you left off and where Senator Johanns left off, because I think—it is, by the way, a fascinating conversation. I appreciate all of you being here today. I think this is fraught with incredible amounts of potential unintended consequences, and we need to be enormously careful about keeping our mind or our focus on what is the problem that we are trying to solve here, because I am enormously skeptical of our ability to predict—or the regulatory agency's ability to predict these economic cycles and then to be able to respond in a way that does not actually compound the problem that we are facing. I think we have just seen 20 years of leverage piling up on our system and lack of attention to that that has led to the destruction of, you know, our economy and the dreams of a lot of people who live in my State and other States.

I fully agree that we need to—that having resolution authority in place would have made an enormous difference in this case and kept us out of the Alice in Wonderland world that we are in now where we are having conversations here about how people get paid in private institutions where the taxpayer has actually had to come to the rescue of firms that we should never have had to rescue. I think both the Fed Chairman and the Treasury Secretary have been doing good work trying to get us out of here, and I think they are right to say that we were left with an assortment of terrible choices and we took the least bad. And I think our objective here needs to be to make sure we never find ourselves in that place again.

I guess the question that I have for you, Chairman Bair, is when you talk about a council—and, again, I do not have anything against a council or any of this, and it might help. But when you talk about a council that anticipates risk, I think I get that. I am a little skeptical, but I get it. You also talked about a council that mitigates risk. Could you tell us more about what that means, if you would put some flesh on those bones for us?

Ms. BAIR. Mitigate or reduce risk—you cannot get risk completely out of the system. We are a capitalist system, so there has got to be some risk and return. But I think excessive risk perhaps would be a better example.

In terms of the powers of the systemic risk council, I would put prudential requirements at the top of my list, and requirements for capital and margining and other constraints on leverage. There was too much leverage that had been built up on the system, and we believe that this council should have the authority to set minimum standards.

For example, if the council decides that the FDIC is not setting high enough capital standards for its banks, or if the Federal Reserve is not setting high enough standards for its bank holding companies, or having high enough standards for the quality of capital, the council could step in and raise those standards.

So I think there are some checks and balances as well that you get that you may not with vesting all this power in one single entity.

Senator BENNET. That is an interesting idea, and would the effect of that be to remove some of the risk of regulatory capture of the other agency?

Ms. BAIR. I think that is exactly right.

Senator BENNET. This is a question for the panel generally. One thing we have learned in this economic crisis is that the United States economy is in no way isolated from the rest of the world. As we think about this set of new laws and regulations, how should we think about how we connect to the rest of the world and the regulators connect to regulators across the globe?

Ms. BAIR. Well, I think we should lead the world. I do not think we should wait for the rest of the world, or we could be waiting a very long time—at least in my limited experience with some of these international groups. I think especially on resolution authority they are looking to the United States to define the model. So I think you should seize the moment and forge ahead and lead, not follow, because I do think there are still a lot of folks looking to us for leadership, and I think we can help define what the international standards ultimately will be.

Senator BENNET. Mr. Chairman, I will end just by saying that I hope that whatever it is we arrive at here and whatever we do, the Administration leads toward a bias that when firms need to fail, they fail, and we can make sure we do that in an orderly way and that we are not ever again in the circumstance we are in today, which is to prop up institutions simply because we had no other good choice.

These were problems that were avoidable, and it is just a shame that the taxpayers have found themselves where we are.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator. I couldn't agree more, and the point has been made by several, the options being, one, to pour billions in or to collapse them. There have to be alternatives within those two bookends that give us far more flexibility to respond to these situations. If we don't do anything else, I think a resolution mechanism is going to be a tremendously important contribution to this.

And again, I think as I listen—as the Chair of this Committee, my job is in part to listen to all of my colleagues—and as I listen to this, while we haven't settled on a process yet, I am certainly beginning to sense a consensus developing around the importance of that issue, so I thank my colleagues and thank Senator Bennet for raising that issue again.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. I would like to ask unanimous consent to enter my opening statement into the record.

Chairman DODD. Yes, and I would ask that of all my colleagues, as well.

Senator BUNNING. OK. Chairman Bair, I have asked you this question before and probably will ask you again. When do you expect to end the Temporary Liquidity Guarantee Program?

Ms. BAIR. October 31.

Senator BUNNING. For sure?

Ms. BAIR. For sure, yes. All indications are that we will be able to exit the program, yes. The guaranteed balances are down. Use of the program is down significantly. And yes, I anticipate we will be in a very good position to exit October 31.

Senator BUNNING. Good. This is for all of the witnesses. This question has two parts. As I have said before, I doubt we can create a regulator that will be able to see and stop systemic risk. So the first question for each of you is, if you really think Government can assemble a regulator that will not be outsmarted by Wall Street, first of all—in other words, can the Government really understand what the financial industries are doing and spot the risk ahead of time, or at least as they are happening?

And second, it seems to me a more practical and effective way to limit the damage firms can do is to limit their size and exposure to other firms, in other words, the interaction between major firms. That also has a benefit of allowing the free markets to operate, but within reasonable limits.

My question for each of you is do you agree with that, and answer also the first one, if you will. You can all take a shot at it, in no order.

Ms. BAIR. I will be happy to. Look, we can have better quality regulation. We can have more even regulation. But regulation will never correct all of this. You need more robust market discipline, which is why we really need an effective resolution mechanism. The market will then understand that when these institutions get into trouble, those who invested with them or extended credit to them are going to take losses.

On the interconnectedness and exposures, yes, Senator, I think you are absolutely right to focus on that. One thing we suggest in our testimony that would be an area ripe for consideration through a council, if it is formed, would be whether there should be some limits on the firms' reliance on short-term liabilities.

Senator BUNNING. Well, shouldn't we include everything, though?

Ms. BAIR. Well, I think——

Senator BUNNING. In other words, we are talking about things that are not regulated at all. Secretary Chairman Reed and myself are having hearings on those things outside the regulatory bodies right now.

Ms. BAIR. Right. So I think you are right. The relationships of financial intermediaries to other entities in the economy, stress testing those on a marketwide basis, are all things that require a lot of interagency cooperation and something that the council would be well-equipped to provide.

You are absolutely right. Interconnectedness is a key indicator of systemic risk and it is something, I think, we can do a better job addressing through regulation in containing risk.

Senator BUNNING. Ms. Schapiro.

Ms. SCHAPIRO. Senator, I think we can do better as regulators. We will never be perfect, but we can certainly do better.

Senator BUNNING. We all know that, so you don't have to——

[Laughter.]

Ms. SCHAPIRO. I thought self-confession was helpful here.

[Laughter.]

Ms. SCHAPIRO. I think we can constrain risk taking through heightened capital requirements, more effective capital requirements, margin.

But I really want to address your second question because I think it is particularly important in the context, for example, of over-the-counter derivatives, which trade in the hundreds of trillions of dollars on a bilateral or counterparty to counterparty basis, without transparency, without in many instances sufficient margin or collateral behind those positions.

Senator BUNNING. Our markets, they just trade.

Ms. SCHAPIRO. Exactly right. And so the goal of moving as many of those transactions onto central clearing platforms so that we take out the counterparty risk and remove the bilateral nature of those contracts so a clearinghouse is interposed between all the parties, I think would do an enormous amount to reduce the systemic risk and reduce the exposure of financial institutions to each other——

Senator BUNNING. Just by registering?

Ms. SCHAPIRO. By clearing them through a central——

Senator BUNNING. Clearing.

Ms. SCHAPIRO. ——through a central clearinghouse.

Senator BUNNING. OK. Mr. Tarullo.

Mr. TARULLO. Senator, with respect to the first part of your question, I would agree and go further, actually. I think part of what we have observed is not only that Government observers can't figure out every instance of systemic risk, but market participants themselves are sometimes unaware of the fact that they are engaging in practices that are subject to the domino effect of everything falling down.

I don't think that means we should give up. I think it means we have to go into the exercise with a realistic sense of what you can and cannot accomplish. You are going to have false positives and you are going to have false negatives, which means that there needs to be a certain modesty associated with the exercise. But I do think that with efforts to quantify—to get data in a standardized form where you see the amount of leverage building up in different parts of the economy—you can take some steps down the road.

Your interconnectedness point, I think, is critical. That is why we suggested in the prepared testimony that in thinking about capital regulation for larger firms, one should try to devise a metric that looks at interconnectedness, that looks at the very things that create systemic risk, rather than just replicate the siloed approach to capital regulation we have had in the past.

Senator BUNNING. Let me get my last question in, and this is for Sheila. All the largest institutions, financial institutions, have international ties, or at least most of them, and money can flow across borders very easily. AIG is probably the best known example of how problems can cross borders. How do you deal with the risk created in our country by actions somewhere else as well as the impact of actions on the U.S. markets themselves?

Ms. BAIR. Well, I think the international component of this is very difficult, and that is why I said earlier, I think we should try to lead and set the standards which then we can try to leverage into international agreements, especially when these large institutions get into trouble. The FDIC cochairs a working group with the Basel Committee to address the situation where a U.S. firm with large international operations gets into trouble, or vice-versa.

One advantage we have here in the United States is that we require banks to be chartered here—organized under our laws, insured separately, and regulated as if they were domiciled here. So there is some insulation for U.S. customers of those entities if they get into trouble.

We do not require the opposite, though—that our banks and financial institutions doing business overseas must be organized separately. So we suggest in our written testimony that this might be something to think about. Clearly, with greater legal autonomy and organization within each of these home jurisdictions, if the entity does get into trouble, it makes the resolution a lot simpler.

Senator BUNNING. Thank you very much, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

I want to follow—thank you all for joining us and thank you, each of you, for your public service in very trying, difficult times.

I want to follow up on Chairman Dodd's discussion or allusion to the powers given to the systemic risk regulator. I was intrigued by Senator Bunning's statement that we not be outsmarted by Wall Street and that we in the Senate not be outsmarted by Wall Street, that you as regulators in the structure we build not be outsmarted by Wall Street.

And I think sort of the longer time you spend here watching, whether it is the financial system or the health care system or anything else, history is replete with industry always trying to, in some sense—not accusing of illegality, but in some sense staying ahead of the sheriff, that they are always trying to find a way around whatever rules we write, whether it is health insurance companies gaming the system and we try to write rules for them or whether it is financial institutions or anything else in the whole regulatory system structure that we have built.

I ask you, and I would start with Mr. Tarullo, but I would like all of you to just comment on it. Give me sort of a prescriptive walk-through of what, in fact, we are able to do with the—what kind of powers the systemic risk regulator should have to prevent another mortgage meltdown. Be as specific as you can walking through for us in very understandable terms about what kind of powers the systemic risk regulator has to prevent those kind of market meltdowns, if you would.

Mr. TARULLO. So Senator, again, I just want to qualify the notion of systemic risk regulator, because again, it depends on how many of those powers you invest in a particular agency. I would say, getting at Senator Dodd's perspective, as to where the powers ought to be. I think you are going to need simple, straightforward but strong rules to get at things like leverage for precisely the reason you said. If you try to go too activity-specific, you are always going to have people arbitraging and trying to do something that accomplishes the same end. So one has to look to overarching rules that provide some constraint upon it. I would say that is number one.

Number two, I think you do have to have an adaptable set of regulators and supervisors who are looking at emerging practices and are able to—and have the backup authority to act against those practices.

Number three, and I guess I would say in the consumer protection arena, I think that there—most importantly of all—you probably needed a change in attitude. I think—again, as an academic, teaching through the 2000s—during that period, I just didn't see an enormous amount of interest in financial services consumer protection, frankly, at any of the financial regulatory agencies. There was, as Senator Dodd pointed out, power to take action. There was certainly examination authority. Each of the agencies had things they could have done. Perhaps not everything. They couldn't have stopped some things, but could certainly have stopped a lot. So, I actually do think in the consumer protection area the basic problem is one of attitude, orientation, and leadership.

Senator BROWN. Would you—and I want to hear from the two Chairs, too, but would you in writing discuss with me, because I want to get to them, what you mean by change in attitude, and more importantly, how we get there, how we——

Mr. TARULLO. Sure.

Senator BROWN. Just send me a letter about that——

Mr. TARULLO. Happy to.

Senator BROWN. ——if you would think about it and come up with it.

Mr. TARULLO. Yes.

Senator BROWN. OK. Chairman Schapiro.

Ms. SCHAPIRO. Thank you. Well, I would agree with you. It is always a challenge for regulators to keep up with the latest financial innovation and the latest trading practices, product designs from Wall Street. I would say, I think to some extent, Wall Street outsmarted itself over the last couple of years and not just the regulators, which is why, through a lack of good risk management procedures, perhaps a lack of understanding entirely the nature of the businesses they were engaged in or the degree to which they were dependent upon counterparties is significant contributors to the situation.

I think there are a few things we can do and we really must do. We have got to bring unregulated products under the regulatory umbrella. I talked already about OTC derivatives and I won't go back through that, but I think it is a very significant gap.

I think we have to be much more robust about capital requirements and risk management procedures within the firms. We have to have regulators who are willing to be skeptical every single day and every hour of every day about the quality of risk management procedures within the firms that we are all responsible for regulating.

I think we have to have an across-the-board commitment to much more robust stress testing so that we are thinking more about the huge impact but low probability events and factoring that into how we go forward with our regulatory programs.

And to refer back to something we talked about with Senator Corker, I think we need to find ways to encourage more engaged and knowledgeable boards in these financial institutions.

Senator BROWN. OK. Chairman Bair.

Ms. BAIR. Specifically focusing on the resolution mechanism, under the regime we would suggest going forward, a Wall Street firm couldn't come and ask for assistance from the Government without submitting to a resolution procedure, meaning that they would be closed. So I think that they will stop asking, number one, if that is the tradeoff.

I do agree that there has been some Balkanization of regulatory responsibility . That is why we think a council with ownership and a clear statutory mandate to be responsible for the system, addressing systemic risk, and getting ahead of systemic risk, will help change that attitude. It would get us all working together as opposed to saying that it is not really my agency's responsibility.

I do think the ability of the council to set minimum standards, as well, will be an important check against regulatory capture or perhaps a lax attitude. That is another feature that could create a more robust regulatory environment.

Senator BROWN. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman, and Chairman Bair, I am going to focus most of my questions on you, although I may, if I have time, be able to get to the others on the same issue.

I am going to focus on the resolution authority issue again. I know that you have proposed that the resolution authority be with the FDIC and that it be expanded to bank holding companies and there is a bit of a discussion as to how broadly it should be expanded and where this authority should reside, or should be placed.

But when you look at the issue of the need for a resolution authority, we have, first of all, the fact that right now, we only have resolution authority for banks. You indicated that we should expand that to bank holding companies. We also have the issue or a piece of the issue that Senator Bunning raised with regard to international holdings and what we deal with when we have American institutions that have acquired sometimes dozens if not hundreds of foreign subsidiaries and how we deal with those kinds of jurisdictional issues.

I would just be curious as to your thoughts about where should the resolution authority be placed—I think I know the answer to that—but also how broad do we need to be in terms of the establishment of such resolution authority.

Ms. BAIR. Well, as you said, for bank holding companies, the FDIC would like to be the resolution authority simply because we already are for the insured depository institutions and you need a consistent single unified resolution regime. For other types of entities, if Congress wanted to give us that authority, we would take it. We are really the only place where this very specialized expertise resides. We have closed over 3,000 institutions throughout our existence, small ones, large ones, and we have the staff and the ability to ramp up very quickly, as we have done over the past 18 months and have in the past. Institutionally, this is what we are equipped to do, so I think it would make some sense.

The international component of this is very difficult and we think that this will be a multiyear process to get some of these institutions in shape where their resolution could be much more streamlined. One of the things we suggest in my written testimony, it is also suggested in the Administration's white paper, is to require these large institutions to have their own will, so to speak. They need to have their own liquidation plan that they would update, say, on a quarterly basis. The plan would also be facilitated by having greater legal separateness among the functional components. Part of the problem is these functional components are so intertwined, so deposits you may get overseas may be funding assets in the United States. Trying to tease all of that out in an orderly fashion is difficult. So we do think there is some infrastructure that needs to be put in place here.

By designating some entity as the resolution authority, it will facilitate international discussions. We are doing that now, but we just have the bank piece of it. I think whoever is designated with the resolution authority would be the entity that could negotiate agreements with other jurisdictions and have systems and agreements in place to deal with situations where an internationally active organization gets into trouble. Protocols would be in place to deal with that situation.

Senator CRAPO. Would expansion of the authority at FDIC to include bank holding companies have allowed you to reach to Lehman Brothers and AIG?

Ms. BAIR. Well, yes, theoretically it could have. AIG was a thrift holding company. Assuming that you expanded the authorities to both bank and thrift holding companies or the charters were collapsed under Federal Reserve jurisdiction, requiring everybody to become a bank holding company, yes, it would.

Senator CRAPO. And then where would we stop—or, I guess, is expansion to bank holding companies sufficient? I am thinking we have insurance companies, hedge funds——

Ms. BAIR. Right.

Senator CRAPO. ——private equity firms, mutual funds, pension funds——

Ms. BAIR. Yes.

Senator CRAPO. How broadly do we need to reach?

Ms. BAIR. Yes. Well, again——

Senator CRAPO. What is the systemic system that we are talking about here?

Ms. BAIR. We would not want the FDIC to decide that. I think that is something that the Systemic Risk Council really would be best equipped to do. And also, our process does not contemplate that the FDIC would be the authority to decide to close the entity. That could be done a couple of different ways. One would be through the systemic risk process we have now. If it is a holding company, it could be done by the Federal Reserve Board as the primary regulator of the bank holding company. That is the way the process works now. The primary regulator makes the decision to close the institution—that is frequently done in consultation with us—but then appoints us as a receiver.

Senator CRAPO. Do you think it would be adequate to simply extend jurisdiction to bank holding companies?

Ms. BAIR. That would be an option if you wanted to do something quickly. As I said before, I am concerned that we are not out of the woods yet, and as the market starts to differentiate between weak and strong and we exit these Government programs, we may be back in the soup. I hope that is not the case, but I am not sure.

I think as an interim measure, you could very easily extend our authority to bank holding companies. This approach would not require Congress to address systemic risk or anything else. I think we would still need to do address systemic risk down the road. But yes, this could be a short-term measure. We have drafted language at the request of some of you which would be a very simple amendment process. That would be a very good tool to have now.

Senator CRAPO. And I assume that you would agree that establishing an expanded resolution authority would help us to get away from the concern that creating a systemic risk regulator for those so-called "too-large-to-fail" firms——

Ms. BAIR. Right.

Senator CRAPO. ——would create an implicit Government guarantee that they would be propped up as opposed to allowed to run down.

Ms. BAIR. That is right. We want it to be a bad thing, not a good thing, to be systemic. That is exactly right. I think you do that through a robust resolution regime that, as Chairman Schapiro said, makes it clear to the market that this is the process that will be used and shareholders and creditors will take losses.

Senator CRAPO. Well, thank you. My time is up. I would love to have had this same question answered by our other two witnesses. Maybe we will be able to get some——

Chairman DODD. Take a minute, Mike. Go ahead.

Senator CRAPO. Could we have the other two witnesses comment on this? Thank you.

Ms. SCHAPIRO. I really agree with what Sheila has said and am very supportive of that. I guess the only slight amendment I would have would be for bank holding companies that have a broker-dealer subsidiary where customer accounts are protected under the specific law that there be consultation in that process with the SEC, which I fully expect there would be.

Senator CRAPO. Thank you.

Mr. TARULLO. Senator, just a couple of comments here. One, I would hope that the universe would actually not expand that greatly. That is, as we have commented before, Chapter 11 is the appropriate route for most entities, financial and nonfinancial. This ought to be a somewhat discrete mechanism which is used only in really unusual circumstances.

Senator CRAPO. Thank you. In that context, if we do—I tend to agree with that, as well, but if we do keep this narrowly focused, or as narrow as we are talking here, then I think we really need to face that question of the implicit Government guarantee of the firms that are regulated by the systemic risk regulator or the system we establish.

Mr. TARULLO. And Senator, with respect to bank holding companies, you don't have to reach that question because there is no need to distinguish between the systemically important and nonsystemically important. It is only when you get to the entities that are not currently supervised that you have that issue.

Senator CRAPO. Right.

Chairman DODD. Thank you, Mike, very much. Good point.

Senator Merkley.

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

One of the components of the President's plan is the Consumer Financial Protection Agency. There hasn't been a lot of discussion of that this morning, so Chair Bair, can you give us a sense of your insights on the role of this potential institution and whether it is an appropriate one to create?

Ms. BAIR. We support the creation of the agency—an agency that is focused exclusively on consumer protection in financial services that can apply standards across the board for both banks and nonbanks and make sure they are the same standards. We think that would help the banking sector because one of the things that drove the rapid decline in mortgage origination standards was inadequate regulation and supervision outside the banking sector. Most of these very high-risk mortgages were done outside of the traditional banking sector, but as competitive pressure drew market share from banks and thrifts, which also lowered their standards in kind. So I think making sure there are even standards across the board is very important.

Where we think the proposal could be strengthened is on its enforcement focus. We strongly recommend that the examination and enforcement component for banks be left with the bank regulators. I say that as a bank regulator but also as an insurer of all institutions with, ultimately, taxpayer exposure with the deposit insurance guarantee. There is a reason why we focus on prudential regulation of banks, as well, and a lot of it is because of FDIC insurance, which is a taxpayer backstop.

There are important synergies you can get between prudential and consumer supervision. We typically cross-train our examiners. We can send in teams of both safety and soundness and consumer compliance. A prime example of where joint safety and soundness and compliance examination can be beneficial can be seen in cases where mortgages that were abusive to consumers were also found to be unsafe and unsound. And frequently, we will find where there is a consumer compliance problem that can flag a more fundamental problem with risk management at the institution.

We think strongly that the rule writing should be for both banks and nonbanks. We are fine with that. But the examination and enforcement mechanism of a newly formed consumer protection agency should focus outside of the banking sector where you really don't have much examination and enforcement activity at all with the mortgage brokers or payday lenders. There are a lot of abuses outside the banking system that we think could and should be addressed by this agency. But, we really think their focus should be on creating more robust enforcement mechanisms for the nonbank sector.

I don't understand why moving all the examiners from the bank regulators to this new agency and then making them responsible for both banks and nonbanks is going to work. I don't think it will. It would be highly disruptive to the FDIC. That is, about 21 percent of our examiners being pulled out of the FDIC. I assume it is a similar percentage for the other regulators. We think we do a good job on examination and enforcement. We have never had the ability to write rules, so that doesn't really change things for us. So we would ask you to consider that change in the Administration's proposal, but we do support the agency.

Senator MERKLEY. Somewhat related to this, the systemic risk conversation is partly about institutions and it is partly about practices. By practices, I would mention things such as prepayment penalties in mortgage, regulatory arbitrage, whether there is a fundamental conflict of interest in the rating system in which the entity that you are rating is paying for that rating, and the issue of the amounts of leverage that were established in the system under Cox's supervision of the SEC.

I am trying to sort out, how does one decide when you have a consumer issue that would be driven by the Consumer Financial Protection Agency? When is it an issue that the systemic risk regulators would take on? And when would it be an issue that the regular bank regulators would take on, and how would it get worked out in terms of how to proceed?

Ms. BAIR. Well, I think it does go both ways. What we have suggested in my written testimony, is that bank regulators should be represented on the board of the new consumer agency. Again, as an insurer as well as supervisor, we think the FDIC would have a unique perspective that should be represented. We also would be happy to have the head of these two agencies serve on our board because there are synergies and interconnectedness between prudential supervision and safety and soundness, and I think those need to be dealt with and that would be one way to deal with them.

There has always been a separation between rule writing and enforcement for the consumer laws, at least for banks. The Federal Reserve Board has had that authority for federally insured banks. The FDIC and the OCC have never had the ability to write rules. We have just had the examination enforcement component.

Senator MERKLEY. I want to get in one last question before I run out of time. Paul Volcker had a report that came out in January—I think it was called the "Group of 30 Report"—that addressed the issue of proprietary trading by banks and essentially using the capital assets of the bank, should banks freely engage in purchasing assets regardless of the risk, and does that create systemic risk, and they had recommendations for constraints on proprietary trading.

I open it up to all three of you. Do you have any thoughts about—this hasn't gotten a lot of attention and I am curious of your thinking.

Ms. BAIR. This probably doesn't surprise you, but as the insurer of banks we would strongly prefer that the proprietary trading occur outside the bank, in an affiliate. If it does occur in a bank holding company that includes an insured depositor institution, that is a risk factor that should be considered in setting assessments if the Congress decides to approve an assessment system for larger institutions.

Ms. SCHAPIRO. I would just add that I think proprietary trading with either taxpayers' money in the event of a supported institution or a customer's money does absolutely create risks that we need to be sensitive to. On the broker-dealer side, you are not permitted to proprietary trade with customer funds, and most of that activity takes place outside the regulated broker-dealer.

Mr. TARULLO. Senator, I would just say that regardless of where these activities are taking place, they can create risk under some circumstances. There needs to be capital, liquidity, and other kinds of regulation which contain the risk no matter where it takes place.

Senator MERKLEY. Thank you very much.

Senator WARNER [presiding]. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman. I appreciate it. And thank you to the witnesses. I think we have covered most of the ground, and I do not necessarily need to rerake the same set of leaves. But I have an overall concern here, and I do not expect a specific answer. I just want to raise it and get some conversation.

Systemic risk, what is it? If we do not have a definition of systemic risk that everybody can understand and buy into, we are getting into a messy situation that could end up being just as bad as what we have just come through.

I listened to all of this and think, OK, if I were the CEO of one of these companies, and, Sheila, you are saying we want to stigmatize the company if it becomes too-big-to-fail or is showing a systemic risk, the first thing I would say to all of my staff would be, "Find out what will cause us to cross the threshold of being stigmatized as a Tier 1 'too-big-to-fail' and make sure we manage our business in such a way as to avoid that."

Now, if the definition of systemic risk is sufficiently loose, we can find ways around the definition, become too-big-to-fail without being defined as "too-big-to-fail," and end up with the board or the single regulator, whoever it is, facing the mess that we have talked about.

If the definition is clear and accurate, then the reaction on the part of the CEOs of the company will be, “We want to avoid being stigmatized,” and the whole thing will be self-policing. So the market will react to that definition by saying we will not do this and we will not do that and we will not do the other thing.

So who gets to decide what is too-big-to-fail? Who gets to define what is a systemic risk? And what should we be looking for as we do that?

I guess one last—I have tried to probe into the Lehman Brothers decision because I, with the benefit of hindsight, think the Lehman Brothers decision is probably what triggered the mess that got us into the need for TARP. And digging down through it, I am told ultimately we did not have enough data. When we made the Lehman Brothers decision that said, “yes, we will allow Lehman to go down,” we did not have enough data. And if we had had more, we probably would have made the different decision and would have stepped in to try to save Lehman the same way we saved Bear Stearns.

So that is a real-life example of what happens when you do not have a clear definition of what is too-big-to-fail. Comments?

Ms. SCHAPIRO. Senator, I think you raise really a critical point here, and I think it is one reason I believe the existence of a council will be so important, because making a determination about what is a systemically important institution and how its business practices are evolving over time to move it perhaps in and out of that definition is something a council, a diverse perspective and diverse expertise on different types of financial institutions, I think will be pretty well-suited to do based on an analysis of data, examination reports, information from counterparties and so forth.

And so I think for us to be able to determine—I mean, we can come up with a definition of systemically important. It is an institution whose failure puts at risk other institutions or the financial system as a whole. But I do not think it tells us very much because it is, in fact, so general.

So I think a council will actually have the ability, and it will have to be an incredibly dynamic process, and that is why I think designating them that way is a mistake, because you will be designated and undesignated. People will structure their business to fall right under the designation. But I think for the primary regulators and the council to understand those institutions that we need to be particularly focused on will be important and facilitated by a council.

Senator BENNETT. OK. I am glad that Sheila referred earlier about a dollar threshold might be the trigger. An efficiency threshold might be the trigger. An interconnected threshold might be the trigger. There is no single trigger, is what it has come down to.

Mr. TARULLO. Senator, I think your question is going to have importance regardless of whether it is a council, the Fed, a new agency, or somebody else. I think the question you put your finger on matters, no matter who the designator is. And here is the basic dilemma, though, that you all face.

As I said a moment ago, with respect to already supervised institutions—bank holding companies—you do not have to draw that sharp line in the sand. You can have an approach to regulation and supervision which is in a sense graduated, squeezing more tightly as there is more interconnectedness, but there is no one place at which you say here is the line.

The problem comes with institutions that are currently outside the perimeter of regulation.

Senator BENNETT. Exactly.

Mr. TARULLO. And there, the choices, I think, are several. Basically you have got three choices.

Choice one is you say here are the group of institutions which we think under stressed conditions would pose a systemic risk under some set of criteria.

Two, here is a set of institutions about which we would not say that with that level of assurance, but it at least would be in the ballpark to think about them in this way.

Either of those requires you to draw a line somewhere.

The third option, of course, is to say that basically every financial firm, no matter what it calls itself, has to be subject to basic rules and regulations. But that, of course, is itself a change from our current circumstance because we do not have that kind of perimeter.

I do not think any of those is a clean choice. There are advantages and disadvantages to each, and that is why I think the question you raised is one that we are going to have to address as best we can no, matter which road people choose to go down.

Senator BENNETT. Sheila, you wanted to comment.

Ms. BAIR. I did. We are suggesting that the resolution authority be applicable to any bank holding company, so for resolution purposes, you would not have to differentiate up front. And whether it was used I think would be a determination made by the primary supervisor about whether to avoid systemic ramifications from a normal bankruptcy process by employing the special resolution process, which still has the same claims priority that bankruptcy has with unsecured creditors and shareholders taking losses before the Government. It is a way that we can plan and use additional powers we have to set up bridge banks or to accept or repudiate contracts. The special powers we have really work better for financial intermediaries. But you do not have to make that determination in advance.

I think the dollar threshold I mentioned, in the context of whether there would be an assessment to fund a large institution resolution fund, would really determine who is not systemic as opposed to who is. So for maybe anybody below—pick a number—$25 billion, you can safely assume they are not systemic, so they would not be caught in this assessment. But even those caught in the assessment, the amount of the assessment would be risk based. So if you are a plain vanilla regional bank, you take deposits, you make loans, you do not do much else, you are probably not going to have much of an assessment. If you are a complex bank holding company with a lot of proprietary trading, OTC dealmaking, *et cetera,* you are probably going to have a higher assessment.

As Governor Tarullo said, really the only time where you would need to do it in advance is if there was a large systemically important institution that is not already under consolidated Federal supervision. I do think the council should have the flexibility and authority to define those institutions and bring them under prudential supervision if that is the case. I think that is something the council should do. It would be a tremendous power, and I think it would benefit from the multiplicity of views that would be on the council.

Senator BENNETT. The power to define becomes ultimately the power that controls everything.

Ms. BAIR. In terms of institutions, especially if you do away with the thrift charter, there are only a few institutions—I am not going to name any specific institutions—that come to mind that would not already be under Federal prudential supervision. So I am not sure actually if that piece of it in practice would be that profound. As a result of the crisis, pretty much everybody has become a bank holding company or are on their way to doing so. So I am not sure in practical terms that it would be that huge of a change.

Senator BENNETT. Thank you, Mr. Chairman.

Senator WARNER. Well, I want to thank the panel for hanging in, and I think it is down to Senator Martinez and me for the last two on this, and we have actually a second panel. I have a slew of questions, and I will try to ask them very quickly, again, so that Senator Martinez can get his questions in, and we can respect the second panel if we could try to answer fairly quickly.

I strongly, as I made clear, believe that the council is the right approach. I guess I would ask for rather quick responses here—if possible, even kind of yes/no. I would love to—should that council have an independently appointed, Presidential appointment with congressional approval chair? Should it have the ability to look across all financial markets? Should it be able to be the aggregator of data from all of the prudential regulators up to with an independent staff that could aggregate and assess this data?

Should it have, as I think we have heard you say, the power to issue rules, require enhanced leverage, or capital rules? And should it be able to force the day-to-day prudential regulators to take action and, if not, have backup authority to take action if the prudential regulator does not?

I want to try to—I think Senator Bennett asked very appropriate questions about how we define. I am trying now to get into how we structure if we went forward with this council approach, recognizing that Professor Tarullo may not concur on the——

Mr. TARULLO. As you know, Senator, the Board at this juncture has a somewhat more contained view of the council, so let me just—you said "Professor" before rather than "Governor," and I will slip back into that prior role, which is to say that I think you need to ask yourself at some point whether you are not basically creating a new agency that has brought in all the functions of the other agencies. If you have got a council that basically is able to direct everybody to do what the council thinks you ought to do, it is not that far from the Financial Services Authority mechanism in the U.K. or something like that. Obviously, there are a lot of gradations along the way.

Senator WARNER. Thank you.

Chairman Schapiro and Chairman Bair.

Ms. SCHAPIRO. I think you asked five questions, and I think I have five yeses to all of them. I have not thought very carefully through the structure in terms of Presidential appointee confirmed by the Senate, but I think that makes sense. I do believe it needs to have the ability to aggregate data, to look across financial markets and all financial institutions. That is the whole purpose to my way of thinking. And I believe very strongly it needs the power to set capital requirements, leverage limitations, and other prudential regulatory requirements.

And I would have, I guess, one *caveat* on the ability to force prudential regulators to take action if they do not do that, and my view on that would be to raise standards, yes, not to lower standards.

Senator WARNER. Chairman Bair.

Ms. BAIR. I would say yes.

Senator WARNER. Thank you.

One of the things that Senator Corker has brought before you all a number of times, and I agree with him, is this notion of enhanced resolution authority for the FDIC for bank holding companies. I concur with his approach and that our goal ought to be allowing these institutions to actually fail in an orderly process and not be simply propped up ad infinitum.

You know, there are a lot of questions beyond that, and we may even have an interim basis here, but one of the concerns I have with the Administration's proposal is there is still a—how do you fund that resolution? There is still the idea of having to go to the Treasury or the Fed to get the dollars in the interim and go back and do a retroactive funding of the resolution. And clearly you do not want to have prefund so much from existing small banks.

How have you thought about a prefunding mechanism? And how do we make sure that the prefunding, if you do agree with the prefunding, is a large enough net that you are going to capture potentially some of these institutions that may not obviously fall into a current FDIC coverage area?

Ms. BAIR. We support a prefunding mechanism, and it is important to note that this fund would be for working capital. This is not an insurance program, so we would not be guaranteeing liabilities as we do with the Deposit Insurance Fund. This would be for working capital to facilitate resolutions where necessary to make sure there are no disruptions to the system.

It would take some time to build that fund up, so initially you might have to establish a line of credit with the Treasury Department. This should all be completely separate from the Deposit Insurance Fund and what goes on with insured depository institutions. To the extent we resolved a bank holding company with both banks, and nonbank functions, we would allocate losses to each fund in a way that would keep them completely separate.

Similarly, those with the large deposit bases should not be double-assessed, so whatever they are paying into the Deposit Insurance Fund, will take care of what is in the bank. Any other costs would be allocated outside the bank.

I do think prefunding is important from the perspective not only of making sure there is something to call upon so you do not have to immediately borrow from taxpayers to facilitate one of these resolutions. But I also think it is a tool that can complement prudential supervision to disincent high-risk behavior. We use risk-based assessments now for deposit insurance. Congress gave us that authority in early 2006. We like some of the impact it has had on behavior, and I think through this assessment system you could do the same types of things.

So, for instance, if you did not want to be so extreme as to tell bank holding companies they could not do proprietary trading anymore, maybe you say they can do that in an affiliate, but we are going to charge you a higher assessment. I think it does have a way to impact behavior, but not in a way that you set hard and fast rules or limits that can be arbitraged or may result in unintended consequences.

Mr. TARULLO. Senator, I think this is another one of those areas where you have got downsides as well as upsides whichever way you go. The downside of *ex post* funding, as has already been suggested, is you have to go back and do an assessment *ex post.* You have to borrow money from the Treasury in the interim—I certainly hope not the Federal Reserve here—for setting up this mechanism.

But if you go the prefunding route, there is not really much experience to know what you are prefunding. As Sheila already said, you are probably not going to be at a point any time in the near future where you would have the fund you would need, so you would need a backup line of authority.

And I guess the incentive, or signal, question would have to be asked: If you already have a preset pot of money which is reserved for resolution situations, does that make it more likely that it will be used? And I do not think there is a clear answer to that either.

Senator WARNER. I have got another—I am just going to make one quick comment, because I do not want to interfere on Senator Martinez's time. But just as we think about these gradations—and I think, you know, as we think size, I hope there will be some scaling of this as opposed to a simple line that you cross over. The one question I also would want to ask for your answer on, but as we look at bank holding companies taking on a whole series of additional functions that oftentimes look a lot like hedge fund functions, as you mentioned, Chairman Bair, in terms of their internal trading functions, should there be additional capital requirements for these nonbank functions that are taking place inside bank holding companies? And as we look at putting barriers on that "too-big-to-fail," "too-big-to-fail" is size and sometimes also a series of additional functions.

I will move now to Senator Martinez.

Senator MARTINEZ. Thank you, Senator Warner. I appreciate it very much. I just believe a lot has been covered, and I do not want to again go over ground that has been covered. But there is one area that we have not talked about, and I would like to know the views of all three of you. It has to do with the GSEs, the Government-sponsored enterprises. They are entities that I think define "too-big-to-fail." I think they also were systemically very risky. However, they had this implied Government guarantee that they continue to enjoy.

Obviously, we have done a great deal to do what we should have done much earlier, which is put a regulatory scheme in place that might prevent some of the problems in the past. But thinly capitalized, a huge and ever growing market share which even continues to this day, an implied Government guarantee which provided investors a buffer from reality or from the consequences of investments, and I think the whole ball of wax of our mortgage system became very much troubled as a result of their activities and their actions. And I cannot—I think if we were to look back upon this period and what we have been through, I think it would be impossible to overestimate the impact that they have had and all the problems we have seen.

How do they fit into what we are talking about here? What is the appropriate place for them to fit? Is there a future that they even should have as Government-sponsored enterprises? Or should they be simply part of the private sector?

As I look at each of your functions, they fall under none of you—maybe perhaps a little bit under Chair Schapiro, but not a lot. Exactly. So we are still in the problem.

So if we look at what it is that got us where we are today, I would love for us to focus on what got us here rather than just—and, obviously, AIG is a big part of the problem, and, obviously, there are a lot of other, you know, issues and relationships and interconnectedness and all of that. But would you please address the GSEs for me?

Mr. TARULLO. So, Senator, one thing for sure, the guarantee is no longer implicit. It is now——

Senator MARTINEZ. Which, by the way, some would say it never was.

Mr. TARULLO. There is considerable force to that as well.

The Board, as you know—long before my arrival there—had expressed concerns about the GSEs, and I do not think anything that has happened in the last 10 months would have reduced those concerns.

I guess I would say that there are a number of ways one can go but, going forward, what would be critical is to distinguish private roles from a public role. There is a real public role that can be played by GSEs. That is why they were originally started. But when you have a public role, that is when guarantees, implicit or explicit, are going to be involved. And that is when you are trying to implement a set of policies, so those activities are going to have to be constrained, and you are going to have to make sure that the entity is really functioning as a public entity under a certain obvious set of constraints.

My characterization of some of the GSEs over the last 10 years would be that nobody could tell where the public ended and the private began.

Ms. BAIR. I would just add that the Federal Reserve Board was an early sounder of risk. And at Treasury, especially when I was at Treasury, similarly, we tried to sound the alarms.

I think, though, one of the advantages of——

Senator MARTINEZ. I will speak up for HUD as well.

[Laughter.]

Ms. BAIR. Absolutely. A lot of people. I think this council would be able to give voice to those concerns and have real authority to address them. I think that is one of the advantages of the council. I think the Administration proposal would put the FHFA on the council. And if you continue with these GSEs—I do not know what their future is, but if they continue—they clearly still represent tremendous systemic exposure. So I think this would be a prime area where in the past you would have had a mechanism where we could have forced some real action through this council. Going forward, if the GSEs continue to function this way, the regulators should be represented as well.

Ms. SCHAPIRO. I do not have much to add, although let me stand up for the SEC, long before I arrived, in their push for public reporting by the GSEs.

I do think Dan makes an excellent point about distinguishing the public and private roles and attendant consequences of having that public policy mission. It needs to be, I think, very transparent and well-understood by the marketplace.

Senator MARTINEZ. Well, I think the market, you know, when you put paper in the market and people invest, I do not know how that is ever a public role, really. I am not sure you can have private investors and a board of directors that is then beholden to the investors or to their public role. And that is my trouble with the whole idea of the GSEs the way they are chartered. So I think I for one would wonder how their future should really be and whether, in fact, they still have a role that ought to be as it has been in the past. Or should we very dramatically alter that going forward?

Thank you for your input, and thank you for being here this morning.

Senator WARNER. Senator Menendez.

Senator MENENDEZ. Well, thank you, Mr. Chairman. Thank you all for your testimony.

Let me ask, you know, for those of us who are struggling to define what the boundaries of systemic risk are, which is, I think, one of the key questions—and I know you have been asked some of these, and you have given some answers. But to me, it is more complicated than just the size of a firm or what business it is in, but how significant its activities are as well as how extensive its relationships are with other firms and consumers. So we have used very often "too-big-to-fail." Sometimes I wonder whether we should be looking at too interconnected to fail.

And in that respect, you know, should, for example, extensive relationships with small business and consumers count in defining systemic risk? By way of example, CIT. CIT is the largest lender to small businesses in America and has been in financial difficulties. It seems to me that unless an entity like that can find its way out of its financial difficulties, we are talking about hundreds of thousands of small businesses across the Nation who will not have the type of financing they need to conduct their activities, which is the greatest creator of jobs in the country at a time in which the country is desperately in need of jobs.

So how do we look, for example, at that? Is that an element of systemic risk? If it is, then define it for me a little better. If it is not, tell me why it is not.

Mr. TARULLO. So I will start, Senator. I do not think any of us probably wants to be speaking with reference to any particular entity, so let me just try to speak in more abstract terms.

I think we do need to draw a distinction between entities that are economically significant and entities that pose systemic financial risk. There are many entities in this country whose failure would have very adverse economic consequences on a lot of people who deal with them—a lot of employees, communities, suppliers, and the like—but that do not create systemic financial risk in the sense that their failure leads to a kind of immediate cascading effect, in which leverage that is consecutively held by a lot of institutions that have counterparty relationships with one another suddenly becomes a problem. As asset values deteriorate and margin calls increase, you have to put up more collateral or you have to sell assets because you do not have enough collateral to put up. That is the pattern that we saw with Bear, Lehman, and AIG, and, in fact, you can go back 11 years and say that is the pattern you saw with Long Term Capital Management.

Senator MENENDEZ. So a cascading of thousands of businesses that would not have access to capital would not be a systemic risk?

Mr. TARULLO. It would be a very severe economic problem, but the reason I would say it would not be a systemic financial risk is that it does not unwind essentially overnight or——

Senator MENENDEZ. So the automobile industry would fall in the same context as you are describing.

Mr. TARULLO. I think the judgment on the automobile industry was that, again, there were truly enormous costs, particularly in a situation in which the economy was headed down so quickly anyway, and I gather that is why the Administration and many Members of Congress thought that action should be taken.

But it did not pose a systemic financial risk even though it did impose substantial financial hardship. I do not think any of us wants to tell you that an approach to systemic risk will either prevent or mitigate all important economic——

Senator MENENDEZ. So let me take a different—I do not know if any of you want to jump in to that question, but let me take a different tack on that. So we are looking at a $3, $4 trillion commercial mortgage problem coming down the pike in a marketplace that at this point in time I am told by entities across the country there is no—largely speaking, in the private sector there is not the wherewithal for that market to take these mortgages that will be rolling over.

Now, having looked at our lack of action on the homeownership sign and what happened there, is that something that we think poses systemic risk? Or do you put it under your same category, may create enormous economic consequences but obviously does not have financial risk? Although I would say that if all those people default and cannot find a mortgage in the marketplace, those institutions will be holding a large number—maybe backed up by some degree of security with the properties, but they will have large numbers of defaults and less under a marketplace that has reduced in value and less than their holdings presently require. So what is that?

Mr. TARULLO. Well, I think it depends, Senator, again, on where the concentration is to be found and what the impact of the failure of an institution holding any form of exposure would be.

Let me just say with respect to commercial real estate, I agree with your assessment that it is a looming problem. It is a looming problem for communities and for economic performance generally. It is a looming problem for many financial institutions in this country. I do not know that one can classify it in and of itself as being a systemic risk or not being a systemic risk. It is surely an issue and a problem, which is why I think all the bank supervisors have been paying attention to the exposures. And now speaking only for the Fed, we extended the TALF program to commercial mortgages precisely because of the absence of credit flows and the absence of secondary markets there.

Ms. SCHAPIRO. Senator, I would just add briefly that I think there are—your question really points out something very important. We are very focused on systemically important institutions, but there are absolutely systemically risky practices that, if engaged in by a broad range of institutions, no one of which might be a systemically important institution, but those practices taken together across the marketplace as a whole absolutely have the potential to create broad systemic risk for the financial system at large.

Senator MENENDEZ. My time is up, but I will submit a question to you, Chairman Bair, about your FDIC-OCC dispute on big banks versus community banks, because I just do not quite understand that community banks that were not the cause of the challenges we face get hit at the same rate as entities that did create some of those risks and that have greater risk overall. So I do not quite get it, but I would love to hear the answer.

Senator WARNER. Thank you, Senator Menendez, and I would like to thank the panel. You have hung in for a long time and we will, I know, have additional questions which we will submit to you. Thank you all.

If we could go ahead and move to the second panel, and my thanks to the second panel's forbearance. If the second panel could move quickly to their seats so that we could move forward, I think we do have a vote, as I understand, coming up in the next 45 minutes, so we want to make sure folks get a chance to testify.

I am going to go ahead and introduce our panel, even though they are in the midst of still being seated. Vincent Reinhart has spent more than two decades working on domestic and international aspects of U.S. monetary policy. He served for the last 6 years of his Federal Reserve career as Secretary and Economist to the Federal Open Market Committee and has served in a variety of senior positions at the Federal Reserve. Mr. Reinhart, thank you for being here.

Paul Schott Stevens has served as President and Chief Executive Officer of the Investment Company Institute since June 2004. Outside ICI, Mr. Stevens' career has included varied roles in private law practices, corporate counsel, and in Government service. Mr. Stevens, thank you for being here, as well.

Alice Rivlin, as we all know, is the Senior Fellow in Economic Studies Programs at Brookings. She was the Founding Director of the CBO and has served as Director of the White House Office of Management and Budget. Alice, thank you for appearing here, as well.

Allan Meltzer is a Professor of Political Economy and Public Policy at the Carnegie Mellon University and is also a visiting scholar at AEI.

I don't normally get a chance to sit here in the chair. I don't want to mess it up too much, but recognizing that Senator Bunning said we actually may have a series of votes starting even earlier than 45 minutes from now, I would ask each of the panel, recognizing there are only three of us here still on this side of the dais, if they could make their statements relatively short so that we could make sure we could get a chance to ask questions.

Mr. Reinhart.

**STATEMENT OF VINCENT R. REINHART, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE**

Mr. REINHART. Thank you for the opportunity to testify today, even if it is late in the session. No doubt, the American people expect significant remedial action in the aftermath of the extraordinary Government support to financial institutions over the past year.

In my view, the Congress should form a committee of existing supervisors headed by an independent director, appointed by the President, and confirmed by the Senate. The director should have a budget for staff and real powers to compel cooperation among the constituent agencies and reporting from unregulated entities, if necessary. The constituent agencies should regularly be directed to draft reports in their areas of expertise for consideration by the full committee and transmittal to the Congress. This could include twice-a-year reports on financial stability from the Fed, appraisals of the health of the banking system from the FDIC, and assessments of the resilience of markets from the CFTC and the SEC.

I believe there are compelling reasons that the responsibility of the financial stability supervisor should not be given to the Fed. I worked in the Federal Reserve system for a quarter century and hold its staff in high esteem. But any group of people in an independent agency given too many goals will be pulled in too many directions. And there is one goal given to the Fed that should not be jeopardized, the pursuit of maximum employment and stable prices. Indeed, that goal is so pivotal that Congress should be thinking of narrowing, not broadening, the Fed's focus.

A financial stability committee could foster the achievement over time for robust rules on the resolution of private firms, simplification of the financial system, and consolidation of financial agencies. That is the opportunity for real, long-lasting benefits.

Senator WARNER. Thank you, Mr. Reinhart.

Mr. Stevens.

**STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CEO, INVESTMENT COMPANY INSTITUTE**

Mr. STEVENS. Thank you, Senator Warner, Senator Shelby, and Members of the Committee. You may recall I testified before the Committee in March and recommended at that time that the best way to approach systemic risk regulation would be to create a statutory council of senior Federal regulators. Such a body would be best equipped to look across the system and anticipate and address emerging threats to its stability.

As I thought about the challenge, I told the Committee that my model was the National Security Council, which Congress established in 1947 to coordinate and integrate, quote, "domestic foreign and military policies relating to the national security." From 1987 to 1989, I served on the NSC staff. I was its first legal advisor. I helped lead a reorganization of the NSC, of the system and of its staff, and I then served as Chief of the NSC staff under National Security Advisor Colin Powell.

Based on that experience, I believe an interagency council with a strong authority in a focused area, in this case monitoring and directing the response to risks that threaten overall financial stability, could, like the NSC, serve the Nation well in addressing complex and multifaceted risks.

The Administration has proposed creation of a Financial Services Oversight Council, but one that would have at best an advisory or consultative role. The lion's share of systemic risk authority would be vested in the Fed, and that approach strikes me as achieving the wrong balance. Most importantly, it fails to make meaningful use of the expertise and viewpoints of other regulators and it represents, as some Members of the Committee have observed, a very worrisome expansion of the Federal Reserve's authority over the Nation's entire financial system.

I would note my reading of the Administration's legislative proposals would, for example, suggest that dozens of mutual fund companies could conceivably be under scrutiny as Tier 1 Financial Holding Companies, a result that was, to say the least, surprising to me.

I would urge Congress instead to create a strong Systemic Risk Council, one with teeth. Effectively addressing risk to the financial system at large requires diverse inputs and perspectives. The standing membership of the council should include the core Federal regulators, within my judgment, the Treasury Secretary serving as Chair. For independence, the council should be supported by a very strong Executive Director appointed by the President and a small, highly experienced staff. For accountability, the council should be required to report regularly on its activities to the Congress.

By statute, the council should be charged with identifying risks and directing regulatory actions needed to mitigate them. Responsibility for addressing the risks should lie with the functional regulators, operating for this purpose only under the council's direction. The council would thus have clear authority, but over a very limited range of issues, only major unaddressed hazards, not day-to-day regulation.

This approach has several advantages. The council would enlist expertise across the spectrum of financial services. It would be well-suited to balancing competing interests. It would engage the functional regulators as full partners. At the same time, its independent staff could serve as a check on the functional regulators and avoid the regulatory capture that could result if one agency were set over all institutions deemed systemically risky or too-big-to-fail. And the council could be up and running quickly, while it might take years for any existing agency to assemble the requisite skills to oversee all areas of the financial system.

Critics of the model have said that convening a committee is not the best way to put out a fire, and that may be, but the goal of systemic risk regulation should be to prevent or contain fires before they consume our financial system, and a broad-based council surely is the very best body for designing a strong fire code.

Thank you for the opportunity to testify. I look forward to your questions.

Senator WARNER. Thank you for both getting your statements in under your time.

Ms. Rivlin, the Chairman is back. Let us see if we can keep this, you know, if I can show off a little bit to show that everybody gets through their statements quickly.

**STATEMENT OF ALICE M. RIVLIN, SENIOR FELLOW, ECONOMIC STUDIES, BROOKINGS INSTITUTION**

Ms. RIVLIN. We are on a roll here. Thank you, Mr. Chairman and Members of the Committee.

Controlling systemic risk breaks into two questions, I think, how to avoid the excesses of a bubble economy that can burst and cause a catastrophic downward spiral, and second, how to make sure that if a large interconnected institution fails, it doesn't start that downward spiral and take others with it.

On the first question, how to prevent the excesses of a bubble, we need to fix regulatory gaps. Ineffective regulation contributed to the excesses and allowed lax lending standards and all of the things that we have worried about. And we need to correct the perverse incentives that crept into the system, as with the originate-to-distribute model.

That can be done, correcting the gaps and perverse incentives, but however we do that, the job is not over. Participants in the financial system will try to avoid the rules, whatever they are. The system will need constant monitoring to make sure that new gaps and perverse incentives are not creeping in that lead to new excesses and instability.

So I think one job is this monitoring function. The Obama Administration would put this function with a Financial Oversight Council chaired by the Treasury but with its own staff. I think it would make more sense to put this function at the Federal Reserve, perhaps consulting with a council. The Fed has the clear overview of the whole economy. It fits with the job that they already have for monitoring the economy and the health of the banking system.

I would also give the Fed another tool, broader control of the amount of leverage in the system. Bubbles get out of hand when demand is fueled by big increases in speculation with other people's money. The short-term interest rate is not a sufficient tool for controlling as that price bubbles. So I would recommend working out a system in which not only capital requirements, but other constraints on leverage across the system could be tightened in the face of a serious bubble threat.

Then there is the problem of the large interconnected institution. This can be mitigated by making it more expensive to get big, having capital requirements rise as institutions grow, for instance. We need much more effective prudential regulation of all financial institutions, especially as they get big enough to threaten the system.

The Obama Administration proposes designating institutions that pose systemic risk and giving the Fed responsibility for consolidated prudential regulation of what they call Tier 1 Financial Holding Companies. I think both parts of that proposition would be a mistake.

We should not designate institutions as too-big-to-fail and give them their own regulator. It is hard to make up that list. But we would also be creating a new set of GSEs. There is a danger that the regulator of too-big-to-fail institutions would see its job as keeping them from failing and the result would eventually be expensive bailouts.

Second, I would definitely not put additional regulatory responsibility at the Federal Reserve. The Fed is very good at monetary policy. It should be headed and staffed by strong macroeconomists who are charged with keeping on top of economic developments. These are different skills from regulation and I think putting an additional regulatory responsibility which they have historically not been very good at at the Fed would dilute their monetary policy focus.

I also fear that adding a new set of regulatory authorities to the Fed's task would threaten the independence of monetary policy, which is very important to preserve. Congress would justifiably want more control over such a powerful agency, appropriations, accountability for policy, and so forth. It might easily threaten the independence of the Federal Reserve in taking unpopular decisions to rein in the bubble economy.

Thank you, Mr. Chairman.

Senator WARNER. Professor Meltzer.

**STATEMENT OF ALLAN H. MELTZER, PROFESSOR OF POLITICAL ECONOMY, TEPPER SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY**

Mr. MELTZER. Mr. Chairman, Senator Shelby, thank you for the opportunity to be here. I believe that effective regulation should await evidence and conclusions about the causes of the recent crisis. There are so many assertions about those causes that Congress should want to avoid a rush to regulate.

During much of the past 15 years, I have written three volumes entitled *The History of the Federal Reserve.* Working with several assistants, we have read virtually all of the minutes of the Board of Governors, the Federal Open Market Committee, the Directors of the Federal Reserve Bank of New York, staff papers, internal memos, and so on. I speak from that perspective. I speak also from experience in Japan, where I served as the honorary advisor to the

Bank of Japan during the 1990s when they were undergoing their banking and financial crisis.

First, I do not know of any clear examples in the history of the Federal Reserve in which the Federal Reserve acted in advance of a crisis or a series of banking and financial failures. I have had the privilege of working with various Secretaries of the Treasury. Here is how the problem presents itself to them.

There are a group of people who say, if you don't do the bailout now, you are going to have a crisis and it will go down in the history books with your name on it. There will be a few people who will say—very few, I may say—who will say, let the failing institution fail and make sure that you protect the market from having the failure spread. That is a question that really is at the center of this. It is not whether we should get rid of "too-big-to-fail." I think many people recognize that "too-big-to-fail" is a disaster. What we need to worry about is how do we prevent problems from spreading. I am pleased to see that there is a good deal of skepticism among the Members of the Committee about simply appointing another regulator and saying to them, do what Secretaries of the Treasury, Chairmen of the Federal Reserve have done historically. That won't work.

There are three things which I think are central to any such discussion. First is the question of incentives. How do we make incentives for prudent behavior on the part of bankers? We let them fail.

Second, how do we make sure that bankers will not want to fail? We tell them you can fail and the best way to avoid failure is to hold capital. We need to buildup the capital. In the 1920s, banks everywhere had much more capital than they do now. A bank's window said, some of you may remember, listed the paid-in surplus and capital. By the 1950s, that was gone and it said, "Member FDIC." That was a change in attitude. So we need to worry about capital.

And last but something that I have not heard here but which should be part of your discussion is we need a lender of last resort proposal. The Federal Reserve in 96 years has never clearly enunciated what its role as lender of last resort is. It must be a role that the Congress will accept. No role will be viable if the Congress doesn't accept it. But there must be such a rule and that rule should say, hold capital and hold negotiable assets that you can sell to the Federal Reserve at the discount window what they will accept. That is the way in which we keep crises from spreading. We say, you are responsible as a banker and you must hold capital to protect yourself and you must have negotiable assets that you can sell to the Federal Reserve discount window because that is what it is there for. Without that, we won't have safety.

What difference will there be if we establish one of these super-regulators? Why will they behave differently than the Treasury Secretaries that I have talked about, Federal Reserve Chairmen? Why will they not say about the Tier 1 risk people, you are too-big-to-fail. We can't allow that to happen. We have to use taxpayer money to bail you out. I don't believe that it will work.

The first law of regulation—my first law of regulation is regulators make rules. Markets learn to circumvent them. You have heard lots of examples of that. It is a dynamic process. There is no set of rules which is going to for all time regulate this process. We need to change the incentives and the incentives have to be, you fail, we protect the market.

Senator WARNER. Thank you all for your testimony. Thank you for your abbreviated testimony.

If I ever get a chance to sit here again, I am not going to go first, Chairman Dodd.

[Laughter.]

Chairman DODD [presiding]. He has got a future in the Senate, I would say.

[Laughter.]

Chairman DODD. Thank you, Mark, very much, and thanks for chairing the Committee for a few minutes.

Well, thank all of you. What a wealth of talent at this table and a wealth of experience, as well. You really offer some very great counsel and advice to us as we try to navigate these waters. I think all of us, as I said earlier, are very conscious of the fact that this is a tremendous challenge and we want to get it right.

I think you have heard a number of us make the point that, unlike other efforts ongoing today, this is one that is almost devoid of ideology as we are looking at it and how do we do this in a way that is going to provide the kind of confidence-building measures that are so critical for the stability of our financial institutions, and that word "confidence" more than anything else is one that—I don't know of any specific formula that gets you there. It is one of those items that you know it when you have it and you know it when you don't, and trying to create through this process, even the process itself we are going through, I hope has some confidence-building qualities to it, as the Committee of primary jurisdiction over these matters to what steps do we take in order to reestablish that level of confidence.

On the part of all the consumers and users of financial services, from the shareholder to the borrower to the depositor to the policy holder, all of whom have different assumptions of risk as they engage in financial activities, but essential in all of them, weaving its way through each one of them is confidence—confidence the system is going to work, that it is going to be there to protect them, that they are going to be safe, not that they necessarily have a guaranteed return on the activities they engage in, but the system won't fail them. They may make a bad bet, but it is not because the system was corrupt or fell apart on them. And so that is really, I think, what we are all trying to achieve in this.

Senator Shelby chaired this Committee and has a strong understanding and sense of it. People like Mark Warner and Jim Bunning, Mark has had a great background and experience in this in his private life, and Jim Bunning was ahead of the curve on this Committee, working with others on the Committee, identifying very early on the issue of the residential mortgages. So there has been a lot of history on the Committee going back, so we are appreciative of it.

And let me start with a question you have somewhat addressed already. The Fed has long argued that its prudential supervisory regulatory powers over banks and holding companies are critical to the effectiveness of its monetary policy, that they are interrelated, and three out of the four of you have experience at the Fed. Given your own past roles in setting and executing monetary policy at the Fed, we would like to hear your views on this. This idea that you can separate and distinguish in those roles is one that really is not wise.

And a follow-up, Dr. Meltzer. Based on your study of the Federal Reserve's history, do you see the Fed's bank supervisory role as critical to its monetary policy function, as well——

Mr. MELTZER. No, sir, and the staff has told them many times the answer is it really is unrelated. I mean, they can get the information from the other agencies. The reason the Fed, I believe, the reason the Fed wants supervisory authority is because it wants a coalition of people to protect themselves against pressures that come from the Administration and Congress. It wants people who know about the Fed, that want to protect its monetary policy responsibilities and they have used it in that way.

At one time in the history, the Committee, your Committee—not you, but your Committee got very angry at Chairman Burns because of the extent to which he had used that mechanism to protect himself against something that the Congress wanted to do.

Chairman DODD. Alice.

Ms. RIVLIN. I don't think that the supervising individual banks is important to making monetary policy. I know that was said around the table when I was at the Fed, but I didn't really experience that we learned a lot from the supervising particular banking institutions that was useful to monetary policy.

What is important is for the Fed to have access to information about how things are going and that is why I think the monitoring function of being in charge of monitoring for systemic risk is—they ought to be doing that anyway, but to give them that formal responsibility, I think, would be helpful. But I don't think they have to supervise individual institutions. In fact, I think it would be bad to do that.

Chairman DODD. Let me ask you this, Alice, and the question has been raised with others and you may have addressed it before I walked back in in your statements, and that is the potential conflict. Given the principal function and responsibility of the Fed of monetary policy—and I don't think anyone disagrees, that is the primary responsibility—is there not the risk of being in conflict from time to time when you are asked to be both simultaneously the systemic risk regulator and functioning as the fundamental, chief responsibility of monetary policy, where you could actually—you are letting one trump the other. There are not necessarily going to be consistent objectives at given moments in time.

Ms. RIVLIN. That could be true. I think the more important point, though, is that they are different skills. If you really want a set of people who are good at regulating institutions and helping them not make stupid decisions, then it is a different kind of staff and leadership than the people who are good at macroeconomics and figuring out what to do about the economy.

Chairman DODD. Yes. Mr. Reinhart, do you have a view on this?

Mr. REINHART. Sure, a couple points. One is when you give an entity that has macropowers a supervisory responsibility, they have the ability to clean up their mistakes after the fact. Would a

Fed that can lend to an institution be more willing to lend to it when it hadn't identified it as a systemic threat? Would it be willing to use its monetary policy tool to make markets function better in an environment where it had failed to identify some market areas as posing systemic risk?

Now, for 6 years, I signed off on the minutes and transcripts of the Federal Open Market Committee, a wonderful resource actually giving the details of deliberations of monetary policy. And the next time you hear someone say there is important cross-pollination between monetary policy decisions and bank supervision, you should ask them to go back to the FOMC transcripts and give you the examples where there was a significant discussion about bank supervisory matters that informed the monetary policy decision.

The fact is, as has already been noted, an agency is filled with hardened silos and the economists don't talk to the lawyers who don't talk to the bank supervisors. What is important is to enforce an information sharing, and in some ways, it is easier to do that across agencies than within an agency.

Chairman DODD. Paul, I want to give you a quick chance to respond to that. My time is up, but it is good to see you and thanks for being here.

Mr. STEVENS. Thank you, Chairman Dodd. Lacking the experience that my colleagues have at the Fed, I will pass on that question.

Chairman DODD. All right.

Mr. MELTZER. Mr. Chairman, may I just say, Congress passed FDICIA to try to prevent exactly what you just described. They have not used FDICIA.

Chairman DODD. Good point.

Senator Shelby.

Senator SHELBY. Dr. Reinhart, you were the Director, it is my understanding, of the Division of Monetary Policy at the Fed.

Mr. REINHART. Yes, sir.

Senator SHELBY. And from what I gather from your testimony, you do not believe the Fed needs to regulate financial institutions in order to conduct or perform its monetary policy functions, do you, or do you not?

Mr. REINHART. Yes. I think the Fed needs an understanding, a deep understanding of the ways markets work, about the way the institutions work in general. They need to share information from other agencies. But the talents to be able to tell a macrostory to fit all those parts of the picture together for the implications for policy are not ones that need supervision.

Senator SHELBY. Dr. Meltzer, in your testimony, you question the wisdom of relying too much on capital standards to guard against systemic risk. You point out the problems of the Basel Accord that they caused. You also note that banks have been very successful in circumventing regulation, which we see. My question to you, are there limits on how much Congress can manage systemic risk through regulation, and if so, what measures can be adopted to create incentives for the private sector to better manage risk?

Mr. MELTZER. Two critical things. Get rid of "too-big-to-fail" and replace it with more capital in the banks.

Second, get a lender of last resort rule that you are willing to live with, that the Fed is willing to live with, that the regulators are willing to live with, which says institutions can fail. The market will be protected from the spread of that failure to other institutions. Without those changes, no regulation is going to work.

I gave this talk at the council on Foreign Relations and I said, lawyers make regulations. Markets learn to circumvent them. The first question was from a lawyer. He said, it is we lawyers who teach them how to circumvent them.

Senator SHELBY. You have got it right.

Doctor, in your examination of history, has the Federal Reserve demonstrated that it is inherently better at identifying systemic risk than any other regulator?

Mr. MELTZER. It is hard to identify systemic risk. You know, the term "systemic risk" is a term of art. I mean, it is indeed a term of art, because as the questions on the Committee showed earlier, every Congressman, every Senator will see—properly see—a failing institution in his region as a problem which is systemic. How are they going to fight that? I mean, you, Senator, along with many people argued against the GSEs——

Senator SHELBY. That is right.

Mr. MELTZER. ——thought that something had to be done. But Congress wasn't going to do that. Is a systemic regulator going to say, ignore Congress and do that? Is that what we want? No. Is it possible? I don't believe it is possible in the American system of Government, nor do I think it should be possible in the American system of Government for people to say the Congress doesn't have a right even to make the mistakes that it makes.

Senator SHELBY. Ms. Rivlin, the Fed's wide-ranging responsibilities seem to me to appear at times to distract it from its primary mission of monetary policy. For example, just the other day, the topics covered at our recent Humphrey-Hawkins hearing demonstrate this point. While the discussion should have centered on monetary policy, by our count, only about 27 percent of the questions even addressed monetary policy from this Committee. How concerned are you that we may be asking one institution to do too much?

Ms. RIVLIN. I am very concerned, Senator Shelby, and that is why I don't think it is a good idea to have a new responsibility for "too-big-to-fail" institutions at the Fed or indeed to identify those institutions at all. I am not sure that the Humphrey-Hawkins questioning, since we are in the middle of a catastrophe and there were all sorts of things to ask about, is exactly an example of that, but I do fear that we will distract the Fed from monetary policy.

Senator SHELBY. Thank you very much. Thank you, Mr. Chairman.

Senator WARNER [presiding]. Senator Reed.

Senator REED. Thank you, Mr. Chairman, and thank you for your testimony today and for your answers.

As the President's plan evolves, if it is not modified, the Federal Reserve essentially would be the direct regulator of most of the major financial institutions of the country. It would eliminate OTS, *et cetera.* There has been the suggestion here, or at least the recommendation, that they get out of the business of regulating banks. But then I would presume they would still have the authority, in fact, the responsibility to regulate the holding company structure, the subsidiaries, the affiliates where a lot of the problems really evolved. Is that your sense, Mr. Reinhart?

Mr. REINHART. That is why actually I would be a strong proponent of simplification of the rules, consolidation of the agencies, and putting in place a forceful resolution mechanism for entities. So my preference would be to roll in the existing agencies, including the supervisory part of the Federal Reserve for holding companies, into a new Federal regulator.

Senator REED. Mr. Stevens, do you have an opinion?

Mr. STEVENS. Yes. Thank you, Senator. I had an occasion to look through, at least briefly, the Administration's legislative language and the entities that would be vetted to determine whether they are Tier 1 Financial Holding Companies, at least potentially, represent an enormous universe of firms—$10 billion or more in assets, $100 billion or more in assets under management, $2 billion or more in gross annual revenue. All of those firms would be potentially subject to review for whether they should be designated Tier 1 Financial Holding Companies under a series of standards, the last of which is any other factor that the Fed thinks is important.

So I don't know, reading the legislation, what the universe of Fed-regulated entities will be, but it is potentially enormously large. I asked our research department, how many mutual fund firms are there, through their mutual funds or other asset management activities, that may have $100 billion or more in assets under management, and as I said in my statement, our best guess is that there are dozens of them, many of whom would be quite surprised to learn that they are systemically risky, none of whom thinks that they are too-big-to-fail.

Senator REED. Dr. Rivlin.

Ms. RIVLIN. I would go with Mr. Reinhart on this. Moving to a consolidated regulator with less potential for regulatory arbitrage would seem to me fine, and moving the regulation of bank holding companies out of the Fed would also seem to me fine. But the real point is, don't make it worse. Don't put a huge new regulatory responsibility at the Federal Reserve.

Senator REED. And Dr. Meltzer.

Mr. MELTZER. Senator, I don't have any quarrel with Vince Reinhart's proposal. I would say that if you look around the world, we have separation of regulation and monetary policy. We have it together. It doesn't seem to make a great deal of difference. That is, for the failures that we have, why is that? Because we lack the incentives on the regulators to close down "too-big-to-fail" and protect the market.

Senator REED. And your proposal is, I think, a very direct response to that, which would be to have higher capital levels which presumably smaller institutions could result or would result from that.

One other question, because it is implicit, I think, in what we are talking about in terms of dealing with derivatives, *et cetera,* and that is establishing capital ratios for risky operations. Can you comment on that approach, too?

Mr. MELTZER. Yes. I would say, let the institution choose its size, but increase the capital requirement more than proportional to the size of the assets so that we—the reason I want that is I want the stockholders and the management to bear the losses. There is no gain in economies of scale and economies of scope that the public is going to realize from large institutions that compensates for the costs we just paid. So we want the costs to be on them, and that gives them an incentive not to do the things they have been doing.

Senator REED. Thank you, Mr. Chairman. Thank you.

Senator WARNER. A vote has started and——

Senator BUNNING. I am going to be very short. I have got one question, because I have waited for this panel a long time.

[Laughter.]

Senator BUNNING. This is for anybody that would like to answer. Do you think the Federal Reserve would do a better job at monetary policy if its only mission was keeping a stable currency?

Mr. MELTZER. I will start with that. I believe—I like the dual requirement. I think that represents what all central banks, whatever their requirements are, all central banks have to be concerned about what is happening to the public. But they also need to have much more attention on maintaining price stability. I think the Committee needs to say, we are going to require the Federal Reserve to adopt some principle by which they operate that limits their discretion to make the mistakes that they have been making.

Senator BUNNING. Thank you, because they don't pay any attention to us. Go ahead.

Mr. MELTZER. They do it if it is in the law.

Senator BUNNING. Well, even if we write it into the law, they don't do it, because in 1994, we wrote it into the law that they monitor all mortgages within the banking system that they control and within the mortgage brokers. And for 14 years, they didn't write a regulation.

Alice.

Ms. RIVLIN. I would actually keep the dual focus on employment, as well as inflation.

Senator BUNNING. OK.

Ms. RIVLIN. And I think the Fed gets pretty high marks, actually, on the inflation front, as do other central banks over the last few years.

Senator BUNNING. Depending on who is scoring.

Ms. RIVLIN. Well, OK, but we have not had a big inflation problem. Now, maybe the Fed doesn't get all the credit for it, but it is not that they haven't paid attention on that front. They may not have paid attention——

Senator BUNNING. Oh, I didn't say they didn't pay attention, but they failed to act is all I can tell you.

Go ahead.

Mr. STEVENS. Senator, all I would say, not being the Fed expert here, is——

Senator BUNNING. You don't have to be a Fed expert to understand.

Mr. STEVENS. ——at least there is a strong question to ask—why the authority should be so dramatically expanded.

Senator BUNNING. OK.

Mr. REINHART. I believe the Fed Reserve would be better off if it had a narrow mandate. Maximum employment and stable prices sounds right to me. I think are many reasons why that would be better, including keeping the focus of the institution, also providing——

Senator BUNNING. Rather than expanding their portfolio.

Mr. REINHART. Certainly not expanding. Also making it clearer to the public exactly what the Federal Reserve does and improving the relationships with the Congress.

Senator BUNNING. That would take a lot of work.

Mr. REINHART. If it was narrowly focused. When you think about it, a lot of these hearings get consumed by issues other than monetary policy.

Senator BUNNING. When they came to us, when they asked for the TARP money and said, this is going to be as transparent as anything that we have ever dealt with, and they have completely stonewalled who they lent the money to, how much money they printed, and what banks got it and what they spent it for. So transparency is out the door.

Thank you for your answers. Thank you.

Senator WARNER. Well, I am not going to get a chance to ask my questions. That is the last time I will take this middle position here as the temporary Chair. But just two quick comments because we are going to have to run off and vote.

One, thank you all very much for your testimony this morning. My apologies that the session started late. We will, I am sure, all have additional questions.

I share the overwhelming view of the panel that systemic risk ought to not be placed with the Fed and ought to be empowered with a new independent council that includes the Fed. I also would like to hear a longer—a written question I will submit. I do believe we ought to further explore the idea of a single end-to-end depository regulator for all prudential regulation and take that out of the Fed and out of the FDIC as well as the consolidation of the OCC and OTS.

And I do share Professor Meltzer's concerns about how we put stumbling blocks in front of "too-big-to-fail." Increased capital, obviously one. I think we have to look at increased capital on resolution and whether even a contingent liability fund inside firms of "too-large" that might actually cause some self-policing among those institutions.

The question I will also submit to you is whether those nontraditional banking activities, as more and more of these large bank holding companies look like hedge funds, look like trading funds, have all these other nontraditional banking aspects, should there be higher capital requirements on those what would be arguably riskier activities. But I will submit those as questions and look forward to your answers.

I again thank the panel for their patience and indulgence. Thank you all very much.

The hearing is adjourned.

[Whereupon, at 12:44 p.m., the hearing was adjourned.]

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

## PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

The economic crisis introduced a new term to our national vocabulary—systemic risk. It is the idea that in an interconnected global economy, it's easy for some people's problems to become everybody's problems.

The failures that destroyed some of our Nation's most prestigious financial institutions also devastated the economic security of millions of working Americans who did nothing wrong—their jobs, homes, retirement security, gone in a flash because of Wall Street greed and regulatory neglect.

After years of focusing on short term profits while ignoring long term risks, a number of companies, giants of the financial industry found themselves in serious trouble.

Some failed. Some were sold under duress. And an untold number only survived because of Government intervention: loans, guarantees, and direct injections of capital.

Taxpayers had no choice but to step in, assuming billions of dollars of risk, and save companies because our system wasn't set up to withstand their failure. These efforts saved our economy from catastrophe, but real damage remains.

Investors, who lost billions, were scared to invest. Credit markets dried up. With no one willing to make loans, businesses couldn't make payroll, employees were laid off, and families couldn't get mortgages or loans to buy an automobile.

Wall Street's failures have hit Main Streets across the country. It will take years, perhaps decades, to undo damage that a stronger regulatory system could have prevented.

While many Americans understand why we had to take extraordinary measures this time, it doesn't mean they aren't angry. It doesn't mean they aren't worried. And it doesn't mean they don't expect us to fix the problems that allowed this to happen.

First and foremost, we need somebody looking at the whole economy for the next big problem, with the authority to do something about it.

The Administration has a bold proposal to modernize our financial regulatory system. It would give the Federal Reserve new authority to identify, regulate, and supervise all financial companies considered to be systemically important.

It would establish a council of regulators to serve in a solely advisory role.

And it would provide a framework for companies to fail, if they must fail, in a way that does not jeopardize the entire financial system.

It's a thoughtful proposal. But the devil is in the details and I expect changes to be made.

I share my colleagues' concerns about giving the Fed additional authority to regulate systemic risk.

The Fed hasn't done a perfect job with the responsibilities it already has.

This new authority could compromise the independence the Fed needs to carry out effective monetary policy.

Additionally, systemic risk regulation involves too broad of a range of issues for any one regulator to oversee.

And so, I am especially interested to hear from our witnesses your ideas on how we get this right.

Many of you have suggested a council with real authority that would effectively use the combined knowledge of all of the regulatory agencies.

As President Obama has said, when we rebuild our economy, we must ensure that its foundation rests on rock, not on sand. Today, we continue our work to lay the cornerstones for that foundation—strong, smart, effective regulation that protects working families without hindering growth.

## PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you Mr. Chairman.

At the core of the Administration's financial regulatory reform proposal is the concept of systemic risk. The President believes that it can be regulated and that the Fed should be the regulator.

As we begin to consider how to address systemic risk, my main concern is that while there appears to be a growing consensus on the need for a systemic risk regulator, there is no agreement on how to define systemic risk, let alone how to manage it.

I believe that it would be legislative malfeasance to simply tell a particular regulator to manage all financial risks without having reached some consensus on what systemic risk is and whether it can be regulated at all.

Should we reach such a consensus, we then must be very careful not to give our markets a false sense of security that could actually exacerbate our "too-big-to-fail" problem.

If market participants believe that they no longer have to closely monitor risks presented by financial institutions, the stage will be set for our next economic crisis.

If we can decide what systemic risk is and that it is something that should and can be regulated, our next question should be: Who should regulate it?

Unfortunately, the Administration's proposal largely places the Federal Reserve in charge of regulating systemic risk.

It would grant the Fed authority to regulate any bank, securities firm, insurer, investment fund or any other type of financial institution that the Fed deems a systemic risk.

The Fed would be able to regulate any aspect of these firms, even over the objections of other regulators. In effect, the Fed would become a regulatory leviathan of unprecedented size and scope.

I believe that expanding the Fed's powers in this manner could be very dangerous.

The mixing of monetary policy and bank regulation has proven to be a formula for taxpayer-funded bailouts and poor monetary policy decisions.

Giving the Fed ultimate responsibility for the regulation of systemically important firms will provide further incentive for the Fed to hide its regulatory failures by bailing out troubled firms.

Rather than undertaking the politically painful task of resolving failed institutions, the Fed could take the easy way out and rescue them by using its lender-of-last-resort facilities or open market operations.

Even worse, it could undertake these bailouts without having to obtain the approval of Congress.

In our system of Government, elected-officials should make decisions about fiscal policy and the use of taxpayer dollars, not unelected central bankers.

Handing over the public purse to an enhanced Fed is simply inconsistent with the principles of democratic Government.

Augmenting the Federal Reserve's authority also risks burdening it with more responsibility than one institution can reasonably be expected to handle.

In fact, the Federal Reserve is already overburdened with its responsibility for monetary policy, the payment system, consumer protection, and bank supervision.

I believe anointing the Fed as the systemic risk regulator will make what has proven to be a bad bank regulator even worse.

Let us not forget that it was the Fed that pushed for the adoption of the flawed Basel II capital accords, which would have drained our banking system of capital.

It was the Fed that failed to adequately supervise Citigroup and Bank of America, setting the stage for bailouts in excess of $400 billion.

It was the Fed that failed to adopt mortgage underwriting guidelines until well after this crisis was underway.

It was the Fed that said there was no need to regulate derivatives.

It was also the Fed that lobbied to become the regulator of financial holding companies as part of Gramm-Leach-Bliley.

The Fed won that fight and got the additional authority it sought. Ten years later, however, it is clear that the Fed has proven that it is incapable of handling that responsibility.

Ultimately, if we are able to reach some sort of agreement on systemic risk and whether it can be managed, I strongly believe that we should consider every possible alternative to the Fed as the systemic risk regulator.

Thank you Mr. Chairman.

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## PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you Mr. Chairman for holding today's hearing. Hearings like this will be important as the Committee prepares to consider legislation to modernize our financial regulatory system and establish a mechanism to identify systemic risks to our economy.

There is widespread agreement that institutions exploiting gaps in our regulatory system greatly contributed to the current economic crisis. These institutions, while oftentimes large and complex, were able to offer products with minimal regulation and operate with little oversight. The scope of the economic crisis is indicative of the breadth of the gaps in our regulatory system.

Many have suggested that the best way to close these gaps is through the creation of an entity to oversee systemically risky firms, what some have termed "too-big-to-fail." This entity could watch, evaluate, and when necessary, intervene to prevent failures of large firms from leading to an economy-wide meltdown.

That said, we must be able to identify systemic risks without creating unnecessary regulation and without giving large firms the idea that the Federal Government is there to bail them out if they make poor decisions. A systemic risk regulator would have to put taxpayer protection at the top of its priority list.

It is my hope that Members of this Committee from both sides of the aisle can find a proposal to better monitor systemic risk, whether within an existing agency or with the creation of a new entity. Regardless of who does it, we need to identify systemic risk in our financial markets to prevent another crisis like the one we are experiencing from happening again and to aid in our economic recovery and reform. We must get this right. I look forward to hearing from today's witnesses.

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## PREPARED STATEMENT OF SENATOR JACK REED

Today's hearing will help us create a new framework for identifying and minimizing systemic risks, so that we can prevent our financial markets from ever again facing the turmoil we have witnessed over the last year. We need to be thoughtful and deliberate in our approach, but we need to act soon. As part of this process, we should think carefully about some key remaining questions.

First, there seems to be a consensus emerging among regulators and many in Congress on the need for a Council to address risks in the financial system. But my colleagues and I will need to think carefully about the specific role and tools available to such a Council. The Administration's proposal would establish a Financial Services Oversight Council, to be chaired by Treasury and consisting of the banking, securities, and other financial regulators.

Such an approach gathers the right people around the table but may leave them with no "teeth" to intervene to prevent or react to problems. Much of the responsibility for setting standards would remain with the Federal Reserve, which raises serious concerns given its failure in recent years to identify serious risks to our financial system, and the agency's inaction on consumer protection issues.

Second, under the Administration's plan, there would be heightened supervision and consolidation of all large, interconnected financial firms, including a process for identifying Tier 1 financial holding companies. This approach has merit, but requires careful consideration, especially as it would apply to firms that have operated under various exemptions and grandfathering provisions. We will also need to carefully consider if and how to identify Tier 1 firms on an ongoing basis. Today's hearing will allow for the consideration of the best approach in this area, including whether it is best done by a Council or a single regulator.

Finally, among the issues we should consider is the Administration's proposal to enhance the Federal Reserve's authority with respect to the safety and soundness of systemically important payment, clearing, and settlement arrangements. This issue is of particular importance because of the role of these systems in increasing regulation of over-the-counter derivatives, and the existing responsibilities of the SEC and the CFTC in this area.

I appreciate the testimony of the witnesses today and I look forward to discussing these important questions.

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## PREPARED STATEMENT OF SENATOR JIM BUNNING

Thank you, Mr. Chairman.

As I have said several times before, I do not think we can create a new regulator that will be able to outsmart Wall Street and prevent future financial failures. And I know the Federal Reserve is not up to the task. In fact, the Fed needs to be reformed so it can get monetary policy right and not create future bubbles through easy money.

Instead of putting all our faith in a super regulator, I think we are better off taking steps to reduce the damage done by future failures. That means making financial institutions smaller, reducing risk factors like leverage, banning some risky practices, sound supervision, and making financial actors live with the consequences of their actions. That also means treating similar activities the same way no matter if they are done by a bank, broker, or other firm, and ending regulation shopping. If we do these things, we will greatly reduce the impact of future failures.

Finally, of all the proposals we have seen, the one outlined in Chairman Bair's testimony today makes the most sense so far. While I think there are other matters that need to be addressed and I may not agree with everything she proposes, I think her plan is a better starting point than the proposal from Treasury and the Fed.

Thank you, Mr. Chairman. I look forward to hearing from the witnesses today.

## PREPARED STATEMENT OF SHEILA C. BAIR

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

JULY 23, 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 importance of reforming our financial regulatory system. The issues under discussion today rival in importance those before the Congress in the wake of the Great Depression.

The proposals put forth by the Administration regarding the structure of the financial system, the supervision of financial entities, the protection of consumers, and the resolution of organizations that pose a systemic risk to the economy provide a useful framework for discussion of areas in vital need of reform. However, these are complex issues that can be addressed in a number of different ways. We all agree that we must get this right and enact regulatory reforms that address the fundamental causes of the current crisis within a carefully constructed framework that guards against future crises.

It is clear that one of these causes was the presence of significant regulatory gaps within the financial system. Differences in the regulation of capital, leverage, complex financial instruments, and consumer protection provided an environment in which regulatory arbitrage became rampant. Reforms are urgently needed to close these regulatory gaps.

At the same time, we must recognize that much of the risk in recent years was built up, within and around, financial firms that were already subject to extensive regulation and prudential supervision. One of the lessons of the past several years is that regulation and prudential supervision alone are not sufficient to control risk taking within a dynamic and complex financial system. Robust and credible mechanisms to ensure that market participants will actively monitor and control risk taking must be in place.

We must find ways to impose greater market discipline on systemically important institutions. In a properly functioning market economy there will be winners and losers, and when firms—through their own mismanagement and excessive risk taking—are no longer viable, they should fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the market's incentive to monitor the actions of similarly situated firms. Unfortunately, the actions taken during the past year have reinforced the idea that some financial organizations are too-big-to-fail. The solution must involve a practical, effective and highly credible 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."

The notion of "too-big-to-fail" creates a vicious circle that needs to be broken. Large firms are able to raise huge amounts of debt and equity and are given access to the credit markets at favorable terms without consideration of the firms' risk profile. Investors and creditors believe their exposure is minimal since they also believe the Government will not allow these firms to fail. The large firms leverage these funds and become even larger, which makes investors and creditors more complacent and more likely to extend credit and funds without fear of losses. In some respects, investors, creditors, and the firms themselves are making a bet that they are immune from the risks of failure and loss because they have become too big, believing that regulators will avoid taking action for fear of the repercussions on the broader market and economy.

If anything is to be learned from this financial crisis, it is that market discipline must be more than a philosophy to ward off appropriate regulation during good times. It must be enforced during difficult times. Given this, we need to develop a resolution regime that provides for the orderly wind-down of large, systemically important financial firms, without imposing large costs to the taxpayers. In contrast to the current situation, this new regime would not focus on propping up the current firm and its management. Instead, under the proposed authority, the resolution would concentrate on maintaining the liquidity and key activities of the organization so that the entity can be resolved in an orderly fashion without disrupting the functioning of the financial system. Losses would be borne by the stockholders and bondholders of the holding company, and senior management would be replaced. Without a new comprehensive resolution regime, we will be forced to repeat the costly, *ad hoc* responses of the last year.

My testimony discusses ways to address and improve the supervision of systemically important institutions and the identification of issues that pose risks to the financial system. The new structure should address such issues as the industry's excessive leverage, inadequate capital, and overreliance on short-term funding. In addition, the regulatory structure should ensure real corporate separateness and the separation of the bank's management, employees, and systems from those affiliates. Risky activities, such as proprietary and hedge fund trading, should be kept outside of insured banks and subject to enhanced capital requirements.

Although regulatory gaps clearly need to be addressed, supervisory changes alone are not enough to address these problems. Accordingly, policy makers should focus on the elements necessary to create a credible resolution regime that can effectively address the resolution of financial institutions regardless of their size or complexity and assure that shareholders and creditors absorb losses before the Government. This mechanism is at the heart of our proposals—a bank and bank holding company resolution facility that will impose losses on shareholders and unsecured debt investors, while maintaining financial market stability and minimizing systemic consequences for the national and international economy. The credibility of this resolution mechanism would be further enhanced by the requirement that each bank holding company with subsidiaries engaged in nonbanking financial activities would be required to have, under rules established by the FDIC, a resolution plan that would be annually updated and published for the benefit of market participants and other customers.

The combined enhanced supervision and unequivocal prospect of an orderly resolution will go a long way to assuring that the problems of the last several years are not repeated and that any problems that do arise can be handled without cost to the taxpayer.

**Improving Supervision and Regulation**

The widespread economic damage that has occurred over the past 2 years 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. Our current system clearly failed in many instances to manage risk properly and to provide stability. Many of the systemically significant entities that have needed Federal assistance were already subject to extensive Federal supervision. For various reasons, these powers were not used effectively and, as a consequence, supervision was not sufficiently proactive.

Insufficient attention was paid to the adequacy of complex institutions' risk management capabilities. Too much reliance was placed on mathematical models to drive risk management decisions. Notwithstanding the lessons from Enron, off-balance sheet-vehicles were permitted beyond the reach of prudential regulation, including holding company capital requirements. The failure to ensure that financial products were appropriate and sustainable for consumers caused significant problems not only for those consumers but for the safety and soundness of financial institutions. Lax lending standards employed by lightly regulated nonbank mortgage originators initiated a downward competitive spiral which led to pervasive issuance of unsustainable mortgages. Ratings agencies freely assigned AAA credit ratings to the senior tranches of mortgage securitizations without doing fundamental analysis of underlying loan quality. Trillions of dollars in complex derivative instruments were written to hedge risks associated with mortgage-backed securities and other exposures. This market was, by and large, excluded from Federal regulation by statute.

A strong case can be made for creating incentives that reduce the size and complexity of financial institutions. A financial system characterized by a handful of giant institutions with global reach and a single regulator is making a huge bet on the performance of those banks and that regulator.

Financial firms that pose systemic risks should be subject to regulatory and economic incentives that require these institutions to hold larger capital and liquidity buffers to mirror the heightened risk they pose to the financial system. In addition, restrictions on leverage and the imposition of risk-based premiums on institutions and their activities would act as disincentives to growth and complexity that raise systemic concerns. In contrast to the standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both their size and complexity. To address procyclicality, the capital standards should provide for higher capital buffers that increase during expansions and are available to be drawn down during contractions. In addition, these firms should be subject to higher Prompt Corrective Action standards under U.S. laws and holding company capital requirements that are no less stringent than those applicable to insured banks. Regulators also should take into account off-balance-sheet assets and conduits as if these risks were on-balance-sheet.

*The Need for a Financial Services Oversight Council*

The significant size and growth of unsupervised financial activities outside the traditional banking system—in what is termed the shadow financial system—has made it all the more difficult for regulators or market participants to understand the real dynamics of either bank credit markets or public capital markets. The existence of one regulatory framework for insured institutions and a much less effective regulatory scheme for nonbank entities created the conditions for arbitrage that permitted the development of risky and harmful products and services outside regulated entities.

A distinction should be drawn between the direct supervision of systemically significant financial firms and the macroprudential oversight and regulation of developing risks that may pose systemic risks to the U.S. financial system. The former appropriately calls for the identification of a prudential supervisor for any potential systemically significant entity. Entities that are already subject to a prudential supervisor, such as insured depository institutions and financial holding companies, should retain those supervisory relationships.

The macroprudential oversight of systemwide risks requires the integration of insights from a number of different regulatory perspectives—banks, securities firms, holding companies, and perhaps others. Only through these differing perspectives can there be a holistic view of developing risks to our system. As a result, for this latter role, the FDIC supports the creation of a Council to oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. In addition, for systemic entities not already subject to a Federal prudential supervisor, this Council should be empowered to require that they submit to such oversight, presumably as a financial holding company under the Federal Reserve—without subjecting them to the activities restrictions applicable to these companies.

Supervisors across the financial system failed to identify the systemic nature of the risks before they were realized as widespread industry losses. The performance of the regulatory system in the current crisis underscores the weakness of monitoring systemic risk through the lens of individual financial institutions and argues for the need to assess emerging risks using a systemwide perspective. The Administration's proposal addresses the need for broader-based identification of systemic risks across the economy and improved interagency cooperation through the establishment of a new Financial Services Oversight Council. The Oversight Council described in the Administration's proposal currently lacks sufficient authority to effectively address systemic risks.

In designing the role of the Council, it will be important to preserve the longstanding principle that bank regulation and supervision are best conducted by independent agencies. Careful attention should be given to the establishment of appropriate safeguards to preserve the independence of financial regulation from political influence. The Administration's plan gives the role of Chairman of the Financial Services Oversight Council to the Secretary of the Treasury. To ensure the independence and authority of the Council, consideration should be given to a configuration that would establish the Chairman of the Council as a Presidential appointee, subject to Senate confirmation. This would provide additional independence for the Chairman and enable the Chairman to focus full time on attending to the affairs of the Council and supervising Council staff. Other members on the Council could include, among others, the Federal financial institution, securities and commodities regulators. In addition, we would suggest that the Council include an odd number of members in order to avoid deadlocks.

The Council should complement existing regulatory authorities by bringing a macroprudential perspective to regulation and being able to set or harmonize prudential standards to address systemic risk. Drawing on the expertise of the Federal regulators, the Oversight Council should have broad authority and responsibility for identifying institutions, products, practices, services and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, and completing analyses and making recommendations. In order to do its job, the Council needs the authority to obtain any information requested from systemically important entities.

The crisis has clearly revealed that regulatory gaps, or significant differences in regulation across financial services firms, can encourage regulatory arbitrage. Accordingly, a primary responsibility of the Council should be to harmonize prudential regulatory standards for financial institutions, products and practices to assure that market participants cannot arbitrage regulatory standards in ways that pose systemic risk. The Council should evaluate differing capital standards which apply to commercial banks, investment banks, and investment funds to determine the extent to which differing standards circumvent regulatory efforts to contain excess leverage in the system. The Council could also undertake the harmonization of capital and margin requirements applicable to all OTC derivatives activities—and facilitate interagency efforts to encourage greater standardization and transparency of derivatives activities and the migration of these activities onto exchanges or Central Counterparties.

The Council also could consider requiring financial companies to issue contingent debt instruments—for example, long-term debt that, while not counting toward the satisfaction of regulatory capital requirements, automatically converts to equity under specific conditions. Conditions triggering conversion could include the financial companies' capital falling below prompt corrective action mandated capital levels or regulators declaring a systemic emergency. Financial companies also could be required to issue a portion of their short-term debt in the form of debt instruments that similarly automatically convert to long-term debt under specific conditions, perhaps tied to liquidity. Conversion of long-term debt to equity would immediately recapitalize banks in capital difficulty. Conversion of short-term debt to long-term debt would ameliorate liquidity problems.

Also, the Council should be able to harmonize rules regarding systemic risks to serve as a floor that could be met or exceeded, as appropriate, by the primary prudential regulator. Primary regulators would be charged with enforcing the requirements set by the Council. However, if the primary regulators fail to act, the Council should have the authority to do so. The standards set by the Council should be designed to provide incentives to reduce or eliminate potential systemic risks created by the size or complexity of individual entities, concentrations of risk or market practices, and other interconnections between entities and markets. Any standards set by the Council should be construed as a minimum floor for regulation that can be exceeded, as appropriate, by the primary prudential regulator.

The Council should have the authority to consult with systemic and financial regulators from other countries in developing reporting requirements and in identifying potential systemic risk in the global financial market. The Council also should report to Congress annually about its efforts, identify emerging systemic risk issues and recommend any legislative authority needed to mitigate systemic risk.

Some have suggested that a council approach would be less effective than having this authority vested in a single agency because of the perception that a deliberative council such as this would need additional time to address emergency situations that might arise from time to time. Certainly, some additional thought and effort will be needed to address any dissenting views in council deliberations. However, a Council with regulatory agency participation will provide for an appropriate system of checks and balances to ensure that decisions reflect the various interests of public and private stakeholders. In this regard, it should be noted that the board structure at the FDIC, with the participation of the Comptroller of the Currency and the Director of the Office of Thrift Supervision, is not very different from the way the Council would operate. In the case of the FDIC, quick decisions have been made with respect to systemic issues and emergency bank resolutions on many occasions. Based on our experience with a board structure, we believe that decisions could be made quickly by a deliberative council.

**Resolution Authority**

Even if risk-management practices improve dramatically and we introduce effective macroprudential supervision, the odds are that a large systemically significant firm will become troubled or fail at some time in the future. The current crisis has clearly demonstrated the need for a single resolution mechanism for financial firms that will preserve stability while imposing the losses on shareholders and creditors and replacing senior management to encourage market discipline. A timely, orderly resolution process that could be applied to both banks and nonbank financial institutions, and their holding companies, would prevent instability and contagion and promote fairness. It would enable the financial markets to continue to function smoothly, while providing for an orderly transfer or unwinding of the firm's operations. The resolution process would ensure that there is the necessary liquidity to complete transactions that are in process at the time of failure, thus addressing the potential for systemic risk without creating the expectation of a bailout.

Under the new resolution regime, Congress should raise the bar higher than existing law and eliminate the possibility of open assistance for individual failing entities. The new resolution powers should result in the shareholders and unsecured creditors taking losses prior to the Government, and consideration also should be given to imposing some haircut on secured creditors to promote market discipline and limit costs potentially borne by the Government.

*Limitations of the Current Resolution Authority*

The FDIC's resolution powers are very effective for most failed bank situations (see Appendix). However, systemic financial organizations present additional issues that may complicate the FDIC's process of conducting an efficient and economical resolution. As noted above, many financial activities today take place in financial firms that are outside the insured depository institution where the FDIC's existing authority does not reach. These financial firms must be resolved through the bankruptcy process, as the FDIC's resolution powers only apply to insured depository institutions. Resolving large complex financial firms through the bankruptcy process can be destabilizing to regional, national, and international economies since the timing is uncertain and the process can be complex and protracted and may vary by jurisdiction.

By contrast, the powers that are available to the FDIC under its statutory resolution authorities can resolve financial entities much more rapidly than under bankruptcy. The FDIC bears the unique responsibility for resolving failed depository institutions and is therefore able to plan for an orderly resolution process. Through this process, the FDIC works with the primary supervisor to gather information on a troubled bank before it fails and plans for the transfer or orderly wind-down of the bank's assets and businesses. In doing so, the FDIC is able to maintain public confidence and perform its public policy mandate of ensuring financial stability.

*Resolution Authority for Systemically Important Financial Firms*

To ensure an orderly and comprehensive resolution mechanism for systemically important financial firms, Congress should adopt a resolution process that adheres to the following principles:

- The resolution scheme and processes should be transparent, including the imposition of losses according to an established claims priority where stockholders and creditors, not the Government, are in the first loss position.
- The resolution process should seek to minimize costs and maximize recoveries. The resolution should be conducted to achieve the least cost to the Government as a whole with the FDIC allocating the losses among the various affiliates and subsidiaries proportionate to their responsibilities for the cost of the failure.
- There should be a unified resolution process housed in a single entity.
- The resolution entity should have the responsibility and the authority to set assessments to fund systemic resolutions to cover working capital and unanticipated losses.
- The resolution process should allow the continuation of any systemically significant operations, but only as a means to achieve a final resolution of the entity. A bridge mechanism, applicable to the parent company and all affiliated entities, allows the Government to preserve 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 financial organization and its assets, which can reduce losses to the receivership.
- The resolution entity must effectively manage its financial and operational risk exposure on an ongoing basis. The receivership function necessarily entails certain activities such as the establishment of bridge entities, implementing purchase and assumption agreements, claims processing, asset liquidation or disposition, and franchise marketing. The resolving entity must establish, maintain, and implement these functions for a covered parent company and all affiliated entities.

Financial firms often operate on a day-to-day basis without regard to the legal structure of the firm. That is, employees of the holding company may provide vital services to a subsidiary bank because the same function exists in both the bank and the holding company. However, this intertwining of functions can present significant issues when trying to wind down the firm. For this reason, there should be requirements that mandate greater functional autonomy of holding company affiliates.

In addition, to facilitate the resolution process, the holding companies should have an acceptable resolution plan that could facilitate and guide the resolution in the event of a failure. Through a carefully considered rule making, each financial holding company should be required to make conforming changes to their organization to ensure that the resolution plans could be effectively implemented. The plans should be updated annually and made publicly available.

Congress also should alter the current process that establishes a procedure for open bank assistance that benefits shareholders and eliminates the requirement that the resolution option be the least costly to the Deposit Insurance Fund (DIF).

As stated above, shareholders and creditors should be required to absorb losses from the institution's failure before the Government.

Current law allows for an exception to the standard claims priority where the failure of one or more institutions presents "systemic risk." In other words, once a systemic risk determination is made, the law permits the Government to provide assistance irrespective of the least cost requirement, including "open bank" assistance which inures to the benefit of shareholders. The systemic risk exception is an extraordinary procedure, requiring the approval of super majorities of the FDIC Board, the Federal Reserve Board, and the Secretary of the Treasury in consultation with the President.

We believe that the systemic risk exception should be narrowed so that it is available only where there is a finding that support for open institutions is necessary to address problems which pervade the system, as opposed to problems which are particular to an individual institution. Whatever support is provided should be broadly available and justified in that it will result in least cost to the Government as a whole. If the Government suffers a loss as a result an institution's performance under this exception, the institution should be required to be resolved in accordance with the standard claims priority.

Had this narrower systemic risk exception been in place during the past year, open institution assistance would not have been permitted for individual institutions. An individual institution would likely have been put into a bridge entity, with shareholders and unsecured creditors taking losses before the Government. Broader programs that benefit the entire system, such as the Temporary Liquidity Guarantee Program and the Federal Reserve's liquidity facilities, would have been permitted. However if any individual institution participating in these programs had caused a loss, the normal resolution process would be triggered.

The initiation of this type of systemic assistance should require the same concurrence of the supermajority of the FDIC Board, the Federal Reserve Board and the Treasury Department (in consultation with the President) as under current law. No single Government entity should be able to unilaterally trigger a resolution strategy outside the defined parameters of the established resolution process. Further, to ensure transparency, these determinations should be made in consultation with Congress, documented and reviewed by the Government Accountability Office.

*Other Improvements to the Resolution Process*

Consideration should be given to allowing the resolution authority to impose limits on financial institutions' abilities to use collateral to mitigate credit risk ahead of the Government for some types of activities. The ability to fully collateralize credit risks removes an institution's incentive to underwrite exposures by assessing a counterparty's ability to perform from revenues from continuing operations. In addition, the recent crisis has demonstrated that collateral calls generate liquidity pressures that can magnify systemic risks. For example, up to 20 percent of the secured claim for companies with derivatives claims against the failed firm could be haircut if the Government is expected to suffer losses. This would ensure that market participants always have an interest in monitoring the financial health of their counterparties. It also would limit the sudden demand for more collateral because the protection could be capped and also help to protect the Government from losses. Other approaches could include increasing regulatory and supervisory disincentives for excessive reliance on secured borrowing.

As emphasized at the beginning of this statement, a regulatory and resolution structure should, among other things, ensure real corporate separateness and the separation of the bank's management, employees, and systems from those of its affiliates. Risky activities, such as proprietary trading, should be kept outside the bank. Consideration also should be given to enhancing restrictions against transactions with affiliates, including the elimination of 23A waivers. In addition, the resolution process could be greatly enhanced if companies were required to have an acceptable resolution plan that and guides the liquidation in the event of a failure. Requiring that the plans be updated annually and made publicly available would provide additional transparency that would improve market discipline.

*Funding Systemic Resolutions*

To be credible, a resolution process for systemically significant institutions must have the funds necessary to accomplish the resolution. It is important that funding for this resolution process be provided by the set of potentially systemically significant financial firms, rather than by the taxpayer. To that end, Congress should establish a Financial Company Resolution Fund (FCRF) to provide working capital and cover unanticipated losses for the resolution.

One option for funding the FCRF is to prefund it through a levy on larger financial firms—those with assets above a certain large threshold. The advantage of prefunding the FCRF is the ability to impose risk-based assessments on large or complex institutions that recognize their potential risks to the financial system. This system also could provide an economic incentive for an institution not to grow too large. In addition, building the fund over time through consistent levies would avoid large procyclical charges during times of systemic stress.

Alternatively, the FCRF could be funded after a systemic failure through an assessment on other large, complex institutions. The advantage to this approach is that it does not take capital out of institutions until there is an actual systemic failure. The disadvantages of this approach are that it is not risk sensitive, it is initially dependent on the ability to borrow from the Treasury, it assess institutions when they can least afford it and the institution causing the loss is the only one that never pays an assessment.

The systemic resolution entity should have the authorities needed to manage this resolution fund, as the FDIC does for the DIF. The entity should also be authorized to borrow from the Treasury if necessary, but those borrowings should be repaid by the financial firms that contribute to the FCRF.

*International Issues*

Some significant challenges exist for international banking resolution actions since existing bank crisis management and resolution arrangements are not designed to deal specifically with cross-border banking problems. However, providing resolution authority to a specific entity in the U.S. would enhance the ability to enter into definitive memoranda of understanding with other countries. Many of these same countries have recognized the benefits of improving their resolution regimes and are considering improvements. This provides a unique opportunity for the U.S. to be the leader in this area and provide a model for the effective resolution of failed entities.

Dealing with cross-border banking problems is difficult. For example, provisions to allow the transfer of assets and liabilities to a bridge bank or other institution may have limited effectiveness in a cross-border context because these actions will not necessarily be recognized or promptly implemented in other jurisdictions. In the absence of other arrangements, it is presumed that ring fencing will occur. Ring fencing may secure the interests of creditors or individuals in foreign jurisdictions to the detriment of the resolution as a whole.

In the United States, the Foreign Bank Supervision Enhancement Act of 1991 requires foreign banks that wish to do a retail deposit-taking business to establish a separately chartered subsidiary bank. This structural arrangement ensures that assets and capital will be available to U.S. depositors or the FDIC should the foreign parent bank and its U.S. subsidiary experience difficulties. In this sense, it is equivalent to "prepackaged" ring fencing. An idea to consider would be to have U.S. banks operating abroad to do so through bank subsidiaries. This could streamline the FDIC's resolution process for a U.S. bank with foreign operations. U.S. operations would be resolved by the FDIC and the foreign operations by the appropriate foreign regulator. However, this would be a major change and could affect the ability of U.S. banks to attract foreign deposits overseas.

**Resolution Authority for Depository Institution Holding Companies**

To have a process that not only maintains liquidity in the financial system but also terminates stockholders' rights, it is important that the FDIC have the authority to resolve both systemically important and nonsystemically important depository institution holding companies, affiliates and majority-owned subsidiaries in the case of failed or failing insured depository institutions. When a failing bank is part of a large, complex holding company, many of the services essential for the bank's operation may reside in other portions of the holding company, beyond the FDIC's authority. The loss of essential services can make it difficult to preserve the value of a failed institution's assets, operate the bank or resolve it efficiently. The business operations of large, systemic financial organizations are intertwined with business lines that may span several legal entities. When one entity is in the FDIC's control while the other is not, it significantly complicates resolution efforts. Unifying the holding company and the failed institution under the same resolution authority can preserve value, reduce costs and provide stability through an effective resolution. Congress should enhance the authority of the FDIC to resolve the entire organization in order to achieve a more orderly and comprehensive resolution consistent with the least cost to the DIF.

When the holding company structure is less complex, the FDIC may be able to effect a least cost resolution without taking over the holding company. In cases where the holding company is not critical to the operations of the bank or thrift, the FDIC should be able to opt out—that is, allow the holding company to be resolved through the bankruptcy process. The decision on whether to employ enhanced resolution powers or allow the bank holding company to declare bankruptcy would depend on which strategy would result in the least cost to the DIF. Enhanced authorities that allow the FDIC to efficiently resolve failed depository institutions that are part of a complex holding company structure when it achieves the least costly resolution will provide immediate efficiencies in bank resolutions.

**Conclusion**

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial institutions, especially those that are systemically important to the financial system. The FDIC stands ready to work with Congress to ensure that the appropriate steps are taken to strengthen our supervision and regulation of all financial institutions—especially those that pose a systemic risk to the financial system.

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

**Appendix**

*The FDIC's Resolution Authority*

The FDIC has standard procedures that go into effect when an FDIC-insured bank or thrift is in danger of failing. When the FDIC is notified that an insured institution is in danger of failing, we begin assembling an information package for bidders that specifies the structure and terms of the transaction. FDIC staff review the bank's books, contact prospective bidders, and begin the process of auctioning the bank—usually prior to its failure—to achieve the best return to the bank's creditors, and the Deposit Insurance Fund (DIF).

When the appropriate Federal or State banking authority closes an insured depository institution, it appoints the FDIC as conservator or receiver. On the day of closure by the chartering entity, the FDIC takes control of the bank and in most cases removes the failed bank's management. Shareholder control rights are terminated, although shareholders maintain a claim on any residual value remaining after depositors' and other creditors' claims are satisfied.

Most bank failures are resolved by the sale of some or all of the bank's business to an acquiring bank. FDIC staff work with the acquiring bank, and make the transfer as unobtrusive, seamless and efficient as possible. Generally, all the deposits that are transferred to the acquiring bank are made immediately available online or through ATMs. The bank usually reopens the next business day with a new name and under the control of the acquiring institution. Those assets of the failed bank that are not taken by the acquiring institution are then liquidated by the FDIC.

Sometimes banks must be closed quickly because of an inability to meet their funding obligations. These "liquidity failures" may require that the FDIC set up a bridge bank. The bridge bank structure allows the FDIC to provide liquidity to continue the bank's operations until the FDIC has time to market and sell the failed bank. The creation of a bridge also terminates stockholders rights as described earlier.

Perhaps the greatest benefit of the FDIC's process is the quick reallocation of resources. It is a process that can be painful to shareholders, creditors and bank employees, but history has shown that early recognition of losses with closure and sale of nonviable institutions is the fastest path back to economic health.

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## PREPARED STATEMENT OF MARY L. SCHAPIRO

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

JULY 23, 2009

**Introduction**

Chairman Dodd, Ranking Member Shelby, and Members of the Committee: I am pleased to have the opportunity to testify concerning the regulation of systemic risk in the U.S. financial industry. [1]

We have learned many lessons from the recent financial crisis and events of last fall, central among them being the need to identify, monitor, and reduce the possi-

[1] My testimony is on my own behalf, as Chairman of the SEC. The commission has not voted on this testimony.

bility that a sudden shock will lead to a market seizure or cascade of failures that puts the entire financial system at risk.

In turning those lessons into reforms, the following should guide us:

First, there are two different kinds of "systemic risk": (1) the risk of sudden, near-term systemic seizures or cascading failures, and (2) the longer-term risk that our system will unintentionally favor large systemically important institutions over smaller, more nimble competitors, reducing the system's ability to innovate and adapt to change. We must be very careful that our efforts to protect the system from near-term systemic seizures do not inadvertently result in a long-term systemic imbalance.

Second, there are two different kinds of "systemic risk regulation": (1) the traditional oversight, regulation, market transparency and enforcement provided by primary regulators that helps keep systemic risk from developing in the first place, and (2) the new "macroprudential" regulation designed to identify and minimize systemic risk if it does.

Third, we must be cognizant of both kinds of regulation if we are to minimize both kinds of "systemic risk." I believe the best way to achieve this balance is to:

- Address structural imbalances that facilitate the development of systemic risk by closing gaps in regulation, improving transparency and strengthening enforcement; and
- Establish a workable, macroprudential regulatory framework consisting of a single systemic risk regulator (SRR) with clear authority and accountability and a Financial Stability Oversight Council (Council) that can identify risks across the system, write rules to minimize systemic risk and help ensure that future regulatory gaps—and arbitrage opportunities—are minimized or avoided.

Throughout this process, however, we must remain vigilant that our efforts to minimize "sudden systemic risk" do not inadvertently create new structural imbalances that undermine the long-term vibrancy of our capital markets.

**Addressing Structural Imbalances Through Traditional Oversight**

Much of the debate surrounding "systemic risk" and financial regulatory reform has focused on new "macroprudential" oversight and regulation. This debate has focused on whether we need a systemic risk regulator to identify and minimize systemic risk and how to resolve large interconnected institutions whose failure might affect the health of others or the system. The debate also has focused on whether it is possible to declare our readiness to "resolve" systemically important institutions without unintentionally facilitating their growth and systemic importance.

Before turning to those issues, it is important that we not forget the role that traditional oversight, regulation and market transparency play in reducing systemic risk. This is the traditional "block and tackle" oversight and regulation, that is vital to ensuring that systemic risks do not develop in the first place.

*Filling Regulatory Gaps*

One central mechanism for reducing systemic risk is to ensure the same rules apply to the same or similar products and participants. Our global capital markets are incredibly fast and competitive: financial participants are competing with each other not just for ideas and talent but also with respect to "microseconds" and basis points. In such an environment, if financial participants realize they can achieve the same economic ends with fewer costs by flocking to a regulatory gap, they will do so quickly, often with size and leverage.

We have seen this time and again, most recently with over-the-counter derivatives, instruments through which major institutions engage in enormous, virtually unregulated trading in synthetic versions of other, often regulated financial products. We can do much to reduce systemic risk if we close these gaps and ensure that similar products are regulated similarly.

*Improving Market Transparency*

In conjunction with filling regulatory gaps, market transparency can help to decrease systemic risk. We have seen tremendous growth in financial products and vehicles that work exactly like other products and vehicles, but with little or no transparency.

For example, there are "dark pools" in which securities are traded that work like traditional markets without the oversight or information flow. Also, enormous risk resides in "off-balance-sheet" vehicles hidden from investors and other market participants who likely would have allocated capital more efficiently—and away from these risks—had the risks been fully disclosed.

Transparency reduces systemic risk in several ways. It gives regulators and investors better information about markets, products and participants. It also helps regulators leverage market behavior to minimize the need for larger interventions.

Where market participants are given sufficient information about assets, liabilities and risks, they, following their risk-reward analyses, could themselves allocate capital away from risk or demand higher returns for it. This in turn would help to reduce systemic risk before it develops. In this sense, the new "macroprudential" systemic risk regulation (set forth later in this testimony) can be seen as an important tool for identifying and reducing systemic risk, but not a first or only line of defense.

I support the Administration's efforts to fill regulatory gaps and improve market transparency, particularly with respect to over-the-counter derivatives and hedge funds, and I believe they will go a long way toward reducing systemic risk.

*Active Enforcement*

It is important to note the role active regulation and enforcement plays in changing behavior and reducing systemic risks.

Though we need vibrant capital markets and financial innovation to meet our country's changing needs, we have learned there are two sides to financial innovation. At their best, our markets are incredible machines capable of taking "ordinary" investments and savings and transforming them into new, highly useful products—turning today's thrift into tomorrow's stable wealth. At their worst, the self-interests of financial engineers seeking short-term profit can lead to ever more complex and costly products designed less to serve investors' needs than to generate fees.

Throughout this crisis we have seen how traditional processes evolved into questionable business practices, that, when combined with leverage and global markets, created extensive systemic risk. A counterbalance to this is active enforcement that serves as a ready reminder of (1) what the rules are and (2) why we need them to protect consumers, investors, and taxpayers—and indeed the system itself.

**Macroprudential Oversight: The Need for a Systemic Risk Regulator and Financial Stability Oversight Council**

Although I believe in the critical role that traditional oversight, regulation, enforcement, and market transparency must play in reducing systemic risk, they alone are not sufficient.

Functional regulation alone has shown several key shortcomings. First, information—and thinking—can remain "siloed." Functional regulators typically look at particular financial participants or vehicles even as individual financial products flow through them all, often resulting in their seeing only small pieces of the broader financial landscape.

Second, because financial actors can use different vehicles or jurisdictions from which to engage in the same activity, actors can sometimes "choose" their regulatory framework. This choice can sometimes result in regulatory competition—and a race to the bottom among competing regulators and jurisdictions, lowering standards and increasing systemic risk.

Third, functional regulators have a set of statutory powers and a legal framework designed for their particular types of financial products or entities. Even if a regulator could extend its existing powers over other entities not typically within its jurisdiction, these legal frameworks are not easily transferrable either to other entities or other types of risk.

Given these shortcomings, I agree with the Administration on the need to establish a regulatory framework for macroprudential oversight.

Within that framework, I believe a hybrid approach consisting of a single systemic risk regulator and a powerful council is most appropriate. Such an approach would provide the best structure to ensure clear accountability for systemic risk, enable a strong, nimble response should circumstances arise and maintain the broad and differing perspectives needed to best identify developing risks and minimize unintended consequences.

*A Systemic Risk Regulator*

Given the (1) speed, size, and complexity of our global capital markets; (2) large role a relatively small number of major financial intermediaries play in that system; and (3) extent of Government interventions needed to address the recent turmoil, I agree there needs to be a Government entity responsible for monitoring our entire financial system for systemwide risks, with the tools to forestall emergencies. I believe this role could be performed by the Federal Reserve or a new entity specifically designed for this task.

This "systemic risk regulator" should have access to information across the financial markets and, in addition to the individual functional regulators, serve as a second set of eyes upon those institutions whose failure might put the system at risk. It should have ready access to information about institutions that might pose a risk to the system, including holding company liquidity and risk exposures; monitor whether institutions are maintaining capital levels required by the Council; and have clear delegated authority to respond quickly in extraordinary circumstances.

In addition, an SRR should be required to report to the Council on its supervisory programs and the risks and trends it identifies at the institutions it supervises.

*Financial Stability Oversight Council*

Further, I agree with the Administration and FDIC Chairman Bair that this SRR must be combined with a newly created Council. I believe, however, that any Council must be strengthened beyond the framework set forth in the Administration's "white paper."

This Council should have the tools needed to identify emerging risks, be able to establish rules for leverage and risk-based capital for systemically important institutions; and be empowered to serve as a ready mechanism for identifying emerging risks and minimizing the regulatory arbitrage that can lead to a regulatory race to the bottom.

To balance the weakness of monitoring systemic risk through the lens of any single regulator, the Council would permit us to assess emerging risks from the vantage of a multidisciplinary group of financial experts with responsibilities that extend to different types of financial institutions, both large and small. Members could include representatives of the Department of the Treasury, SEC, CFTC, FRB, OCC, and FDIC.

The Council should have authority to identify institutions, practices, and markets that create potential systemic risks and set standards for liquidity, capital and other risk management practices at systemically important institutions. The SRR would then be responsible for implementing these standards.

The Council also should provide a forum for discussing and recommending regulatory standards across markets, helping to identify gaps in the regulatory framework before they morph into larger problems. This hybrid approach can help minimize systemic risk in a number of ways:

- First, a Council would ensure different perspectives to help identify risks that an individual regulator might miss or consider too small to warrant attention. These perspectives would also improve the quality of systemic risk requirements by increasing the likelihood that second-order consequences are considered and flushed out;
- Second, the financial regulators on the Council would have experience regulating different types of institutions (including smaller institutions) so that the Council would be more likely to ensure that risk-based capital and leverage requirements do not unintentionally foster systemic risk. Such a result could occur by giving large, systemically important institutions a competitive advantage over smaller institutions that would permit them to grow even larger and more risky; and
- Third, the Council would include multiple agencies, thereby significantly reducing potential conflicts of interest (*e.g.,* conflicts with other regulatory missions).

The Council also would monitor the development of financial institutions to prevent the creation of institutions that are either too-big-to-fail or too-big-to-succeed. In that regard, I believe that insufficient attention has been paid to the risks posed by institutions whose businesses are so large and diverse that they have become, for all intents and purposes, unmanageable. Given the potential daily oversight role of the SRR, it would likely be less capable of identifying and avoiding these risks impartially. Accordingly, the Council framework is vital to ensure that our desire to minimize short-term systemic risk does not inadvertently undermine our system's long-term health.

*Coordination of Council/SRR With Primary Regulators*

In most times, I would expect the Council and SRR to work with and through primary regulators of systemically important institutions. The primary regulators understand the markets, products and activities of their regulated entities. The SRR, however, can provide a second layer of review over the activities, capital, and risk management procedures of systemically important institutions as a backstop to ensure that no red flags are missed.

If differences arise between the SRR and the primary regulator regarding the capital or risk management standards of systemically important institutions, I strongly believe that the higher (more conservative) standard should govern. The systemic risk regulatory structure should serve as a "brake" on a systemically important institution's riskiness; it should never be an "accelerator."

In emergency situations, the SRR may need to overrule a primary regulator (for example, to impose higher standards or to stop or limit potentially risky activities). However, to ensure that authority is checked and decisions are not arbitrary, the Council should be where general policy is set, and only then to implement a more rigorous policy than that of a primary regulator. This will reduce the ability of any single regulator to "compete" with other regulators by lowering standards, driving a race to the bottom.

*Unwinding Systemic Risk—A Third Option*

I agree with the Administration, the FDIC, and others that the Government needs a credible resolution mechanism for unwinding systemically important institutions.

Currently, banks and broker-dealers are subject to well-established resolution processes under the Federal Deposit Insurance Corporation Improvement Act and the Securities Investor Protection Act, respectively. No corresponding resolution process exists, however, for the holding companies of systemically significant financial institutions.

In times of crisis when a systemically important institution may be teetering on the brink of failure, policy makers are left in the difficult position of choosing between two highly unappealing options: (1) providing Government assistance to a failing institution (or an acquirer of a failing institution), thereby allowing markets to continue functioning but potentially fostering more irresponsible risk taking in the future; or (2) not providing Government assistance but running the risk of market collapses and greater costs in the future.

Markets recognize this Hobson's choice and can actually fuel more systemic risk by "pricing in" the possibility of a Government backstop of large-interconnected institutions. This can give them an advantage over their smaller competitors and make them even larger and more interconnected.

A credible resolution regime can help address these risks by giving policy makers a third option: a controlled unwinding of the institution over time. Structured correctly, such a regime could force market participants to realize the full costs of their decisions and help reduce the "too-big-to-fail" dilemma. Structured poorly, such a regime could strengthen market expectations of Government support, as a result fueling "too-big-to-fail" risks.

Avoidance of conflicts of interest in this regime will be paramount. Different regulators with different missions may have different priorities. For example, both customer accounts with broker-dealers and depositor accounts in banks must be protected and should not be used to cross-subsidize other efforts. A healthy consultation process with a regulated entity's primary regulator will provide needed institutional knowledge to ensure that potential conflicts such as this are minimized.

**Conclusion**

To better ensure that systemwide risks will be identified and minimized without inadvertently creating larger risk down the road, I recommend that Congress establish a strong Financial Stability Oversight Council, comprised of the primary regulators.

The Council should have responsibility for identifying systemically significant institutions and systemic risks, making recommendations about and implementing actions to address those risks, promoting effective information flow, setting liquidity and capital standards, and ensuring key supervisors apply those standards appropriately.

The various primary regulators offer broad perspectives across markets that represent a wide range of institutions and investors. This array of perspectives is essential to build a foundation for the development of a robust regulatory framework better designed to withstand future periods of market or economic volatility and help restore investors' confidence in our Nation's markets. I believe a structure such as this provides the best balance for reducing sudden systemic risk without undermining the competitive and resilient capital markets needed over the long term.

Thank you again for the opportunity to present my views. I look forward to working with the Committee on any financial reform efforts it may undertake, and I would be pleased to answer any questions.

## PREPARED STATEMENT OF DANIEL K. TARULLO

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JULY 23, 2009

Chairman Dodd, Ranking Member Shelby, and other Members of the Committee, I appreciate the opportunity to discuss how to improve the U.S. financial regulatory system so as to contain systemic risk and to address the related problem of too-big-to-fail financial institutions. Experience over the past 2 years clearly demonstrates that the United States needs a comprehensive strategy to help prevent financial crises and to mitigate the effects of crises that may occur.

The roots of this crisis lie in part in the fact that regulatory powers and capacities lagged the increasingly tight integration of conventional lending activities with the issuance, trading, and financing of securities. This crisis did not begin with depositor runs on banks, but with investor runs on firms that financed their holdings of securities in the wholesale money markets. An effective agenda for containing systemic risk thus requires adjustments by all our financial regulatory agencies under existing authorities. It also invites action by the Congress to fill existing gaps in regulation, remove impediments to consolidated oversight of complex institutions, and provide the instruments necessary to cope with serious financial problems that do arise.

In keeping with the Committee's interest today in a systemic risk agenda, I will identify some of the key administrative and legislative elements that should be a part of that agenda. Ensuring that all systemically important financial institutions are subject to effective consolidated supervision is a critical first step. Second, a more macroprudential outlook—that is, one that takes into account the safety and soundness of the financial system as a whole, as well as individual institutions—needs to be incorporated into the supervision and regulation of these firms and financial institutions more generally. Third, better and more formal mechanisms should be established to help identify, monitor, and address potential or emerging systemic risks across the financial system as a whole, including gaps in regulatory or supervisory coverage that could present systemic risks. A council with broad representation across agencies and departments concerned with financial supervision and regulation is one approach to this goal. Fourth, a new resolution process for systemically important nonbank financial firms should be created that would allow the Government to wind down a troubled systemically important firm in an orderly manner. Fifth, all systemically important payment, clearing, and settlement arrangements should be subject to consistent and robust oversight and prudential standards.

The role of the Federal Reserve in a reoriented financial regulatory system derives, in our view, directly from its position as the Nation's central bank. Financial stability is integral to the achievement of maximum employment and price stability, the dual mandate that Congress has conferred on the Federal Reserve as its objectives in the conduct of monetary policy. Indeed, there are some important synergies between systemic risk regulation and monetary policy, as insights garnered from each of those functions informs the performance of the other. Close familiarity with private credit relationships, particularly among the largest financial institutions and through critical payment and settlement systems, makes monetary policy makers better able to anticipate how their actions will affect the economy. Conversely, the substantial economic analysis that accompanies monetary policy decisions can reveal potential vulnerabilities of financial institutions.

While the improvements in the financial regulatory framework outlined above would involve some expansion of Federal Reserve responsibilities, that expansion would be an incremental and natural extension of the Federal Reserve's existing supervisory and regulatory responsibilities, reflecting the important relationship between financial stability and the roles of a central bank. An effective and comprehensive agenda for addressing systemic risk will also require new responsibilities for other Federal agencies and departments, including the Treasury, Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), and Federal Deposit Insurance Corporation (FDIC).

### Consolidated Supervision of Systemically Important Financial Institutions

The current financial crisis has clearly demonstrated that risks to the financial system can arise not only in the banking sector, but also from the activities of other financial firms—such as investment banks or insurance organizations—that traditionally have not been subject, either by law or in practice, to the type of regulation and consolidated supervision applicable to bank holding companies. While effective consolidated supervision of potentially systemic firms is not, by itself, sufficient to foster financial stability, it certainly is a necessary condition. The Administration's recent proposal for strengthening the financial system would subject all systemically important financial institutions to the same framework for prudential supervision on the same consolidated or groupwide basis that currently applies to bank holding companies. In doing so, it would also prevent systemically important firms that have become bank holding companies during the crisis from reversing this change and escaping prudential supervision in calmer financial times. While this proposal is an important piece of an agenda to contain systemic risk and the "too-big-to-fail" problem, it would not actually entail a significant expansion of the Federal Reserve's mandate.

The proposal would entail two tasks—first identifying, and then effectively supervising, these systemically important institutions. As to supervision, the Bank Holding Company Act of 1956 (BHCA) designates the Federal Reserve as the consolidated supervisor of all bank holding companies. That act provides the Federal Reserve a range of tools to understand, monitor, and, when appropriate, restrain the risks associated with an organization's consolidated or groupwide activities. Under this framework, the Federal Reserve has the authority to establish consolidated capital requirements for bank holding companies. In addition, subject to certain limits I will discuss later, the act permits the Federal Reserve to obtain reports from and conduct examinations of a bank holding company and any of its subsidiaries. It also grants authority to 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.

Under the BHCA, the Federal Reserve already supervises some of the largest and most complex financial institutions in the world. In the course of the financial crisis, several large financial firms that previously were not subject to mandatory consolidated supervision—including Goldman Sachs, Morgan Stanley, and American Express—became bank holding companies, in part to assure market participants that they were subject to robust prudential supervision on a consolidated basis. While the number of additional financial institutions that would be subject to supervision under the Administration's approach would of course depend on standards or guidelines adopted by the Congress, the criteria offered by the Administration suggest to us that the initial number of newly regulated firms would probably be relatively limited. One important feature of this approach is that it provides ongoing authority to identify and supervise other firms that may become systemically important in the future, whether through organic growth or the migration of activities from regulated entities.

Determining precisely which firms would meet these criteria will require considerable analysis of the linkages between firms and markets, drawing as much or more on economic and financial analysis as on bank supervisory expertise. Financial institutions are systemically important if the failure of the firm to meet its obligations to creditors and customers would have significant adverse consequences for the financial system and the broader economy. At any point in time, the systemic importance of an individual firm depends on a wide range of factors. Obviously, the consequences of a firm's failure are more likely to be severe if the firm is large, taking account of both its on- and off-balance sheet activities. But size is far from the only relevant consideration. The impact of a firm's financial distress depends also on the degree to which it is interconnected, either receiving funding from, or providing funding to, other potentially systemically important firms, as well as on whether it performs crucial services that cannot easily or quickly be executed by other financial institutions. In addition, the impact varies over time: the more fragile the overall financial backdrop and the condition of other financial institutions, the more likely a given firm is to be judged systemically important. If the ability of the financial system to absorb adverse shocks is low, the threshold for systemic importance will more easily be reached. Judging whether a financial firm is systemically important is thus not a straightforward task, especially because a determination must be based on an assessment of whether the firm's failure would likely have systemic effects during a future stress event, the precise parameters of which cannot be fully known.

For supervision of firms identified as systemically important to be effective, we will need to build on lessons learned from the current crisis and on changes we are already undertaking in light of the broader range of financial firms that have come under our supervision in the last year. In October, we issued new consolidated supervision guidance for bank holding companies that provides for supervisory objectives and actions to be calibrated more directly to the systemic significance of individual institutions and bolsters supervisory expectations with respect to the corporate governance, risk management, and internal controls of the largest, most complex organizations.[1] We are also adapting our internal organization of supervisory activities to take better advantage of the information and insight that the economic and financial analytic capacities of the Federal Reserve can bring to bear in financial regulation.

The recently completed Supervisory Capital Assessment Process (SCAP) reflects some of these changes in the Federal Reserve's system for prudential supervision of the largest banking organizations. This unprecedented process specifically incorporated forward-looking, cross-firm, and aggregate analyses of the 19 largest bank holding companies, which together control a majority of the assets and loans within the financial system. Importantly, supervisors in the SCAP defined a uniform set of parameters to apply to each firm being evaluated, which allowed us to evaluate on a consistent basis the expected performance of the firms, drawing on individual firm information and independently estimated outcomes using supervisory models. Drawing on this experience, we will conduct horizontal examinations on a periodic basis to assess key operations, risks, and risk-management activities of large institutions.

We also plan to create a quantitative surveillance program for large, complex financial organizations that will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole. This work will be performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and accounting and legal experts. This program will be distinct from the activities of on-site examination teams so as to provide an independent supervisory perspective, as well as to complement the work of those teams.

To be fully effective, consolidated supervisors must have clear authority to monitor and address safety and soundness concerns and systemic risks in all parts of an organization, working in coordination with other supervisors wherever possible. As the crisis has demonstrated, the assessment of nonbank activities is essential to understanding the linkages between depository and nondepository subsidiaries and the risk profile of the organization as a whole. The Administration's proposal would make useful modifications to the provisions added to the law in 1999 that limit the ability of the Federal Reserve to monitor and address risks within an organization and its subsidiaries on a groupwide basis.[2]

**A Macroprudential Approach to Supervision and Regulation**

The existing framework for the regulation and supervision of banking organizations is focused primarily on the safety and soundness of individual organizations, particularly their insured depository institutions. As the Administration's proposal recognizes, the resiliency of the financial system could be improved by incorporating a more explicit macroprudential approach to supervision and regulation. A macroprudential outlook, which considers interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis, complements the current microprudential orientation of bank supervision and regulation.

Indeed, a more macroprudential focus is essential in light of the potential for explicit regulatory identification of systemically important firms to exacerbate the "too-big-to-fail" problem. Unless countervailing steps are taken, the belief by market participants that a particular firm is too-big-to-fail, and that shareholders and creditors of the firm may be partially or fully protected from the consequences of a failure, has many undesirable effects. It materially weakens the incentive of shareholders and creditors of the firm to restrain the firm's risk taking, provides incentives for financial firms to become very large in order to be perceived as too-big-to-fail, and creates an unlevel competitive playing field with smaller firms that may not be regarded as having implicit Government support.

Creation of a mechanism for the orderly resolution of systemically important nonbank financial firms, which I will discuss later, should help remediate this problem. In addition, capital, liquidity, and risk-management requirements for system-

[1] See Supervision and Regulation Letter 08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations", and the associated interagency guidance.

[2] The Administration's proposal also would close the loophole in current law that allowed certain investment banks, as well as other financial and nonfinancial firms, to acquire 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. The Board has for many years supported such a change.

ically important firms will need to be strengthened to help counteract moral hazard effects, as well as the greater potential risks these institutions pose to the financial system and to the economy. We believe that the agency responsible for supervision of these institutions should have the authority to adopt and apply such requirements, and thus have clear accountability for their efficacy. Optimally, these requirements should be calibrated based on the relative systemic importance of the institution, a different measure than a firm's direct credit and other risk exposures as calculated in traditional capital or liquidity regulation.

It may also be beneficial for supervisors to require that systemically important firms maintain specific forms of capital so as to increase their ability to absorb losses outside of a bankruptcy or formal resolution procedure. Such capital could be in contingent form, converting to common equity only when necessary to mitigate systemic risk. A macroprudential approach also should be reflected in regulatory capital standards more generally, so that banks are required to increase their capital levels in good times in order to create a buffer that can be drawn down as economic and financial conditions deteriorate.

The development and implementation of capital standards for systemically important firms is but one of many elements of an effective macroprudential approach to financial regulation. Direct and indirect exposures among systemically important firms are an obvious source of interdependency and potential systemic risk. Direct credit exposures may arise from lending, loan commitments, guarantees, or derivative counterparty relationships among institutions. Indirect exposures may arise through exposures to a common risk factor, such as the real estate market, that could stress the system by causing losses to many firms at the same time, through common dependence on potentially unstable sources of short-term funding, or through common participation in payment, clearing, or settlement systems.

While large, correlated exposures have always been an important source of risk and an area of focus for supervisors, macroprudential supervision requires special attention to the interdependencies among systemically important firms that arise from common exposures. Similarly, there must be monitoring of exposures that could grow significantly in times of systemwide financial stress, such as those arising from OTC derivatives or the sponsorship of off-balance-sheet financing conduits funded by short-term liabilities that are susceptible to runs. One tool that would be useful in identifying such exposures would be the cross-firm horizontal reviews that I discussed earlier, enhanced to focus on the collective effects of market stresses.

The Federal Reserve also would expect to carefully monitor and address, either individually or in conjunction with other supervisors and regulators, the potential for additional spillover effects. Spillovers may occur not only due to exposures currently on a firm's books, but also as a result of reactions to stress elsewhere in the system, including at other systemically important firms or in key markets. For example, the failure of one firm may lead to deposit or liability runs at other firms that are seen by investors as similarly situated or that have exposures to such firms. In the recent financial crisis, exactly this sort of spillover resulted from the failure of Lehman Brothers, which led to heightened pressures on other investment banks. One tool that could be helpful in evaluating spillover risks would be multiple-firm or system-level stress tests focused particularly on such risks. However, this type of test would greatly exceed the SCAP in operational complexity; thus, properly developing and implementing such a test would be a substantial challenge.

**Potential Role of a Council**

The breadth and heterogeneity of the U.S. financial system have been great economic strengths of our country. However, these same characteristics mean that common exposures or practices across a wide range of financial markets and financial institutions may over time pose risks to financial stability, but may be difficult to identify in their early stages. Moreover, addressing the pervasive problem of procyclicality in the financial system will require efforts across financial sectors. To help address these issues, the Administration has proposed the establishment of a Financial Services Oversight Council composed of the Treasury and all of the Federal financial supervisory and regulatory agencies, including the Federal Reserve.

The Board sees substantial merit in the establishment of a council to conduct macroprudential analysis and coordinate oversight of the financial system as a whole. The perspective of, and information from, supervisors on such a council with different primary responsibilities would be helpful in identifying and monitoring emerging systemic risks across the full range of financial institutions and markets. A council could be charged with identifying emerging sources of systemic risk, including: large and rising exposures across firms and markets; emerging trends in leverage or activities that could result in increased systemic fragility; possible misalignments in asset markets; potential sources of spillovers between financial firms or between firms and markets that could propagate, or even magnify, financial shocks; and new markets, practices, products, or institutions that may fall through the gaps in regulatory coverage and become threats to systemic stability. In addition, a council could play a useful role in coordinating responses by member agencies to mitigate emerging systemic risks identified by the council, and by helping coordinate actions to address procylicality in capital regulations, accounting standards (particularly with regard to reserves), deposit insurance premiums, and other supervisory and regulatory practices. In light of these responsibilities and its broad membership, a council also would be a useful forum for identifying financial firms that are at the cusp of being systemically important and, when appropriate, recommending such firms for designation as systemically important. Finally, should Congress choose to create default authority for regulation of activities that do not fall under the jurisdiction of any existing financial regulator, the council would seem the appropriate instrumentality to determine how the expanded jurisdiction should be exercised.

A council could be tasked with gathering and evaluating information from the various supervisory agencies and producing an annual report to the Congress on the state of the financial system, potential threats to financial stability, and the responses of member agencies to identified threats. Such a report could include recommendations for statutory changes where needed to address systemic threats due to, for example, growth or changes in unregulated sectors of the financial system. More generally, a council could promote research and other efforts to enhance understanding, both nationally and internationally, of the underlying causes of financial instability and systemic risk and possible approaches to countering such developments.

To fulfill such responsibilities, a council would need access to a broad range of information from its member financial supervisors regarding the institutions and markets under their purview, as well as from other Government agencies. Where the information necessary to monitor emerging risks was not available from a member agency, a council likely would need the authority to collect such information directly from financial institutions and markets. [3]

**Improved Resolution Process**

A key element to addressing systemic risk is the creation of a new regime that would allow the orderly resolution of systemically important nonbank financial firms. In most cases, the Federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after the Lehman and AIG experiences, there is little doubt that there needs to be a third option between the choices of bankruptcy and bailout.

The Administration's proposal would create such an option by allowing the Treasury to appoint a conservator or receiver for a systemically important nonbank financial institution that has failed or is in danger of failing. The conservator or receiver would have a variety of authorities—similar to those provided the FDIC with respect to failing insured banks—to stabilize and either rehabilitate or wind down the firm in a way that mitigates risks to financial stability and to the economy. For example, the conservator or receiver would have the ability to take control of the management and operations of the failing firm; sell assets, liabilities, and business units of the firm; and repudiate contracts of the firm. These are appropriate tools for a conservator or receiver. However, Congress may wish to consider adding some constraints as well—such as requiring that shareholders bear losses and that creditors be entitled to at least the liquidation value of their claims.

Importantly, the proposal would allow the Government, through a receivership, to impose "haircuts" on creditors and shareholders of the firm, either directly or by "bridging" the failing institution to a new entity, when consistent with the overarching goal of protecting the financial system and the broader economy. This aspect of the proposal is critical to addressing the "too-big-to-fail" problem and the resulting moral hazard effects that I discussed earlier.

The Administration's proposal appropriately would establish a high standard for invocation of this new resolution regime and would create checks and balances on its potential use, similar to the provisions governing use of the systemic risk exception to least-cost resolution in the Federal Deposit Insurance Act (FDI Act). The

[3] To facilitate information collections and interagency sharing, a council should have the clear authority for protecting confidential information subject, of course, to applicable law, including the Freedom of Information Act.

Federal Reserve's participation in this decision-making process would be an extension of our long-standing role in protecting financial stability, involvement in the current process for invoking the systemic risk exception under the FDI Act, and status as consolidated supervisor for large banking organizations. The Federal Reserve, however, is not well suited, nor do we seek, to serve as the resolution agency for systemically important institutions under the new framework.

As we have seen during the recent crisis, a substantial commitment of public funds may be needed, at least on a temporary basis, to stabilize and facilitate the orderly resolution of a large, highly interconnected financial firm. The Administration's proposal provides for such funding needs to be addressed by the Treasury, with the ultimate costs of any assistance to be recouped through assessments on financial firms over an extended period of time. We believe the Treasury is the appropriate source of funding for the resolution of systemically important financial institutions, given the unpredictable and inherently fiscal nature of this function. The availability of such funding from Treasury also would eliminate the need for the Federal Reserve to use its emergency lending authority under section 13(3) of the Federal Reserve Act to prevent the failure of specific institutions.

**Payment, Clearing, and Settlement Arrangements**

The current regulatory and supervisory framework for systemically important payment, clearing, and settlement arrangements is fragmented, with no single agency having the ability to ensure that all systemically important arrangements are held to consistent and strong prudential standards. The Administration's proposal would provide the Federal Reserve certain additional authorities for ensuring that all systemically important payment, clearing, and settlement arrangements are subject to robust standards for safety and soundness.

Payment, settlement, and clearing arrangements are the foundation of the Nation's financial infrastructure. These arrangements include centralized market utilities for clearing and settling payments, securities, and derivatives transactions, as well as decentralized activities through which financial institutions clear and settle such transactions bilaterally. While payment, clearing, and settlement arrangements can create significant efficiencies and promote transparency in the financial markets, they also may concentrate substantial credit, liquidity, and operational risks. Many of these arrangements also have direct and indirect financial or operational linkages and, absent strong risk controls, can themselves be a source of contagion in times of stress. Thus, it is critical that systemically important systems and activities be subject to strong and consistent prudential standards designed to ensure the identification and sound management of credit, liquidity, and operational risks.

The proposed authority would build on the considerable experience of the Federal Reserve in overseeing systemically important payment, clearing, and settlement arrangements for prudential purposes. Over the years, the Federal Reserve has worked extensively with domestic and foreign regulators to develop strong and internationally recognized standards for critical systems. Further, the Federal Reserve already has direct supervisory responsibility for some of the largest and most critical systems in the United States, including the Depository Trust Company and CLS Bank and has a role in overseeing several other systemically important systems. Yet, at present, this authority depends to a considerable extent on the specific organizational form of these systems as State member banks. The safe and efficient operation of payment, settlement, and clearing systems is critical to the execution of monetary policy and the flow of liquidity throughout the financial sector, which is why many central banks around the world currently have explicit oversight responsibilities for critical systems.

Importantly, the proposed enhancements to our responsibilities for the safety and soundness of systemically important arrangements would complement—and not displace—the authority of the SEC and CFTC for the systems subject to their supervision under the Federal securities and commodities laws. We have an extensive history of working cooperatively with these agencies, as well as international authorities. For example, the Federal Reserve works closely with the SEC in supervising the Depository Trust Company and also works closely with 21 other central banks in supervising the foreign exchange settlements of CLS Bank.

**Consumer Protection**

A word on the consumer protection piece of the Administration's plan may be appropriate here, insofar as we have seen how problems in consumer protection can in some cases contain the seeds of systemic problems. The Administration proposes to shift responsibility for writing and enforcing regulations to protect consumers from unfair practices in financial transactions from the Federal Reserve to a new Consumer Financial Protection Agency.

Without extensively entering the debate on the relative merits of this proposal, I do think it important to point out some of the benefits that would be lost through this change.

Both the substance of consumer protection rules and their enforcement are complementary to prudential supervision. Poorly designed financial products and misaligned incentives can at once harm consumers and undermine financial institutions. Indeed, as with subprime mortgages and securities backed by these mortgages, these products may at times also be connected to systemic risk. At the same time, a determination of how to regulate financial practices both effectively and efficiently can be facilitated by the understanding of institutions' practices and systems that is gained through safety and soundness regulation and supervision. Similarly, risk assessment and compliance monitoring of consumer and prudential regulations are closely related, and thus entail both informational advantages and resource savings.

Under Chairman Bernanke's leadership, the Federal Reserve has adopted strong consumer protection measures in the mortgage and credit card areas. These regulations benefited from the supervisory and research capabilities of the Federal Reserve, including expertise in consumer credit markets, retail payments, banking operations, and economic analysis. Involving all these forms of expertise is important for tailoring rules that prevent abuses while not impeding the availability of sensible extensions of credit.

### Conclusion

Thank you again for the opportunity to testify on these important matters. The Federal Reserve looks forward to working with Congress and the Administration to enact meaningful regulatory reform that will strengthen the financial system and reduce both the probability and severity of future crises.

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## PREPARED STATEMENT OF VINCENT R. REINHART

RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

JULY 23, 2009

### For Best Results: Simplify

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

No doubt, the American people expect significant remedial action in the aftermath of the extraordinary Government support to financial institutions over the past year. Indeed, this is probably a generational moment in which this Congress will shape the financial landscape for decades to come. At the outset, however, we must remember that greater discipline does not always follow from more intricate oversight.

### The Problem

In fact, complexity has been the bane of our financial system for decades and cannot be the solution going forward. We have created an intricate, multifaceted terrain of opportunities through our financial regulations, tax codes, and accounting rules. There are multiple Federal regulators and State alternatives. Different jurisdictions offer varied enticements in terms of favorable legal structure and tax treatment. And the tax code ranges across region and over time.

Financial firms have burrowed into every nook and cranny. This has required the effort of legal specialists, accounting experts, and financial engineers. As a result, the balance sheets of large firms have been splintered into a collection of special purpose vehicles, and securities have been issued with no other purpose than extracting as much value as possible from the Basel II Supervisory Accord.

This complexity introduces three fundamental problems in monitoring behavior.

First, supervisors are at a decided disadvantage in understanding risk taking and compliance for a firm that might involve dozens of jurisdictions, hundreds of legal entities, and thousands of contractual relationships. Firms know this and tailor individual instruments to a small slice of its clientele to take advantage of tax and accounting rules. Its balance sheet might respond quickly to advances in finance and legal interpretations. And the same risks might be booked in different ways across affiliates, let alone across different institutions, with evident consequences for capital requirements. Indeed, the reliance of self-regulation inherent in the Basel II supervisory agreement can be seen as an official admission of defeat: A large complex financial institution cannot be understood from outside.

But if an institution is so difficult to understand from the outside, how can we expect market discipline to be effective? The second cost of complexity is that the outside discipline of credit counterparties and equity owners is blunted. Creditors are more likely to look to the firm's reputation or a stamp from a rating agency rather than the underlying collateral provided by the financial contract. Equity owners are more likely to defer to senior management, opening the way to compensation abuses and twisting incentives to emphasize short-term gains. In this regard, it is probably not an accident that financial firms tend not to be targets for hostile takeovers—their balance sheets are impenetrable from the outside.

Third, the problems in understanding the workings of a complicated firm are not limited to those on the outside. A complicated firm is also difficult to manage. Employers will find it more difficult to monitor employees, especially when staff on the ground have highly specialized expertise in finance, law, and accounting. Simply put, employees who are difficult to monitor cannot be expected to promote the long-term interests of their workplace. What follows are abuses in matching loans and investments to the appropriate customer and, in some cases, outright fraud.

Note the irony. A firm's effort to take advantage of Government induced distortions by becoming more complicated and by making its instruments more complex lessens the owner's ability to monitor management and management's ability to monitor workers. Market discipline breaks down.

**The Simple Solution**

Sometimes the answer to a complicated problem is simple, as Alexander found with the Gordian Knot. Cut through the existing tangle of financial regulation. Consolidate Federal financial regulators and assume State responsibilities. Simplify accounting rules and the tax code. Make the components of financial firms modular so that the whole can be split up into basic parts at a time of stress, advice that may have eased resolution of AIG's financial products division. With simple rules that define lines more sharply, our Federal regulators will find enforcement much easier. If firms are more transparent, official supervision will be reinforced by the newfound discipline exercised by shareholders and creditors. And with fewer places for self-interest to hide, employees will be more accountable in their efforts to preserve the longer-term value of their firms.

I recognize that a Congress pressed for results might be reluctant to enact radical simplification. The consolidation of multiple agencies and the shift of power away from States to a single Federal entity seem daunting. Even harder might be the necessary reduction in the variety of corporate charters and the pruning of the tax code and accounting rules. Indeed, this is an invitation to jurisdictional warfare, as each regulator jockeys for viability. But a more established set of rules for the resolution of large firms, simplification of regulations generally, and consolidation of supervision specifically should be the aspiration of this Congress. I shall argue that a well-designed financial stability supervisor can be a means to that end.

**A Distinct Choice**

The Treasury recently laid out a new foundation for financial regulation. It envisions granting the Federal Reserve new authority to supervise all firms that could pose a threat to financial stability, even those that do not own banks. I disagree. Such powers should not be given to an existing agency, especially not the Nation's central bank. Rather, the Congress should form a committee of existing supervisors, headed by an independent director, appointed by the President, and confirmed by the Senate. The director should have a budget for staff and real powers to compel cooperation among the constituent agencies and reporting from unregulated entities, if necessary.

Why shouldn't an existing agency head the committee? From the Congress's perspective, an agency is a black box that is difficult to monitor, filled with technicians given multiple tools directed toward multiple goals. The more complicated is its mission, the more opportunities those technicians will have to trade off among those goals. For example, consider the plight, admittedly abstract, of an agency told to enforce a capital standard and to foster lending. At a downturn in the business cycle, it might be tempted to allow overly optimistic asset valuations so as to prevent balance-sheet constraints from slackening lending. Perhaps, this compromise might be consistent with the implied wishes of the Congress. But perhaps not. Because an agency, especially focused on technical matters, tends to be opaque, it will be difficult for its legislative creators to hold it accountable.

There are adverse implications of burdening an agency, any agency, with multiple goals. First, the public will be confused about what goes on behind the curtain. This makes it less likely that the agency will find widespread support for its core responsibilities or anyone who identifies with its mission. Second, and a bit more inside the Beltway, it will be hard to fill the slots at agencies where the job description calls for multiple technical talents and competing demands on time. Third, key relationships of an agency with the Congress and other regulators can become hostage to peripheral turf fights. From my own experience, the atmosphere at Fed hearings was especially charged in 2004 and 2005 in both chambers. Some members and staff thought that Chairman Greenspan was dragging his feet on consumer disclosure regulation. My point is not that they were wrong in criticizing the Chairman. Rather, my point is that time set aside in legislation to discuss the plans and objectives of the Fed for monetary policy was chewed up on other topics. As a result, Fed credibility was impaired for reasons other than the performance of the economy.

**The Fed Exception**

I have thus far offered general objections to giving financial stability responsibilities to an existing agency. I believe that there are even more compelling reasons that those responsibilities should not be given to the Fed. Please recognize that I worked in the Federal Reserve System for a quarter-century and that I hold its staff in high esteem. They are knowledgeable, competent, and committed to their mission. But any group of people in an independent agency assigned too many goals will be pulled in too many directions. And there is one goal given to the Fed that should not be jeopardized: the pursuit of maximum employment and stable prices. Indeed, that goal is so pivotal to the Nation's interest that the Congress should be thinking of narrowing, not broadening, the Fed's focus.

Three other concerns should give you pause before signing on to the Treasury's blueprint of a new role for the Fed.

First, as compared to other agencies, the Fed has significant macroeconomic policy and lending tools. If it failed in its role as systemic supervisor to identify the originator of the next financial crisis, might it be more likely to use those tools beyond what is necessary for the achievement of its core monetary policy responsibility?

Second, you might hear that the expertise gained in assessing financial stability will help to inform the Fed's pursuit of macropolicy goals. That would work in principal. In practice, I believe that there are precious few instances of that favorable feedback, despite the Fed's involvement in bank supervision since its inception. But I stand willing to be proved wrong. The Fed's monetary policy deliberations over the years are extremely well-documented in thousands of pages of minutes and transcripts. Anyone making the case for beneficial spillovers should be asked to produce numerous relevant excerpts from that treasure trove. I do not think they will be able to do so because I do not think those examples exist.

Third, the gift of extraordinary powers to an agency merits forthright accountability from that agency. It is up to you to determine whether the Fed has been sufficiently accountable during this recent episode. In that regard, however, I would note an inconsistency in the Treasury blueprint. It wants to give the Fed new powers regarding financial stability. At the same time, it seeks to circumscribe the one unusual power that the Fed has exercised over the past year by requiring the Treasury Secretary to sign off in advance of lending in unusual and exigent circumstances. Which best describes the true Fed—empowerment or limitation?

**An Alternative**

My strong preference, absent radical simplification, is that the supervision of financial stability be delegated to a committee of existing financial supervisors. Those constituent agencies have the specific expertise to understand our complicated financial world. At the head should be someone appointed by the President and confirmed by the Senate. He or she should have a budget to staff a secretariat deemed suitable. And that agency should have independent powers. It should be able to compel the information sharing among the constituent supervisors and the reporting of information, if necessary, from unregulated entities. The constituent agencies should regularly be directed to draft reports in their areas of expertise for consideration by the full Committee and transmittal to the Congress. This would include twice-a-year reports on macroeconomic stability from the Fed, appraisals of the health of the banking system from the FDIC, and assessments on the resilience of financial market infrastructure from the SEC and the CFTC.

Why does the committee head need to be appointed in that capacity and have unique powers? The committee head needs the heft associated with an independent selection. Without power, the committee would devolve to a debating society that spends the first 5 years of its existence negotiating memoranda of understanding on the sharing of information.

Think about this analogy. In the run-up to the financial crisis, every single large complex financial institution had a senior risk management committee. In most cases, all those committees managed to do was to allow the build-up of large risks. Now the U.S. Government has a significant ownership stake in many of them. The few exceptional, successful firms were the ones that gave the risk managers real powers to control positioning. Why should the Federal Government settle for a toothless authority?

**A Longer-Term Vision**

The real benefits of a financial stability committee would come if the Congress were forward-looking in writing its mandate. The committee could be a vehicle to foster the achievement over time of robust rules for the resolution of private firms, simplification of the financial system, and consolidation of financial agencies.

Let me take each in turn.

*Resolution.* At a time of crisis, we resort to the injection of public funds into private firms because we are afraid of letting market forces play out. Each major firm should negotiate a "living will" with its regulator each year. That living will should detail how the firm should be disassembled in the event of bankruptcy. It should list the segments of the firm that are systemically important and provide contractual mechanisms to ring-fence them. The secretariat of the financial stability committee should assess those plans to make sure what looked good on paper could be applied *in extremis.* Also, the secretariat can recommend industry initiatives to narrow over time the ambit of firm-specific systemically important activities.

Periodically, the head of the committee should report to the Congress—in closed session if necessary—about the status of resolution plans. This would be the opportunity to identify areas for legislation, if necessary, to give the Government more effective resolution powers.

*Simplification.* It will not take long for anyone tasked with working through the innermost machinations of major financial firms to conclude that our system is hopelessly complicated. The head of the financial stability committee should report annually on opportunities to hack away at that underbrush, be it agency regulations, accounting rules, or the tax code. The ambition of the new agency to simplify financial rules, across industries and products, should be as wide as the net cast for threats to financial stability. Those opportunities are both in Federal and State legislation and agency regulation. On a flow basis, new legislation should be scored, much as is already done for budgetary impact, for the effects on the complexity of the financial system.

*Consolidation.* The low hanging fruit of simplification will most likely come in consolidating Federal agencies and State responsibilities. An independent agency head should have the perspective and stature to identify such opportunities that can be the basis of future legislation. That is, part of the job of the committee's chair should be explaining how the committee should get smaller over time.

**Conclusion**

Facilitating resolution, simplifying rules, and consolidating regulators will go a long way in making financial firms more transparent. This will aid in enforcing remaining regulation, disciplining credit decisions, and monitoring employees. It is also patently fairer. Being bigger or more complicated or having better lobbyists will not covey an advantage in a world of clear lines, strict enforcement, and no exceptions. We have lived in a world of fine print and sharp lawyers and look where that got us. We are ready for change.

I would prefer that this change come quickly, but others might see this as too abrupt. If significant simplification does not come now, a strong independent financial stability committee could provide immediate protection and the promise of identifying areas for future progress along the lines I have laid out.

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## PREPARED STATEMENT OF PAUL SCHOTT STEVENS

President and CEO, Investment Company Institute

July 23, 2009

**I. Introduction**

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs) (collectively, "funds"). Members of ICI manage total assets of $10.6 trillion and serve over 93 million shareholders.

Millions of American investors have chosen funds to help meet their long-term financial goals. In addition, funds are among the largest investors in U.S. companies—they hold, for example, about 25 percent of those companies' outstanding stock, approximately 45 percent of U.S. commercial paper (an important source of short-term funding for corporate America), and about 33 percent of tax-exempt debt issued by U.S. municipalities. As both issuers of securities to investors and purchasers of securities in the market, funds have a strong interest in the ongoing consideration by policy makers and other stakeholders of how to strengthen our financial regulatory system in response to the most significant financial crisis many of us have ever experienced.

In early March, ICI released a white paper outlining detailed recommendations on how to reform the U.S. financial regulatory system, with particular emphasis on reforms most directly affecting the functioning of the capital markets and the regulation of funds, as well as the subject of this hearing—how best to monitor for potential systemic risks and mitigate the effect of such risks on our financial system and the broader economy.[1] At a March hearing before this Committee, I summarized ICI's recommendations and offered some of my own thoughts on a council approach to systemic risk regulation, based on my personal experience as the first Legal Adviser to and, subsequently, Executive Secretary of, the National Security Council. Since March, ICI has continued to develop and refine its reform recommendations and to study proposals advanced by others. I very much appreciate the opportunity to appear before this Committee again and offer further perspectives on establishing a framework for systemic risk regulation.

Section II below offers general observations on establishing a formal mechanism for identifying, monitoring, and managing potential risks to our financial system. Section III comments on the Administration's proposed approach to systemic risk regulation. Finally, Section IV describes in detail a proposal to structure a systemic risk regulator as a statutory council of senior Federal financial regulators.

**II. Systemic Risk Regulation: General Observations**

The ongoing financial crisis has highlighted our vulnerability to risks that accompany products, structures, or activities that may spread rapidly throughout the financial system; and that may occasion significant damage to the system at large. Over the past year, various policy makers, financial services industry representatives, and other commentators have called for the establishment of a formal mechanism for identifying, monitoring, and managing risks of this dimension—one that would allow Federal regulators to look across the system and to better anticipate and address such risks.

ICI was an early supporter of creating a systemic risk regulator. But we also have long advocated that two important cautions should guide Congress in determining the composition and authority of such a regulator.[2] First, the legislation establishing a systemic risk regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system that may stifle innovations, impede competition, or impose needless inefficiencies. Second, a systemic risk regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking, or insurance.

Accordingly, in our judgment, legislation establishing a systemic risk regulator should clearly define the nature of the relationship between this new regulator and the primary regulator(s) for the various financial sectors. It should delineate the extent of the authority granted to the systemic risk regulator, as well as identify circumstances under which the systemic risk regulator and primary regulator(s) should coordinate their efforts and work together. We believe, for example, that the primary regulators should continue to act as the first line of defense in addressing potential risks within their spheres of expertise.

In view of the two cautions outlined above, ICI was an early proponent of structuring a systemic risk regulator as a statutory council comprised of senior Federal regulators. As noted above, I testified before this Committee at a March hearing focused on investor protection and the regulation of securities markets. At that time, I recommended that the Committee give serious consideration to the council model, based on my personal experience with the National Security Council (NSC), a body which has served the Nation well for more than 60 years. As the first Legal Adviser to the NSC in 1987, I was instrumental in reorganizing the NSC system and staff

[1] See Investment Company Institute, Financial Services Regulatory Reform: Discussion and Recommendations (March 3, 2009), available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf* (ICI White Paper).

[2] See *id.* at 4.

following the Iran–Contra affair. I subsequently served from 1987 to 1989 as chief of the NSC staff under National Security Adviser Colin Powell.

**III. The Administration's Proposed Approach**

The council approach to a systemic risk regulator has received support from Federal and State regulators and others.[3] It is noteworthy that the Administration's white paper on regulatory reform likewise includes recommendations for a Financial Services Oversight Council (Oversight Council).[4] The Oversight Council would monitor for emerging threats to the stability of the financial system, and would have authority to gather information from the full range of financial firms to enable such monitoring. As envisioned by the Administration, the Oversight Council also would serve to facilitate information sharing and coordination among the principal Federal financial regulators, provide a forum for consideration of issues that cut across the jurisdictional lines of these regulators, and identify gaps in regulation.[5]

Unfortunately, the Administration's proposal would vest the lion's share of authority and responsibility for systemic risk regulation with the Federal Reserve, relegating the Oversight Council to at most an advisory or consultative role. In particular, the Administration recommends granting broad new authority to the Federal Reserve in several respects.[6] The Administration's white paper acknowledges that "[t]hese proposals would put into effect the biggest changes to the Federal Reserve's authority in decades."[7]

I believe that the Administration's approach would strike the wrong balance. Significantly, it fails to draw in a meaningful way on the experience and expertise of other regulators responsible for the oversight of capital markets, commodities and futures markets, insurance activities, and other sectors of the banking system. The Administration's white paper fails to explain why its proposed identification and regulation of Tier 1 Financial Holding Companies (Tier 1 FHCs) is appropriate in view of concerns over market distortions that could accompany "too-big-to-fail" designations. The standards that would govern determinations of Tier 1 FHC status are highly ambiguous.[8] Finally, by expanding the mandate of the Federal Reserve well beyond its traditional bounds, the Administration's approach could jeopardize the Federal Reserve's ability to conduct monetary policy with the requisite degree of independence.

The shortcomings that we see with the Administration's plan reinforce our conclusion that a properly structured statutory council would be the most effective mechanism to orchestrate and oversee the Federal Government's efforts to monitor for potential systemic risks and mitigate the effect of such risks. Below, we set forth our detailed recommendations for the composition, role, and scope of authority that should be afforded to such a council.

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[3] See, *e.g.,* Statement of Damon A. Silvers, Associate General Counsel, AFL–CIO, before the Senate Committee on Homeland Security and Government Affairs, Hearing on "Systemic Risk and the Breakdown of Financial Governance" (March 4, 2009); Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, before the Senate Committee on Banking, Housing, and Urban Affairs, Hearing on "Regulating and Resolving Institutions Considered 'Too-Big-To-Fail' " (May 6, 2009) ("Bair Testimony"); Senator Mark R. Warner, "A Risky Choice for a Risk Czar", *Washington Post* (June 28, 2009).

[4] See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (June 17, 2009), available at *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf* (Administration white paper), at 17-19.

[5] See *id.* at 18.

[6] Under this new authority, the Federal Reserve would have: (1) the ultimate voice in determining which financial firms would potentially pose a threat to financial stability, through designation of so-called "Tier 1 Financial Holding Companies;" (2) the ability to collect reports from all financial firms meeting minimum size thresholds and, in certain cases, to examine such firms, in order to determine whether a particular firm should be classified as a Tier 1 FHC; (3) consolidated supervisory and regulatory authority over Tier 1 FHCs and their subsidiaries, including the application of stricter and more conservative prudential standards than those applicable to other financial firms; and (4) the role of performing "rigorous assessments of the potential impact of the activities and risk exposures of [Tier 1 FHCs] on each other, on critical markets, and on the broader financial system." See *id.* at 19-24.

[7] *Id.* at 25.

[8] The Administration proposes requiring the Federal Reserve to consider certain specified factors (including the firm's size and leverage, and the impact its failure would have on the financial system and the economy) and to get input from the Oversight Council. The Federal Reserve, however, would have discretion to consider other factors, and the final decision of whether to designate a particular firm for Tier 1 FHC status would be its alone. See *id.* at 20-21. This approach, in our view, would vest wide discretion in the Federal Reserve and provide financial firms with insufficient clarity about what activities, lines of business, or other factors might result in a Tier 1 FHC designation.

**IV. Fashioning an Effective Systemic Risk Council**

In concept, an effective Systemic Risk Council (Council) could be similar in structure and approach to the National Security Council, which was established by the National Security Act of 1947. In the aftermath of World War II, Congress recognized the need to assure better coordination and integration of "domestic, foreign, and military policies relating to the national security" and the ongoing assessment of "policies, objectives, and risks." The 1947 Act established the NSC under the President as a Cabinet-level council with a dedicated staff. In succeeding years, the NSC has proved to be a key mechanism used by Presidents to address the increasingly complex and multifaceted challenges of national security policy.

*a. Composition of the Council and Its Staff*

As with formulating national security policy, addressing risks to the financial system at large requires diverse inputs and perspectives. The Council's standing membership accordingly should draw upon a broad base of expertise, and should include the core Federal financial regulators—the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, Chairman of the Securities and Exchange Commission, Chairman of the Commodity Futures Trading Commission, the Comptroller of the Currency (or head of any combined Office of the Comptroller of the Currency and of the Office of Thrift Supervision), the Chairman of the Federal Deposit Insurance Corporation, and the head of a Federal insurance regulator, if one emerges from these reform efforts. As with the NSC, flexibility should exist for the Council to enlist other Federal and State regulators into the work of the Council on specific issues as required—including, for example, self-regulatory organizations and State regulators for the banking, insurance or securities sectors.

The Secretary of the Treasury, as a Presidential appointee confirmed by the Senate and the senior-most member of the Council, should be designated chairman. An executive director, appointed by the President, should run the day-to-day operations of the Council and serve as head of the Council's staff. The Council should meet on a regular basis, with an interagency process coordinated through the Council's staff to support and follow through on its ongoing deliberations.

To accomplish its mission, the Council should have the support of a dedicated, highly experienced staff. The staff should represent a mix of disciplines (*e.g.,* economics, accounting, finance, law) and areas of expertise (*e.g.,* securities, commodities, banking, insurance). It should consist of individuals seconded from Government departments and agencies, as well as individuals having a financial services business, professional, or academic background recruited from the private sector. The Council's staff should operate, and be funded, independently from the functional regulators.[9] Nonetheless, the background and experience of the staff, including those seconded from other parts of Government, would help assure the kind of strong working relationships with the functional regulators necessary for the Council's success. Such a staff could be recruited and at work in a relatively short period of time. The focus in recruiting a staff should be on quality, not quantity, and the Council's staff accordingly need not and should not be large.

*b. Mission and Operation of the Council*

By statute, the Council should have a mandate to monitor conditions and developments in the domestic and international financial markets, and to assess their implications for the health of the U.S. financial system at large. The Council would be responsible for making threshold determinations concerning the systemic risks posed by given products, structures, or activities. It would identify regulatory actions to be taken to address these systemic risks as they emerge, would assess the effectiveness of these actions, and would advise the President and Congress regularly on emerging risks and necessary legislative or regulatory responses. The Council would be responsible for coordinating and integrating the national response to such risks. Nonetheless, it would not have a direct operating role (just as the NSC coordinates and integrates military and foreign policy that is implemented by the Defense or State Department and not by the NSC itself). Rather, responsibility for addressing identified risks would lie with the existing functional regulators, which would act pursuant to their normal statutory authorities but—for these purposes only—under the Council's direction.

Similar to the Administration's Oversight Council proposal, the Council should have two separate but interrelated mandates—(1) the prevention and mitigation of systemic risk and (2) policy coordination and information sharing across the various functional regulators. Under this model, where all the functional regulators have an

[9] A Council designed in this way would differ from the Administration's Oversight Council, which would be staffed and operated within the Treasury Department.

equal voice and stake in the success of the Council, the stronger working relationships and the sense of shared purpose that would grow out of the Council's collaborative efforts would greatly assist in sound policy development, prioritization of effort, and cooperation with the international regulatory community. Further, the staffing and resources of the Council could be leveraged for both purposes. This would address some of the criticisms and limitations of the existing President's Working Group on Financial Markets (PWG).

Information will be the lifeblood of the Council's deliberations and the work of the Council's staff. Having information flow from regulated entities through their functional regulators to the Council and its staff would appropriately draw upon the regulators' existing information and data collection capabilities and avoid unnecessary duplication of effort. To the extent that a particular financial firm is not subject to direct supervision by a Council member, the Council should have the authority to require periodic or other reporting from such firm as the Council determines is necessary to evaluate the extent to which a particular product, structure, or activity poses a systemic risk.[10]

Although the Council and its staff would continually monitor conditions and developments in the financial markets, the range of issues requiring action by the Council itself should be fairly limited in scope—directed only at major unaddressed hazards to the financial system, as opposed to day-to-day regulatory concerns. As noted above, the Council should be required, as a threshold matter, to make a formal determination that some set of circumstances could pose a risk to the financial system at large. That determination would mark the beginning of a consultative process among the Council members, with support from the Council's staff, to develop a series of responses to the identified risks. The Council could then recommend or direct action by the appropriate functional regulators to implement these responses.

Typically, the Council should be able to reach consensus, both on identifying potential risks and developing responses to such risks. To address the rare instance where Council members are unable to reach consensus on a course of action, however, there should be a mechanism—specified in the authorizing legislation—that would require the elevation of disputes to the President for resolution. There likewise should be reporting to Congress of such disputes and their resolution, so as to assure timely Congressional oversight.

To ensure proper follow-through, we envision that the individual regulators would report back to the Council, which would monitor progress and ensure that the regulators are acting in accord with the policy direction set by the Council. At the same time, to ensure appropriate accountability, we recommend that the Council be required to report to Congress whenever it makes a threshold finding or recommends or directs a functional regulator to take action, so that the relevant oversight committees in Congress also may monitor progress and assess the adequacy of the regulatory response.

### *c. Advantages of a Council Model*

We believe that the council model outlined above would offer several important advantages.

First, the Council would avoid risks inherent in designating an existing agency like the Federal Reserve to serve essentially as an all-purpose systemic risk regulator. In such a role, the Federal Reserve understandably may tend to view risks and risk mitigation through its lens as a commercial bank regulator focused on prudential regulation and "safety and soundness" concerns, potentially to the detriment of consumer and investor protection concerns and of nonbank financial institutions. A Council with a diverse membership would bring all competing perspectives to bear and, as a result, would be more likely to strike the proper balance. In ICI's view, such perspectives most certainly must include those of the SEC and the CFTC. In this regard, we are pleased to note that the Administration's reform proposals would preserve the role of the SEC as a strong regulator with broad responsibilities for overseeing the capital markets and key market functions such as clearance, settlement and custody arrangements, while also maintaining its investor protection focus. It is implausible that we could effectively regulate systemic risk in the financial markets without fully incorporating the SEC into that process.

[10] The Administration likewise proposes to grant its Oversight Council the authority to require periodic reporting from financial firms, but the authority would extend to all firms, with simply a *caveat* that the Oversight Council "should, wherever possible," rely upon information already being collected by Council members. See Administration white paper, *supra* note 4, at 19.

Second, systemic risks may arise in different ways and affect different parts of the domestic and global financial system. No existing agency or department has a comprehensive frame of reference or the necessary expertise to assess and respond to any and all such risks. In contrast, the Council would enlist the expertise of the entire regulatory community in identifying and devising strategies to mitigate systemic risks. These diverse perspectives are essential if we are to successfully identify new and unanticipated risks, and avoid simply refighting the "last war." Whatever may be the specified cause of a future financial crisis, it is certain to be different than the one we are now experiencing.

Third, the Council would provide a high degree of flexibility in convening those Federal and State regulators whose input and participation is necessary to addressing a specific issue, without creating an unwieldy or bureaucratic structure. As is the case with the NSC, the Council should have a core membership of senior Federal officials and the ability to expand its participants on an *ad hoc* basis when a given issue so requires. It also could be established and begin operation in relatively short order. Creating an all-purpose systemic risk regulator, on the other hand, would be a long and complex undertaking, and would involve developing expertise that duplicates that which already exists in the various functional regulators.

Fourth, with an independent staff dedicated solely to pursuing the Council's agenda, the Council would be well-positioned to test or challenge the policy judgments or priorities of various functional regulators. This would help address any concerns about "regulatory capture," including those raised by the Administration's proposal concerning the Federal Reserve's exclusive oversight of Tier 1 FHCs. Moreover, by virtue of their participation on the Council, the various functional regulators would themselves likely be more attentive to emerging risks or regulatory gaps. This would help assure a far more coordinated and integrated approach. Over time, the Council also could assist in framing a political consensus about addressing significant regulatory gaps and necessary policy responses.

Fifth, the functional regulators, as distinct from the Council itself, would be charged with implementing regulations to mitigate systemic risks as they emerge. This operational role is appropriate because the functional regulators have the greatest knowledge of their respective regulated industries. Nonetheless, the Council and its staff would have an important independent role in evaluating the effectiveness of the measures taken by functional regulators to mitigate systemic risk and, where necessary, in prompting further actions.

Finally, the council model outlined above would be sufficiently robust to ensure sustained follow-through to address critical and complex issues posing risk to the financial system. By way of illustration, consider the case of Long-Term Capital Management (LTCM), a very large and highly leveraged U.S. hedge fund, which in September 1998 lost 90 percent of its capital and nearly collapsed. Concerned that the hedge fund's collapse might pose a serious threat to the markets at large, the Federal Reserve arranged a private sector recapitalization of LTCM. In the aftermath of this incident, there were studies, reports, and recommendations, including by the PWG and the U.S. Government Accountability Office (GAO). But 10 years later, a January 2008 GAO report noted "the continuing relevance of questions raised over LTCM" and concluded that it was still "too soon to evaluate [the] effectiveness" of the regulatory and industry response to the LTCM experience.[11]

Hopefully, had a Systemic Risk Council such as that described above been in operation at the time of LTCM's near collapse, it might have prompted more searching analysis of, and more timely and comprehensive regulatory action with respect to, the activities that led to LTCM's near collapse—such as the growing use of derivatives to achieve leverage. For example, under the construct outlined above, the Council would have the authority to direct functional regulators to take action to implement policy responses—authority that the PWG does not possess.

*d. Potential Criticisms—And How They Can Be Addressed*

It has been argued that, because of the Federal Reserve's unique crisis-management capability as the central bank and lender of last resort, it is the only logical choice as a systemic risk regulator. To be sure, should our Nation encounter serious financial instability, the Federal Reserve's authorities will be indispensable to remedy the problems. So, too, will be any new resolution authority established for failing large and complex financial institutions. But the overriding purpose of systemic risk regulation should be to identify in advance, and prevent or mitigate, the causes of such instability. This is a role to which the Council, with its diversity of expertise

[11] United States Government Accountability Office, "Hedge Funds, Regulators, and Market Participants Are Taking Steps To Strengthen Market Discipline, But Continued Attention Is Needed" (January 2008), at 3 and 8.

and perspectives, would seem best suited. Put another way, critics of a council model may contend that convening a committee is not the best way to put out a roaring fire. But a broad-based council is the best body for designing a strong fire code—without which we cannot hope to prevent the fire before it ignites and consumes our financial system.

Another potential criticism of the Council is that it may diffuse responsibility and pose difficulties in assuring proper follow-through by the functional regulators. While it is true that each functional regulator would have responsibility for implementing responses to address identified risks, it must be made clear in the legislation creating the Council (and in corresponding amendments to the organic statutes governing the functional regulators) that these responses must reflect the policy direction determined by the Council. Additionally, as suggested by FDIC Chairman Bair, the Council should have the authority to require a functional regulator to act as directed by the Council.[12] In this way, Congress would be assured of creating a Systemic Risk Council with "teeth."

Finally, claiming that a council of Federal regulators "would add a layer of regulatory bureaucracy without closing the gaps that regulators currently have in skills, experience and authority needed to track systemic risk comprehensively," a recent report instead calls for the creation of a wholly independent board to serve as a systemic risk "adviser."[13] As proposed, the board's mission would be to: (1) collect and analyze risk exposure of bank and nonbank institutions and their practices and products that could threaten financial stability; (2) report on those risks and other systemic vulnerabilities; and (3) make recommendations to regulators on how to reduce those risks. We believe this approach would be highly problematic. It would have precisely the effect that its proponents wish to avoid—by adding another layer of bureaucracy to the regulatory system. It would engender a highly intrusive mechanism that would increase regulatory costs and burdens for financial firms. For example, duplication likely would result from giving a new advisory board the authority to gather the financial information it needs to assess potential systemic risks. And if the board's sole function were to look for systemic risks in the financial system, it almost goes without saying that it would surely find them.

**V. Conclusion**

I appreciate this opportunity to testify before the Committee, and I hope that the perspectives I have offered today will assist the Committee in its deliberations about the mechanism(s) needed to monitor and mitigate potential risks to our financial system. More broadly, I would like to commend Chairman Dodd, Ranking Member Shelby, and the other Members of the Committee for their considerable efforts in seeking meaningful reform of our financial services regulatory regime. I—and ICI and its members—look forward to working further with this Committee and Congress to achieve such reform.

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## PREPARED STATEMENT OF ALICE M. RIVLIN

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JULY 23, 2009

Mr. Chairman and Members of the Committee, I am happy to be back before this Committee to give my views on reducing systemic risk in financial services. I will focus on changes in our regulatory structure that might prevent another catastrophic financial meltdown and what role the Federal Reserve should play in a new financial regulatory system.

It is hard to overstate the importance of the task facing this Committee. Market capitalism is a powerful system for enhancing human economic well-being and allocating savings to their most productive uses. But markets cannot be counted on to police themselves. Irrational herd behavior periodically produces rapid increases in asset values, lax lending and overborrowing, excessive risk taking, and outsized profits followed by crashing asset values, rapid deleveraging, risk aversion, and huge loses. Such a crash can dry up normal credit flows and undermine confidence, triggering deep recession and massive unemployment. When the financial system fails on the scale we have experienced recently the losers are not just the wealthy investors and executives of financial firms who took excessive risks. They are aver-

[12] See Bair Testimony, *supra* note 3.
[13] See "Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective" (July 2009), available at *http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf.*

age people here and around the world whose jobs, livelihoods, and life savings are destroyed and whose futures are ruined by the effect of financial collapse on the world economy. We owe it to them to ferret out the flaws in the financial system and the failures of regulatory response that allowed this unnecessary crisis to happen and to mend the system so to reduce the chances that financial meltdowns imperil the world's economic well-being.

**Approaches To Reducing Systemic Risk**

The crisis was a financial "perfect storm" with multiple causes. Different explanations of why the system failed—each with some validity—point to at least three different approaches to reducing systemic risk in the future.

*The highly interconnected system failed because no one was in charge of spotting the risks that could bring it down.*

This explanation suggests creating a Macro System Stabilizer with broad responsibility for the whole financial system charged with spotting perverse incentives, regulatory gaps and market pressures that might destabilize the system and taking steps to fix them. The Obama Administration would create a Financial Services Oversight Council (an interagency group with its own staff) to perform this function. I think this responsibility should be lodged at the Fed and supported by a Council.

*The system failed because expansive monetary policy and excessive leverage fueled a housing price bubble and an explosion of risky investments in asset backed securities.*

While low interest rates contributed to the bubble, monetary policy has multiple objectives. It is often impossible to stabilize the economy and fight asset price bubbles with a single instrument. Hence, this explanation suggests stricter regulation of leverage throughout the financial system. Since monetary policy is an ineffective tool for controlling asset price bubbles, it should be supplemented by the power to change leverage ratios when there is evidence of an asset price bubble whose bursting that could destabilize the financial sector. Giving the Fed control of leverage would enhance the effectiveness of monetary policy. The tool should be exercised in consultation with a Financial Services Oversight Council.

*The system crashed because large interconnected financial firms failed as a result of taking excessive risks, and their failure affected other firms and markets.*

This explanation might lead to policies to restrain the growth of large interconnected financial firms—or even break them up—and to expedited resolution authority for large financial firms (including nonbanks) to lessen the impact of their failure on the rest of the system. Some have argued for the creation of a single consolidated regulator with responsibility for all systemically important financial institutions. The Obama Administration proposes making the Fed the consolidated regulator of all Tier 1 Financial Institutions. I believe it would be a mistake to identify specific institutions as too-big-to-fail and an even greater mistake to give this responsibility to the Fed. Making the Fed the consolidated prudential regulator of big interconnected institutions would weaken its focus on monetary policy and the overall stability of the financial system and could threaten its independence.

**The Case for a Macro System Stabilizer**

One reason that regulators failed to head off the recent crisis is that no one was explicitly charged with spotting the regulatory gaps and perverse incentives that had crept into our rapidly changing financial structure in recent decades. In recent years, antiregulatory ideology kept the United States from modernizing the rules of the capitalist game in a period of intense financial innovation and perverse incentives to creep in.

*Perverse Incentives.* Lax lending standards created the bad mortgages that were securitized into the toxic assets now weighting down the books of financial institutions. Lax lending standards by mortgage originators should have been spotted as a threat to stability by a Macro System Stabilizer—the Fed should have played this role and failed to do so—and corrected by tightening the rules (minimum down payments, documentation, proof that the borrow understands the terms of the loan and other no-brainers). Even more important, a Macro System Stabilizer should have focused on why the lenders had such irresistible incentives to push mortgages on people unlikely to repay. Perverse incentives were inherent in the originate-to-distribute model which left the originator with no incentive to examine the credit worthiness of the borrower. The problem was magnified as mortgage-backed securities were resecuritized into more complex instruments and sold again and again. The Administration proposes fixing that system design flaw by requiring loan originators and securitizers to retain 5 percent of the risk of default. This seems to me too low, especially in a market boom, but it is the right idea.

The Macro System Stabilizer should also seek other reasons why securitization of asset-backed loans—long thought to be a benign way to spread the risk of individual loans—became a monster that brought the world financial system to its knees. Was it partly because the immediate fees earned by creating and selling more and more complex collateralized debt instruments were so tempting that this market would have exploded even if the originators retained a significant portion of the risk? If so, we need to change the reward structure for this activity so that fees are paid over a long enough period to reflect actual experience with the securities being created.

Other examples, of perverse incentives that contributed to the violence of the recent perfect financial storm include Structured Investment Vehicles (SIV's) that hid risks off balance sheets and had to be either jettisoned or brought back on balance sheet at great cost; incentives of rating agencies to produce excessively high ratings; and compensation structures of corporate executives that incented focus on short-term earnings at the expense the longer run profitability of the company.

The case for creating a new role of Macro System Stabilizer is that gaps in regulation and perverse incentives cannot be permanently corrected. Whatever new rules are adopted will become obsolete as financial innovation progresses and market participants find ways around the rules in the pursuit of profit. The Macro System Stabilizer should be constantly searching for gaps, weak links and perverse incentives serious enough to threaten the system. It should make its views public and work with other regulators and Congress to mitigate the problem.

The Treasury makes the case for a regulator with a broad mandate to collect information from all financial institutions and "identify emerging risks." It proposes putting that responsibility in a Financial Services Oversight Council, chaired by the Treasury, with its own permanent expert staff. The Council seems to me likely to be cumbersome. Interagency councils are usually rife with turf battles and rarely get much done. I think the Fed should have the clear responsibility for spotting emerging risks and trying to head them off before it has to pump trillions into the system to avert disaster. The Fed should make a periodic report to the Congress on the stability of the financial system and possible threats to it. The Fed should consult regularly with the Treasury and other regulators (perhaps in a Financial Services Oversight Council), but should have the lead responsibility. Spotting emerging risks would fit naturally with the Fed's efforts to monitor the State of the economy and the health of the financial sector in order to set and implement monetary policy. Having explicit responsibility for monitoring systemic risk—and more information on which to base judgments would enhance its effectiveness as a central bank.

*Controlling Leverage.* The biggest challenge to restructuring the incentives is: How to avoid excessive leverage that magnified the upswing and turned the downswing into a rout? The aspect of the recent financial extravaganza that made it truly lethal was the overleveraged superstructure of complex derivatives erected on the shaky foundation of America's housing prices. By itself, the housing boom and bust would have created distress in the residential construction, real estate, and mortgage lending sectors, as well as consumer durables and other housing related markets, but would not have tanked the economy. What did us in was the credit crunch that followed the collapse of the highly leveraged financial superstructure that pumped money into the housing sector and became a bloated monster.

One approach to controlling serious asset-price bubbles fueled by leverage would be to give the Fed the responsibility for creating a bubble Threat Warning System that would trigger changes in permissible leverage ratios across financial institutions. The warnings would be public like hurricane or terrorist threat warnings. When the threat was high—as demonstrated by rapid price increases in an important class of assets, such as land, housing, equities, and other securities without an underlying economic justification—the Fed would raise the threat level from, say, Three to Four or Yellow to Orange. Investors and financial institutions would be required to put in more of their own money or sell assets to meet the requirements. As the threat moderated, the Fed would reduce the warning level.

The Fed already has the power to set margin requirements—the percentage of his own money that an investor is required to put up to buy a stock if he is borrowing the rest from his broker. Policy makers in the 1930s, seeking to avoid repetition of the stock price bubble that preceded the 1929 crash, perceived that much of the stock market bubble of the late 1920s had been financed with money borrowed on margin from broker dealers and that the Fed needed a tool distinct from monetary policy to control such borrowing in the future.

During the stock market bubble of the late 1990s, when I was Vice Chair of the Fed's Board of Governors, we talked briefly about raising the margin requirement, but realized that the whole financial system had changed dramatically since the 1920s. Stock market investors in the 1990s had many sources of funds other than borrowing on margin. While raising the margin requirements would have been primarily symbolic, I believe with hindsight that we should have done it anyway in hopes of showing that we were worried about the bubble.

The 1930s legislators were correct: monetary policy is a poor instrument for counteracting asset price bubbles; controlling leverage is likely to be more effective. The Fed has been criticized for not raising interest rates in 1998 and the first half of 1999 to discourage the accelerating tech stock bubble. But it would have had to raise rates dramatically to slow the market's upward momentum—a move that conditions in the general economy did not justify. Productivity growth was increasing, inflation was benign and responding to the Asian financial crisis argued for lowering rates, not raising them. Similarly, the Fed might have raised rates from their extremely low levels in 2003 or raised them earlier and more steeply in 2004–5 to discourage the nascent housing price bubble. But such action would have been regarded as a bizarre attempt to abort the economy's still slow recovery. At the time there was little understanding of the extent to which the highly leveraged financial superstructure was building on the collective delusion that U.S. housing prices could not fall. Even with hindsight, controlling leverage (along with stricter regulation of mortgage lending standards) would have been a more effective response to the housing bubble than raising interest rates. But regulators lacked the tools to control excessive leverage across the financial system.

In the wake of the current crisis, financial system reformers have approached the leverage control problem in pieces, which is appropriate since financial institutions play diverse roles. However the Federal Reserve—as Macro System Stabilizer—could be given the power to tie the system together so that various kinds of leverage ratios move in the same direction simultaneously as the threat changes.

With respect to large commercial banks and other systemically important financial institutions, for example, there is emerging consensus that higher capital ratios would have helped them weather the recent crisis, that capital requirements should be higher for larger, more interconnected institutions than for smaller, less interconnected ones, and that these requirements should rise as the systemic threat level (often associated with asset price bubbles) goes up.

With respect to hedge funds and other private investment funds, there is also emerging consensus that they should be more transparent and that financial derivatives should be traded on regulated exchanges or at least cleared on clearinghouses. But such funds might also be subject to leverage limitations that would move with the perceived threat level and could disappear if the threat were low.

One could also tie asset securitization into this system. The percent of risk that the originator or securitizer was required to retain could vary with the perceived threat of an asset price bubble. This percentage could be low most of the time, but rise automatically if Macro System Stabilizer deemed the threat of a major asset price bubble was high. One might even apply the system to rating agencies. In addition to requiring rating agencies to be more transparent about their methods and assumptions, they might be subjected to extra scrutiny or requirements when the bubble threat level was high.

Designing and coordinating such a leverage control system would not be an easy thing to do. It would require create thinking and care not to introduce new loopholes and perverse incentives. Nevertheless, it holds hope for avoiding the run away asset price exuberance that leads to financial disaster.

**Systemically Important Institutions**

The Obama administration has proposed that there should be a consolidated prudential regulator of large interconnected financial institutions (Tier 1 Financial Holding Companies) and that this responsibility be given to the Federal Reserve. I think this is the wrong way to go.

It is certainly important to reduce the risk that large interconnected institutions fail as a result of engaging in highly risky behavior and that the contagion of their failure brings down others. However, there are at least three reasons for questioning the wisdom of identifying a specific list of such institutions and giving them their own consolidated regulator and set of regulations. First, as the current crisis has amply illustrated, it is very difficult to identify in advance institutions that pose systemic risk. The regulatory system that failed us was based on the premise that commercial banks and thrift institutions that take deposits and make loans should be subject to prudential regulation because their deposits are insured by the Federal Government and they can borrow from the Federal Reserve if they get into trouble.

But in this crisis, not only did the regulators fail to prevent excessive risk taking by depository institutions, especially thrifts, but systemic threats came from other quarters. Bear Stearns and Lehman Brothers had no insured deposits and no claim on the resources of the Federal Reserve. Yet when they made stupid decisions and were on the edge of failure the authorities realized they were just as much a threat to the system as commercial banks and thrifts. So was the insurance giant, AIG, and, in an earlier decade, the large hedge fund, LTCM. It is hard to identify a systemically important institution until it is on the point of bringing the system down and then it may be too late.

Second, if we visibly cordon off the systemically important institutions and set stricter rules for them than for other financial institutions, we will drive risky behavior outside the strictly regulated cordon. The next systemic crisis will then likely come from outside the ring, as it came this time from outside the cordon of commercial banks.

Third, identifying systemically important institutions and giving them their own consolidated regulator tends to institutionalize "too-big-to-fail" and create a new set of GSE-like institutions. There is a risk that the consolidated regulator will see its job as not allowing any of its charges to go down the tubes and is prepared to put taxpayer money at risk to prevent such failures.

Higher capital requirements and stricter regulations for large interconnected institutions make sense, but I would favor a continuum rather than a defined list of institutions with its own special regulator. Since there is no obvious place to put such a responsibility, I think we should seriously consider creating a new financial regulator. This new institution could be similar to the U.K.'s FSA, but structured to be more effective than the FSA proved in the current crisis. In the U.S. one might start by creating a new consolidated regulator of all financial holding companies. It should be an independent agency but might report to a board composed of other regulators, similar to the Treasury proposal for a Council for Financial Oversight. As the system evolves the consolidated regulator might also subsume the functional regulation of nationally chartered banks, the prudential regulation of broker-dealers and nationally chartered insurance companies.

I don't pretend to have a definitive answer to how the regulatory boxes should best be arranged, but it seems to me a mistake to give the Federal Reserve responsibility for consolidated prudential regulation of Tier 1 Financial Holding Companies, as proposed by the Obama Administration. I believe the skills needed by an effective central bank are quite different from those needed to be an effective financial institution regulator. Moreover, the regulatory responsibility would likely grow with time, distract the Fed from its central banking functions, and invite political interference that would eventually threaten the independence of monetary policy.

Especially in recent decades, the Federal Reserve has been a successful and widely respected central bank. It has been led by a series of strong macroeconomists—Paul Volcker, Alan Greenspan, Ben Bernanke—who have been skillful at reading the ups and downs of the economy and steering a monetary policy course that contained inflation and fostered sustainable economic growth. It has played its role as banker to the banks and lender of last resort—including aggressive action with little used tools in the crisis of 2008–9. It has kept the payments system functioning even in crises such as 9/11, and worked effectively with other central banks to coordinate responses to credit crunches, especially the current one. Populist resentment of the Fed's control of monetary policy has faded as understanding of the importance of having an independent institution to contain inflation has grown—and the Fed has been more transparent about its objectives. Although respect for the Fed's monetary policy has grown in recent years, its regulatory role has diminished. As regulator of Bank Holding Companies, it did not distinguish itself in the run up to the current crisis (nor did other regulators). It missed the threat posed by the deterioration of mortgage lending standards and the growth of complex derivatives.

If the Fed were to take on the role of consolidated prudential regulator of Tier 1 Financial Holding Companies, it would need strong, committed leadership with regulatory skills—lawyers, not economists. This is not a job for which you would look to a Volcker, Greenspan, or Bernanke. Moreover, the regulatory responsibility would likely grow as it became clear that the number and type of systemically important institutions was increasing. My fear is that a bifurcated Fed would be less effective and less respected in monetary policy. Moreover, the concentration of that much power in an institution would rightly make the Congress nervous unless it exercised more oversight and accountability. The Congress would understandably seek to appropriate the Fed's budget and require more reporting and accounting. This is not necessarily bad, but it could result in more Congressional interference with monetary policy, which could threaten the Fed's effectiveness and credibility in containing inflation.

In summary, Mr. Chairman: I believe that we need an agency with specific responsibility for spotting regulatory gaps, perverse incentives, and building market pressures that could pose serious threats to the stability of the financial system. I would give the Federal Reserve clear responsibility for Macro System Stability, reporting periodically to Congress and coordinating with a Financial System Oversight Council. I would also give the Fed new powers to control leverage across the system—again in coordination with the Council. I would not create a special regulator for Tier 1 Financial Holding Companies, and I would certainly not give that responsibility to the Fed, lest it become a less effective and less independent central bank.

Thank you, Mr. Chairman and Members of the Committee.

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## PREPARED STATEMENT OF ALLAN H. MELTZER

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JULY 23, 2009

### Regulatory Reform and the Federal Reserve

Thank you for the opportunity to present my appraisal of the Administration's proposal for regulatory changes. I will confine most of my comments to the role of the Federal Reserve as a systemic regulator and will offer an alternative proposal. I share the belief that change is needed and long delayed, but appropriate change must protect the public, not bankers. And I believe that effective regulation should await evidence and conclusions about the causes of the recent crisis. There are many assertions about causes. The Congress should want to avoid a rush to regulate before the relevant facts are established. If we are to avoid repeating this crisis, make sure you know what caused it.

During much of the past 15 years, I have written three volumes entitled "A History of the Federal Reserve." Working with two assistants we have read virtually all of the minutes of the Board of Governors, the Federal Open Market Committee, and the Directors of the Federal Reserve Bank of New York. We have also read many of the staff papers and internal memos supporting decisions. I speak from that perspective. I speak also from experience in Japan. During the 1990s, the years of the Japanese banking and financial crisis, I served as Honorary Adviser to the Bank. Their policies included preventing bank failures. This did not restore lending and economic growth.

Two findings are very relevant to the role of the Federal Reserve. First, I do not know of any clear examples in which the Federal Reserve acted in advance to head off a crisis or a series of banking or financial failures. We know that the Federal Reserve did nothing about thrift industry failures in the 1980s. Thrift failures cost taxpayers $150 billion. AIG, Fannie, and Freddie will be much more costly. Of course, the Fed did not have responsibility for the thrift industry, but many thrift failures posed a threat to the financial system that the Fed should have tried to mitigate. The disastrous outcome was not a mystery that appeared without warning. Peter Wallison, Alan Greenspan, Bill Poole, Senator Shelby, and others warned about the excessive risks taken by Fannie and Freddie, but Congress failed to legislate. Why should anyone expect a systemic risk regulator to get requisite Congressional action under similar circumstances? Can you expect the Federal Reserve as systemic risk regulator to close Fannie and Freddie after Congress declines to act?

Conflicts of this kind, and others, suggest that that the Administration's proposal is incomplete. Defining "systemic risk" is an essential, but missing part of the proposal. Trying to define the authority of the regulatory authority when Congress has expressed an interest points up a major conflict.

During the Latin American debt crisis, the Federal Reserve acted to hide the failures and losses at money center banks by arranging with the IMF to pay the interest on Latin debt to those banks. This served to increase the debt that the Governments owed, but it kept the banks from reporting portfolio losses and prolonged the debt crisis. The crisis ended after one of the New York banks decided to write off the debt and take the loss. Others followed. Later, the Treasury offered the Brady plans. The Federal Reserve did nothing.

In the dot-com crisis of the late 1990s, we know the Federal Reserve was aware of the growing problem, but it did not act until after the crisis occurred. Later, Chairman Greenspan recognized that it was difficult to detect systemic failures in advance. He explained that the Federal Reserve believed it should act after the crisis, not before. Intervention to control soaring asset prices would impose large social costs of unemployment, so the Federal Reserve, as systemic risk regulator would be unwise to act.

The dot-com problem brings out that there are crises for which the Federal Reserve cannot be effective. Asset market exuberance and supply shocks, like oil price increases, are nonmonetary so cannot be prevented by even the most astute, far-seeing central bank.

We all know that the Federal Reserve did nothing to prevent the current credit crisis. Before the crisis it kept interest rates low during part of the period and did not police the use that financial markets made of the reserves it supplied. The Board has admitted that it did not do enough to prevent the crisis. It has not recognized that its actions promoted moral hazard and encouraged incentives to take risk. Many bankers talked openly about a "Greenspan put," their belief that the Federal Reserve would prevent or absorb major losses.

It was the Reconstruction Finance Corporation, not the Fed, that restructured banks in the 1930s. The Fed did not act promptly to prevent market failure during the 1970 Penn Central failure, the Lockheed and Chrysler problems, or on other occasions. In 2008, the Fed assisted in salvaging Bear Stearns. This continued the "too-big-to-fail" (TBTF) policy and increased moral hazard. Then without warning, the Fed departed from the course it had followed for at least 30 years and allowed Lehman to fail in the midst of widespread financial uncertainty. This was a major error. It deepened and lengthened the current deep recession. Much of the recent improvement results from the unwinding of this terrible mistake.

In 1990–91, the Fed kept the spread between short- and long-term interest rates large enough to assist many banks to rebuild their capital and surplus. This is a rare possible exception, a case in which Federal Reserve action to delay an increase in the short-term rate may have prevented banking failures.

Second, in its 96-year history, the Federal Reserve has never announced a lender-of-last-resort policy. It has discussed internally the content of such policy several times, but it rarely announced what it would do. And the appropriate announcements it made, as in 1987, were limited to the circumstances of the time. Announcing and following a policy would alert financial institutions to the Fed's expected actions and might reduce pressures on Congress to aid failing entities. Following the rule in a crisis would change bankers' incentives and reduce moral hazard. A crisis policy rule is long overdue. The Administration proposal recognizes this need.

A lender-of-last-resort rule is the right way to implement policy in a crisis. We know from monetary history that in the 19th century the Bank of England followed Bagehot's rule for a half-century or more. The rule committed the Bank to lend on "good" collateral at a penalty rate during periods of market disturbance. Prudent bankers borrowed from the Bank of England and held collateral to be used in a panic. Banks that lacked collateral failed.

Financial panics occurred. The result of following Bagehot's rule in crises was that the crises did not spread and did not last long. There were bank failures, but no systemic failures. Prudent bankers borrowed and paid depositors cash or gold. Bank deposits were not insured until much later, so bank runs could cause systemic failures. Knowing the Bank's policy rule made most bankers prudent, they held more capital and reserves in relation to their size than banks currently do, and they held more collateral to use in a crisis also.

These experiences suggest three main lessons. First, we cannot avoid banking failures but we can keep them from spreading and creating crises. Second, neither the Federal Reserve nor any other agency has succeeded in predicting crises or anticipating systemic failure. It is hard to do, in part because systemic risk is not well-defined. Reasonable people will differ, and since much is often at stake, some will fight hard to deny that there is a systemic risk.

One of the main reasons that Congress in 1991 passed FDICIA (Federal Deposit Insurance Corporation Improvement Act) was to prevent the Federal Reserve from delaying closure of failing banks, increasing losses and weakening the FDIC fund. The Federal Reserve and the FDIC have not used FDICIA against large banks in this crisis. That should change.

The third lesson is that a successful policy will alter bankers' incentives and avoid moral hazard. Bankers must know that risk taking brings both rewards and costs, including failure, loss of managerial position and equity followed by sale of continuing operations.

**An Alternative Proposal**

Several reforms are needed to reduce or eliminate the cost of financial failure to the taxpayers. Members of Congress should ask themselves and each other: Is the banker or the regulator more likely to know about the risks on a bank's balance sheet? Of course it is the banker, and especially so if the banker is taking large risks that he wants to hide. To me that means that reform should start by increasing a banker's responsibility for losses. The Administration's proposal does the opposite by making the Federal Reserve responsible for systemic risk.

*Systemic risk* is a term of art. I doubt that it can be defined in a way that satisfies the many parties involved in regulation. Members of Congress will properly urge that any large failure in their district or State is systemic. Administrations and regulators will have other objectives. Without a clear definition, the proposal will bring frequent controversy. And without a clear definition, the proposal is incomplete and open to abuse.

Resolving the conflicting interests is unlikely to protect the general public. More likely, regulators will claim that they protect the public by protecting the banks. That's what they do now.

The Administration's proposal sacrifices much of the remaining independence of the Federal Reserve. Congress, the Administration, and failing banks or firms will want to influence decisions about what is to be bailed out. I believe that is a mistake. If we use our capital to avoid failures instead of promoting growth we not only reduce growth in living standards we also sacrifice a socially valuable arrangement—central bank independence. We encourage excessive risk taking and moral hazard.

I believe there are better alternatives than the Administration's proposal. First step: End TBTF. Require all financial institutions to increase capital more than in proportion to their increase in size of assets. TBTF gives perverse incentives. It allows banks to profit in good times and shifts the losses to the taxpayers when crises or failures occur.

My proposal reduces the profits from giant size, increases incentives for prudent banker behavior by putting losses back to managements and stockholders where they belong. Benefits of size come from economies of scale and scope. These benefits to society are more than offset by the losses society takes in periods of crisis. Congress should find it hard to defend a system that distributes profits and losses as TBTF does. I believe that the public will not choose to maintain that system forever. Permitting losses does not eliminate services; failure means that management loses its position and stockholders take the losses. Profitable operations continue and are sold at the earliest opportunity.

Second step: Require the Federal Reserve to announce a rule for lender-of-last-resort. Congress should adopt the rule that they are willing to sustain. The rule should give banks an incentive to hold collateral to be used in a crisis period. Bagehot's rule is a great place to start.

Third step: Recognize that regulation is an ineffective way to change behavior. My first rule of regulation states that lawyers regulate but markets circumvent burdensome regulation. The Basel Accord is an example. Banks everywhere had to increase capital when they increased balance sheet risk. The banks responded by creating entities that were not on their balance sheet. Later, banks had to absorb the losses, but that was after the crisis. There are many other examples of circumvention from Federal Reserve history. The reason we have money market funds was that Fed regulation Q restricted the interest that the public could earn. Money market funds bought unregulated, large certificates of deposit. For a small fee they shared the higher interest rate with the public. Much later Congress agreed to end interest rate regulation. The money funds remained.

Fourth step: Recognize that regulators do not allow for the incentives induced by their regulations. In the dynamic, financial markets it is difficult, perhaps impossible, to anticipate how clever market participants will circumvent the rules without violating them. The lesson is to focus on incentives, not prohibitions. Shifting losses back to the bankers is the most powerful incentive because it changes the risk-return tradeoff that bankers and stockholders see.

Fifth step: Either extend FDICIA to include holding companies or subject financial holding companies to bankruptcy law. Make the holding company subject to early intervention either under FDICIA or under bankruptcy law. That not only reduces or eliminates taxpayer losses, but it also encourages prudential behavior.

Other important changes should be made. Congress should close Fannie Mae and Freddie Mac and put any subsidy for low-income housing on the budget. The same should be done to other credit market subsidies. The budget is the proper place for subsidies.

Congress, the regulators, and the Administration should encourage financial firms to change their compensation systems to tie compensation to sustained average earnings. Compensation decisions are too complex for regulation and too easy to circumvent. Decisions should be management's responsibility. Part of the change should reward due diligence by traders. We know that rating agencies contributed to failures. The rating problem would be lessened if users practiced diligence of their own.

Three principles should be borne in mind. First, banks borrow short and lend long. Unanticipated large changes can and will cause failures. Our problem is to minimize the cost of failures to society. Second, remember that capitalism without failure is like religion without sin. It removes incentives for prudent behavior. Third, those that rely on regulation to reduce risk should recall that this is the age of Madoff and Stanford. The Fed, too, lacks a record of success in managing large risks to the financial system, the economy and the public. Incentives for fraud, evasion, and circumvention of regulation often have been far more powerful than incentives to enforce regulation that protects the public.

## RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SHEILA C. BAIR

**Q.1.** *Too-Big-To-Fail*—Chairman Bair, the Obama administration's proposal would have regulators designate certain firms as systemically important. These firms would be classified as Tier 1 Financial Holding Companies and would be subject to a separate regulatory regime. If some firms are designated as systemically important, would this signal to market participants that the Government will not allow these firms to fail? If so, how would this worsen our "too-big-to-fail" problem?

**A.1.** We have concerns about formally designating certain institutions as a special class. Any recognition of an institution as systemically important risks invoking the moral hazard that accompanies institutions that are considered too-big-to-fail. That is why, most importantly, a robust resolution mechanism, in addition to enhanced supervision, is important for very large financial organizations. A vigorous systemic risk regulatory regime, along with resolution authority for bank holding companies and systemically risky financial firms would go far toward eliminating "too-big-to-fail."

**Q.2.** *Government Replacing Management?*—In your testimony, while discussing the need for a systemic risk regulator to provide a resolution regime, you state that "losses would be borne by the stockholders and bondholders of the holding company, and senior management would be replaced." Could you expand upon how the senior management would be replaced? Would the systemic risk regulator decide who needed to be replaced and who would replace them?

**A.2.** When the FDIC takes over a large insured bank and establishes a bridge bank, the normal business practice is to replace certain top officials in the bank, usually the CEO, plus any other senior officials whose activities were tied to the cause of the bank failure. The resolution authority would decide who to replace based on why the firm failed.

**Q.3.** *"Highly Credible Mechanism" for Orderly Resolution*—Chairman Bair, in your testimony you suggest that we must redesign our system to allow the market to determine winners and losers, "and when firms—through their own mismanagement and excessive risk taking—are no longer viable, they should fail." You also suggest that the solution must involve a "highly credible mechanism" for orderly resolution of failed institutions similar to that which exists for FDIC-insured banks.

Do you believe that our current bankruptcy system is inadequate, or do you believe that we must create a new resolution regime simply to fight the perception that we will not allow a systemically important institution to fail?

**A.3.** In the United States, liquidation and rehabilitation of most failing corporations are governed by the Federal bankruptcy code and administered primarily in the Federal bankruptcy courts. Separate treatment, however, is afforded to banks, which are resolved under the Federal Deposit Insurance Act and administered by the

FDIC.[1] The justifications for this separate treatment are banks' importance to the aggregate economy, and the serious adverse effect of their insolvency on others.

Bankruptcy focuses on returning value to creditors and is not geared to protecting the stability of the financial system. When a firm is placed into bankruptcy, an automatic stay is placed on most creditor claims to allow management time to develop a reorganization plan. This can create liquidity problems for creditors—especially when a financial institution is involved—who must wait to receive their funds. Bankruptcy cannot prevent a meltdown of the financial system when a systemically important financial firm is troubled or failing.

Financial firms—especially large and complex financial firms—are highly interconnected and operate through financial commitments. Most obtain a significant share of their funding from wholesale markets using short-term instruments. They provide key credit and liquidity intermediation functions. Like banks, financial firms (holding companies and their affiliates) can be vulnerable to "runs" if their short-term liabilities come due and cannot be rolled over. For these firms, bankruptcy can trigger a rush to the door, since counterparties to derivatives contracts—which are exempt from the automatic stay placed on other contracts—will exercise their rights to immediately terminate contracts, net out their exposures, and sell any supporting collateral.

The statutory right to invoke close-out netting and settlement was intended to reduce the risks of market disruption. Because financial firms play a central role in the intermediation of credit and liquidity, tying up these functions in the bankruptcy process would be particularly destabilizing. However, during periods of economic instability this rush-to-the-door can overwhelm the market and even depress market prices for the underlying assets. This can further destabilize the markets and affect other financial firms as they are forced to adjust their balance sheets.

By contrast, the powers that are available to the FDIC under its special resolution authority prevent the immediate close-out netting and settlement of financial contracts of an insured depository institution if the FDIC, within 24 hours after its appointment as receiver, decides to transfer the contracts to another bank or to an FDIC-operated bridge bank. As a result, the potential for instability or contagion caused by the immediate close-out netting and settlement of qualified financial contracts can be tempered by transferring them to a more stable counterparty or by having the bridge bank guarantee to continue to perform on the contracts. The FDIC's resolution powers clearly add stability in contrast to a bankruptcy proceeding.

For any new resolution regime to be truly "credible," it must provide for the orderly wind-down of large, systemically important financial firms in a manner that is clear, comprehensive, and capable of conclusion. Thus, it is not simply a matter of "perception," although the new resolution regime must be recognized by firms,

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[1] Another exception would be the liquidation or rehabilitation of insurance companies, which are handled under State law.

investors, creditors, and the public as a mechanism in which systemically important institutions will in fact fail.

**Q.4.** *Firms Subject to New Resolution Regime*—Chairman Bair, in your testimony, you continuously refer to "systemically significant entities," and you also advocate for much broader resolution authority. Could you indicate how a "systemically significant entity" would be defined? Will the list of systemically significant institutions change year-to-year? Do you envision it including nonfinancial companies such as GM?

Would all financial and "systemically significant entities" be subject to this new resolution regime? If not, how would the market determine whether the company would be subject to a traditional bankruptcy or the new resolution regime?

Why do we need a systemic risk regulator if we are going to allow institutions to become "systemically important"?

**A.4.** We would anticipate that the Systemic Risk Council, in conjunction with the Federal Reserve would develop definitions for systemic risk. Also, mergers, failures, and changing business models could change what firms would be considered systemically important from year-to-year.

While not commenting on any specific company, nonfinancial firms that become major financial system participants should have their financial activities come under the same regulatory scrutiny as any other major financial system participant.

**Q.5.** *Better Deal for the Taxpayer*—Chairman Bair, you advocate in your testimony for a new resolution mechanism designed to handle systemically significant institutions. Could you please cite specific examples of how this new resolution regime would have worked to achieve a better outcome for the taxpayer during this past crisis?

**A.5.** A proposed new resolution regime modeled after the FDIC's existing authorities has a number of characteristics that would reduce the costs associated with the failure of a systemically significant institution.

First and foremost, the existence of a transparent resolution scheme and processes will make clear to market participants that there will be an imposition of losses according to an established claims priority where stockholders and creditors, not the Government, are in the first loss position. This will provide a significant measure of cost savings by imposing market discipline on institutions so that they are less likely to get to the point where they would have otherwise been considered too-big-to-fail.

Also, the proposed resolution regime would allow the continuation of any systemically significant operations, but only as a means to achieve a final resolution of the entity. A bridge mechanism, applicable to the parent company and all affiliated entities, would allow the Government to preserve systemically significant functions. Also, for institutions involved in derivatives contracts, the new resolution regime would provide an orderly unwinding of counterparty positions as compared to the rush to the door that can occur during a bankruptcy. In contrast, since counterparties to derivatives contracts are exempt from the automatic stay placed on other contracts under the Bankruptcy Code, they will exercise their rights to immediately terminate contracts, net out their exposures, and sell any supporting collateral, which serves to increase the loss to the failed institution.

In addition, the proposed resolution regime enables losses to be imposed on market players who should appropriately bear the risk, including shareholders and unsecured debt investors. This creates a buffer that can reduce potential losses that could be borne by taxpayers.

Further, when the institution and its assets are sold, this approach creates the possibility of multiple bidders for the financial organization and its assets, which can improve pricing and reduce losses to the receivership.

The current financial crisis led to illiquidity and the potential insolvency of a number of systemically significant financial institutions during 2008. Where Government assistance was provided on an open-institution basis, the Government exposed itself to significant loss that would otherwise have been mitigated by these authorities proposed for the resolution of systemically significant institutions. A new resolution regime for firms such as Lehman or AIG would ensure that shareholders, management, and creditors take losses and would bar an open institution bail-out, as with AIG. The powers of a receiver for a financial firm would include the ability to require counterparties to perform under their contracts and the ability to repudiate or terminate contracts that impose continuing losses. It also would have the power to terminate employment contracts and eliminate many bonuses.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM SHEILA C. BAIR**

**Q.1.** You discussed regulatory arbitrage in your written statements and emphasized the benefits of a Council to minimize such opportunities. Can you elaborate on this? Should standards be set by individual regulators, the Council, or both? Can a Council operate effectively in emergency situations?

**A.1.** One type of regulatory arbitrage is regulatory capital arbitrage. It is made possible when there are different capital requirements for organizations that have similar risks. For instance, banks must hold 10 percent total risk-based capital and a 5 percent leverage ratio to be considered well-capitalized, while large broker-dealers (investment banks) were allowed to operate with as little as 3 percent risk-based capital. Thus for similar assets, a bank would have to hold $5 for every $100 of assets, a broker dealer would only be required to hold $3 of capital for every $100 of the same assets. Obviously, it would be more advantageous for broker dealers to accumulate these assets, as their capital requirement was 40 percent smaller than for a comparable bank.

The creation of a Systemic Risk Council with authority to harmonize capital requirements across all financial firms would mitigate this type of regulatory capital arbitrage. Although the capital rules would vary somewhat according to industry, the authority vested in the Council would prevent the types of disparities in capital requirements we have recently witnessed.

Some have suggested that a council approach would be less effective than having this authority vested in a single agency because of the perception that a deliberative council such as this would need additional time to address emergency situations that might arise from time to time. Certainly, some additional thought and effort will be needed to address any dissenting views in council deliberations, but a vote by Council members would achieve a final decision. A Council will provide for an appropriate system of checks and balances to ensure that appropriate decisions are made that reflect the various interests of public and private stakeholders. In this regard, it should be noted that the board structure at the FDIC, with the participation of outside directors, is not very different than the way the council would operate. In the case of the FDIC, quick decisions have been made with respect to systemic issues and emergency bank resolutions on many occasions. Based on our experience with a board structure, we believe that decisions could be made quickly by a deliberative council while still providing the benefit of arriving at consensus decisions.

**Q.2.** What do you see as the key differences in viewpoints with respect to the role and authority of a Systemic Risk Council? For example, it seems like one key question is whether the Council or the Federal Reserve will set capital, liquidity, and risk management standards. Another key question seems to be who should be the Chair of the Council: the Secretary of the Treasury or a different Senate-appointed Chair. Please share your views on these issues.

**A.2.** The Systemic Risk Council should have the authority to impose higher capital and other standards on financial firms notwithstanding existing Federal or State law and it should be able to overrule or force actions on behalf of other regulatory entities to raise capital or other requirements. Primary regulators would be charged with enforcing the requirements set by the Council. However, if the primary regulators fail to act, the Council should have the authority to do so. The standards set by the Council 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 Council would be uniquely positioned to provide the critical linkage between the primary Federal regulators and the need to take a macroprudential view and focus on emerging systemic risk across the financial system. The Council would assimilate information on economic conditions and the condition of supervised financial companies to assess potential risk to the entire financial system. The Council could then direct specific regulatory agencies to undertake systemic risk monitoring activities or impose recommended regulatory measures to mitigate systemic risk.

The Administration proposal includes eight members on the Council: the Secretary of the Treasury (as Chairman); the Chairman of the Federal Reserve Board; the Director of the National Bank Supervisor; the Director of the Consumer Financial Protection Agency; the Chairman of the Securities and Exchange Commission; the Chairman of the Commodities Futures Trading Commission; the Chairman of the FDIC; and the Director of the Federal Housing Finance Agency.

In designing the role of the Council, it will be important to preserve the longstanding principle that bank regulation and supervision are best conducted by independent agencies. For example, while the OCC is an organization within the Treasury Department, there are statutory safeguards to prevent undue involvement of the Treasury in regulation and supervision of National Banks. Given the role of the Treasury in the Council contemplated in the Administration's plan, careful attention should be given to the establishment of appropriate safeguards to preserve the political independence of financial regulation.

Moreover, while the FDIC does not have a specific recommendation regarding what agencies should compose the Council, we would suggest that the Council include an odd number of members in order to avoid deadlocks. One way to address this issue that would be consistent with the importance of preserving the political independence of the regulatory process would be for the Treasury Chair to be a nonvoting member, or the Council could be headed by someone appointed by the President and confirmed by the Senate.

**Q.3.** What are the other unresolved aspects of establishing a framework for systemic risk regulation?

**A.3.** With an enhanced Council with decision-making powers to raise capital and other key standards for systemically related firms or activities, we are in general agreement with the Treasury plan for systemic risk regulation, or the Council could be headed by a Presidential appointee.

**Q.4.** How should Tier 1 firms be identified? Which regulator(s) should have this responsibility?

**A.4.** As discussed in my testimony, the FDIC endorses the creation of a Council to oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. Prior to the current crisis, systemic risk was not routinely part of the ongoing supervisory process. The FDIC believes that the creation of a Council would provide a continuous mechanism for measuring and reacting to systemic risk across the financial system. The powers of such a Council would ultimately have to be developed through a dialogue between the banking agencies and Congress, and empower the Council to oversee unsupervised nonbanks that present systemic risk. Such nonbanks should be required to submit to such oversight, presumably as a financial holding company under the Federal Reserve. The Council could establish what practices, instruments, or characteristics (concentrations of risk or size) that might be considered risky, but would not identify any set of firms as systemic.

We have concerns about formally designating certain institutions as a special class. Any recognition of an institution as systemically important, however, risks invoking the moral hazard that accompanies institutions that are considered too-big-to-fail. That is why, most importantly, a robust resolution mechanism, in addition to enhanced supervision, is important for very large financial organizations.

**Q.5.** One key part of the discussion at the hearing is whether the Federal Reserve, or any agency, can effectively operate with two or more goals or missions. Can the Federal Reserve effectively conduct monetary policy, macroprudential regulation, and consumer protection?

**A.5.** The Federal Reserve has been the primary Federal regulator for State chartered member institutions since its inception and has been the bank holding company supervisor since 1956. With the creation of the Consumer Financial Protection Agency and the Systemic Risk Council, the Federal Reserve should be able to continue its monetary policy role as well as remain the prudential primary Federal regulator for State chartered member institutions and bank holding companies.

**Q.6.** Under the Administration's plan, there would be heightened supervision and consolidation of all large, interconnected financial firms, including likely requiring more firms to become financial holding companies. Can you comment on whether this plan adequately addresses the "too-big-to-fail" problem? Is it problematic, as some say, to identify specific firms that are systemically significant, even if you provide disincentives to becoming so large, as the Administration's plan does?

**A.6.** The creation of a systemic risk regulatory framework for bank holding companies and systemically important firms will address some of the problems posed by "too-big-to-fail" firms. In addition, we should develop incentives to reduce the size of very large financial firms.

However, even if risk-management practices improve dramatically and we introduce effective macroprudential supervision, the odds are that a large systemically significant firm will become troubled or fail at some time in the future. The current crisis has clearly demonstrated the need for a single resolution mechanism for financial firms that will preserve stability while imposing the losses on shareholders and creditors and replacing senior management to encourage market discipline. A timely, orderly resolution process that could be applied to both banks and nonbank financial institutions, and their holding companies, would prevent instability and contagion and promote fairness. It would enable the financial markets to continue to function smoothly, while providing for an orderly transfer or unwinding of the firm's operations. The resolution process would ensure that there is the necessary liquidity to complete transactions that are in process at the time of failure, thus addressing the potential for systemic risk without creating the expectation of a bailout.

Under a new resolution regime, Congress should raise the bar higher than existing law and eliminate the possibility of open assistance for individual failing entities. The new resolution powers should result in the shareholders and unsecured creditors taking losses prior to the Government, and consideration also should be given to imposing some haircut on secured creditors to promote market discipline and limit costs potentially borne by the Government.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM SHEILA C. BAIR**

**Q.1.** A recent media article (*New York Times,* June 14th) states there have been strong disagreements between the FDIC and the OCC over whether the proposal to impose new insurance fees on banks is unfair to the largest banks, with the FDIC arguing that the largest banks contributed to the current crisis and should have to pay more. Can you elaborate on your rationale for requiring big banks to pay more than community banks?

**A.1.** The *New York Times* article referred to the emergency special assessment, adopted on May 22, 2009, which imposes a 5-basis point special assessment rate on each insured depository institution's assets minus Tier 1 capital as of June 30, 2009.

The Federal Deposit Insurance Reform Act of 2005 requires the FDIC to establish and implement a restoration plan if the reserve ratio falls below 1.15 percent of insured deposits. On October 7, 2008, the FDIC established a Restoration Plan for the Deposit Insurance Fund. The Restoration Plan was amended on February 27, 2009, and quarterly base assessment rates were set at a range of 12 to 45 basis points beginning in the second quarter of 2009. However, given the FDIC's estimated losses from projected institution failures, these assessment rates were determined not to be sufficient to return the fund reserve ratio to 1.15 percent. On May 22, 2009, therefore, the FDIC Board of Directors adopted a final rule establishing a 5 basis point special assessment on each insured depository institution's assets minus Tier 1 capital as of June 30, 2009. The special assessment is necessary to strengthen the Deposit Insurance Fund and promote confidence in the deposit insurance system.

The adoption of the final rule on the special assessment followed a request for comment that generated over 14,000 responses. The final rule implemented several changes to the FDIC's special assessment interim rule, including a reduction in the rate used to calculate the special assessment and a change in the base used to calculate the special assessment.

The assessment formula is the same for all insured institutions—big and small. However, it produces higher assessments for institutions that rely more on nondeposit liabilities. These institutions do tend to be the larger institutions. The FDIC considers this appropriate as in the event of the failure of institutions with significant amounts of secured debt, the FDIC's loss is often increased without any compensation in the form of increased assessment revenue.

The amount of the special assessment for any institution, however, will not exceed 10 basis points times the institution's assessment base for the second quarter 2009 risk-based assessment. We believe that the special assessment formula provides incentives for institutions to hold long-term unsecured debt, and for smaller institutions to hold high levels of Tier 1 capital—both good things in the FDIC's view.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM SHEILA C. BAIR**

**Q.1.** Many proposals call for a risk regulator that is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the risk regulator will set rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules different ways. Under such a risk regulator, how would you make sure the rules were being enforced the same across the board?

**A.1.** The significant size and growth of unsupervised financial activities outside the traditional banking system—in what is termed the shadow financial system—has made it all the more difficult for regulators or market participants to understand the real dynamics of either bank credit markets or public capital markets. The existence of one regulatory framework for insured institutions and a much less effective regulatory scheme for nonbank entities created the conditions for arbitrage that permitted the development of risky and harmful products and services outside regulated entities.

We have proposed a Systemic Risk Council composed of the principal prudential regulators for banking, financial markets, consumer protection, and Treasury to look broadly across all of the financial sectors to adopt a "macroprudential" approach to regulation. The point of looking more broadly at the financial system is that reasonable business decisions by individual financial firms may, in aggregate, pose a systemic risk. This failure of composition problem cannot be solved by simply making each financial instrument or practice safe.

Rules and restrictions promulgated by the proposed Systemic Risk Council would be uniform with respect to institutions, products, practices, services, and markets that create potential systemic risks. Again, a distinction should be drawn between the direct supervision of systemically significant financial firms and the macroprudential oversight and regulation of developing risks that may pose systemic risks to the U.S. financial system. The former appropriately calls for the identification of a prudential supervisor for any potential systemically significant holding companies or similar conglomerates. Entities that are already subject to a prudential supervisor, such as insured depository institutions and financial holding companies, should retain those supervisory relationships. In addition, for systemic entities not already subject to a Federal prudential supervisor, this Council should be empowered to require that they submit to such oversight, presumably as a financial holding company under the Federal Reserve—without subjecting them to the activities restrictions applicable to these companies.

We need to combine the current microprudential approach with a macroprudential approach through the Council. The current system focuses only on individual financial instruments or practices. Each agency is responsible for enforcing these regulations only for their institutions. In addition, there are separate regulatory schemes used by the SEC and the CFTC as well as the State level regulation of insurance companies. The macroprudential oversight of systemwide risks requires the integration of insights from a number of different regulatory perspectives—banks, securities firms, holding companies, and perhaps others. Thus, the FDIC supports the creation of a Council to oversee systemic risk issues, develop needed prudential policies, and mitigate developing systemic risks.

**Q.2.** Before we can regulate systemic risk, we have to know what it is. But no one seems to have a definition. How do you define systemic risk?

**A.2.** We would anticipate that the Systemic Risk Council, in conjunction with the Federal Reserve would develop definitions for systemic risk. Also, mergers, failures, and changing business models could change what firms would be considered systemically important from year-to-year.

**Q.3.** Assuming a regulator could spot systemic risk, what exactly is the regulator supposed to do about it? What powers would they need to have?

**A.3.** The failure of some large banks and nonbanks revealed that the U.S. banking agencies should have been more aggressive in their efforts to mitigate excessive risk concentrations in banks and their affiliates, and that the agencies' powers to oversee systemically important nonbanks require strengthening.

As discussed in my testimony, the FDIC endorses the creation of a Council to oversee systemic risk issues, develop needed prudential policies, and mitigate developing systemic risks. For example, the Council could ensure capital standards are strong and consistent across significant classes of financial services firms including nonbanks and GSEs. Prior to the current crisis, systemic risk was not routinely part of the ongoing supervisory process. The FDIC believes that the creation of a Council would provide a continuous mechanism for measuring and reacting to systemic risk across the financial system. The powers of such a Council would ultimately have to be developed through a dialogue between the banking agencies and Congress, and empower the Council to ensure appropriate oversight of unsupervised nonbanks that present systemic risk. Such nonbanks should be required to submit to such oversight, presumably as a financial holding company under the Federal Reserve.

**Q.4.** How do you propose we identify firms that pose systemic risks?

**A.4.** The proposed Systemic Risk Council could establish what practices, instruments, or characteristics (concentrations of risk or size) that might be considered risky, but should not identify any set of firms as systemic. We have concerns about formally designating certain institutions as a special class. We recognize that there may be very large interconnected financial entities that are not yet subject to Federal consolidated supervision, although most of them are already subject to such supervision as a result of converting to banks or financial holding companies in response to the crisis. Any recognition of an institution as systemically important, however, risks invoking the moral hazard that accompanies institutions that are considered too-big-to-fail. That is one reason why, most importantly, a robust resolution mechanism, in addition to enhanced supervision, is important for very large financial organizations.

**Q.5.** Any risk regulator would have access to valuable information about the business of many firms. There would be a lot of people who would pay good money to get that information. How do we protect that information from being used improperly, such as theft or an employee leaving the regulator and using his knowledge to make money?

**A.5.** The FDIC, as deposit insurer and supervisor of over 5,000 banks, prides itself on maintaining confidentiality with our stakeholders. We have a corporate culture that demands strict confidentiality with regard to bank and personal information. Our staff is trained extensively on the use, protection, and disclosure of nonpublic information as well as expectations for the ethical conduct. Disclosure of nonpublic information is not tolerated and any potential gaps are dealt with swiftly and disclosed to affected parties. The FDIC's Office of Inspector General has a robust process for dealing with improper disclosures of information both during and postemployment with FDIC.

These ethical principles are supported by criminal statutes which provide that Federal officers and employees are prohibited from the disclosure of confidential information generally (18 U.S.C. 1905) and from the disclosure of information from a bank examination report (18 U.S.C. 1906).

All former Federal officers and employees are subject to the postemployment restrictions (18 U.S.C. 207), which prohibit former Government officers and employees from knowingly making a communication or appearance on behalf of any other person, with the intent to influence, before any officer or employee of any Federal agency or court in connection with a particular matter in which the employee personally and substantially participated, which involved a specific party at the time of the participation and representation, and in which the U.S. is a party or has a direct and substantial interest.

In addition, an officer or employee of the FDIC who serves as a senior examiner of an insured depository institution for at least 2 months during the last 12 months of that individual's employment with the FDIC may not, within 1 year after the termination date of his or her employment with the FDIC, knowingly accept compensation as an employee, officer, director, or consultant from the insured depository institution; or any company (including a bank holding company or savings and loan holding company) that controls such institution (12 U.S.C. 1820(k).

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM SHEILA C. BAIR**

**Q.1.** I appreciate the FDIC's desire to provide clarity around the process of private investors investing in failed banks that have been taken over by the FDIC. We need to make sure that the final rule doesn't deter private capital from entering the banking system, leaving the FDIC's insurance fund and, ultimately, the taxpayers with the final bill. Are you open to modifying some of the proposed requirements, such as the 15 percent capital requirement?

**A.1.** The Federal Deposit Insurance Corporation is aware of the need for additional capital in the banking system and the potential contribution that private equity capital could make to meet this need. At the same time, the FDIC is sensitive to the need for all investments in insured depository institutions, regardless of the source, to be consistent with protecting the Deposit Insurance Fund and the safety and soundness of insured institutions.

In light of the increased number of bank and thrift failures and the consequent increase in interest by potential private capital investors, the FDIC published for comment on July 9, 2009, a Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (Proposed Policy Statement). The Proposed Policy Statement provided guidance to private capital investors interested in acquiring the deposit liabilities, or the liabilities and assets, of failed insured depository institutions. It included specific questions on the important issues surrounding nontraditional investors in insured financial institutions including the level of capital required for the institution that would be owned by these new entrants into the banking system and whether these owners can be a source of strength. We sought public and industry comment to assist us in evaluating the policies to apply in deciding whether a nontraditional investor may bid on a failed institution.

On August 26, 2009, the FDIC's Board of Directors voted to adopt the Final Statement of Policy on Qualifications for Failed Bank Acquisitions (Final Policy Statement), which was published in the *Federal Register* on September 2, 2009. The Final Policy Statement takes into account the comments presented by the many interested parties who submitted comments. Although the final minimum capital commitment has been adjusted from 15 percent Tier 1 leverage to 10 percent Tier 1 common equity, key elements of the earlier proposed statement remain in place: cross-support, prohibitions on insider lending, limitations on sales of acquired shares in the first 3 years, a prohibition on bidding by excessively opaque and complex business structures, and minimum disclosure requirements.

Importantly, the Final Policy Statement specifies that it does not apply to investors who do not hold more than 5 percent of the total voting powers and who are not engaged in concerted actions with other investors. It also includes relief for investors if the insured institution maintains a Uniform Financial Institution composite rating of 1 or 2 for 7 consecutive years. The FDIC Board is given the authority to make exceptions to its application in special circumstances. The Final Policy Statement also clearly excludes partnerships between private capital investors and bank or thrift holding companies that have a strong majority interest in the acquired banks or thrifts.

In adopting the Final Policy Statement, the FDIC sought to strike a balance between the interests of private investors and the need to provide adequate safeguards for the insured depository institutions involved. We believe the Final Policy Statement will encourage safe and sound investments and make the bidding more competitive and robust. In turn, this will limit the FDIC's losses, protect taxpayers, and speed the resolution process. As a result, the Final Policy Statement will aid the FDIC in carrying out its mission.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM SHEILA C. BAIR**

**Q.1.** Chairwoman Bair, you recently released a proposal which, I believe, asks private equity to maintain a 15 percent Tier 1 capital ratio while well-capitalized banks only maintain a 5 percent ratio and newly established banks an 8 percent ratio. In May, the FDIC announced the successful purchase of Bank United which allowed almost $1 billion of private investment come in and successfully take over the bank's management. By all reports this has been a successful arrangement for both the FDIC and private investment company. Although I understand your policy concerns, I think that the current proposal goes too far in several respects. I am concerned that the FDIC's proposed policy deters private capital from entering the banking system, leaving the FDIC's insurance fund and, ultimately, the taxpayers with the final bill. With bank failures mounting this year, I would have liked see more private investment able to participate in cleaning up these troubled banks.

What can the FDIC do to ensure that more private equity comes in to stem the tide of bank failures?

**A.1.** On August 26, 2009, the FDIC's Board of Directors voted to adopt the Final Statement of Policy on Qualifications for Failed Bank Acquisitions (Final Policy Statement), which was published in the *Federal Register* on September 2, 2009. The Final Policy Statement takes into account the comments presented by the many interested parties who submitted comments. Although the final minimum capital commitment has been adjusted from 15 percent Tier 1 leverage to 10 percent Tier 1 common equity, key elements of the earlier proposed statement remain in place: cross-support, prohibitions on insider lending, limitations on sales of acquired shares in the first 3 years, a prohibition on bidding by excessively opaque and complex business structures, and minimum disclosure requirements.

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In adopting the Final Policy Statement, the FDIC sought to strike a balance between the interests of private investors and the need to provide adequate safeguards for the insured depository institutions involved. We believe the Final Policy Statement will encourage safe and sound investments and make the bidding more competitive and robust. In turn, this will limit the FDIC's losses, protect taxpayers, and speed the resolution process. As a result, the Final Policy Statement will aid the FDIC in carrying out its mission.

**Q.2.** Are you concerned that without attracting private capital, the FDIC's deposit insurance fund and, ultimately, taxpayers will foot the entire bill for the looming bank failures?

**A.2.** We do not see a taxpayer exposure as a result of upcoming bank failures. Our latest publicly released information shows that the FDIC ended the second quarter of 2009 with a DIF balance of $10.4 billion and an additional $32 billion reserve for expected future failure losses. Updates to these numbers show the FDIC estimates that it ended the third quarter of 2009 with a negative fund balance. The contingent loss reserve for expected future losses from failures has grown, however.

To date, the FDIC has required a special assessment to rebuild the DIF and we recently issued a notice of proposed rule making to require the prepayment of assessments for 3 years. Current projections are that assessment income will exceed expected losses from bank failures over the next several years. However, there is a timing problem as the bulk of bank failures are expected to occur in 2009 and 2010, while most assessment income will be booked in later years. Therefore, although the prepayment of assessments will not immediately rebuild the fund balance, it will provide the FDIC with the liquidity needed to fund projected bank failures. Further, even if it became necessary for the FDIC to borrow from the U.S. Treasury, any potential borrowing would be repaid by insured depository institutions.

**Q.3.** If private equity does come in, what could the savings be to the deposit insurance fund?

**A.3.** If, as expected, the FDIC increases the overall number of potential bidders for failed financial institutions by including more private equity firms, it would increase competition and potentially improve the quality of the bids.

**Q.4.** Do you agree with the Secretary's assessment that the FDIC was created to address resolving small banks and thrifts and does not have the appropriate resources to deal with the failure of a major bank?

**A.4.** The FDIC has substantial experience resolving large, complex, internationally active insured depository institutions. Continental Illinois National Bank and Trust, which required FDIC assistance in 1984 was the seventh largest commercial bank in the country at the time. More recently, in September 2008, the FDIC dealt with the failure of Washington Mutual Bank which had total assets of $307 billion. This was the fifth largest bank in the country at that time.

This experience with conservatorships and receiverships has significant parallels for systemically important holding companies and for other types of financial companies, enabling the FDIC to take advantage of its experience in acting as receiver for thousands of insured depository institutions. Also, much of the Administration's special resolution authority proposal is based on the FDIC's current statutory authority. Therefore, expanding the FDIC's activities to systemically significant institutions will be consistent in many respects to its current scope of activities.

**Q.5.** If there are limits on the FDIC's expertise and resources would keep the FDIC from resolving the biggest banks in the country, what are they?

**A.5.** We believe the FDIC is prepared to handle the resolution of an insured depository institution of any size and complexity. Our testimony outlines limitations of our current resolution authority and recommends, on page 7 [see Page 66 of this hearing], principles to guide Congress in adopting a process that ensures an orderly and comprehensive resolution mechanism for systemically important financial firms.

**Q.6.** What are the impediments, if any, that the FDIC would face in resolving the depository institutions associated with Bank of America or Citi?

**A.6.** Although I cannot comment on supervisory matters involving open institutions, any large depository institution can pose special challenges. They typically have extensive foreign operations, higher-than-normal levels of uninsured deposits, expansive branch networks that can span multiple time zones and usually are heavily involved in derivative financial instruments. Further, the largest insured depository institutions are owned by holding companies that own other related entities. These holding companies manage operations by business line with little regard to the legal entities involved. The intertwined nature of the operations of a large bank holding company will present its own set of challenges. This is one reason it is important for the FDIC to have receivership authority over the entire financial services holding company, not just the insured depository institution.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MARY L. SCHAPIRO

**Q.1.** *Identify Systemic Risk in Advance?*—I believe we can all agree that very few if anyone was able to effectively identify where the systemic risk resided in our economy prior to our current financial difficulties. While we had regulatory efforts in effect to combat these risks in commercial bank and thrift institutions, the real risk was shown to be outside of this area.

Chairman Schapiro, what about the structure proposed by the Obama administration gives you confidence that this new regulatory body will succeed where so many others failed?

**A.1.** While there is no guarantee, the one proposed by the Administration represents a number of improvements over the current regulatory landscape in terms addressing gaps in regulatory oversight and minimizing incentives for regulatory arbitrage. For example, the Administration's proposal seeks to address the importance of and strengthen consolidated supervision of large financial conglomerates, including supervision of previously unregulated subsidiaries.

Critical elements of a successful systemic risk regulation program also include strong support of functional regulators. The Council and SRR should complement and augment the role of functional regulators by leveraging their specialized knowledge and expertise and should take action in contravention of functional regulators' standards if necessary when those standards are less stringent than those advocated by the Council or SRR. Indeed, functional regulators' standards are the first line of defense, as functional regulators understand the markets, products and activities of their regulated entities.

The effective implementation of a systemic risk regulation program is critical to its success. Because the process of identifying emerging risks heavily relies on the analysis of significant amounts of information and reporting gathered from firms and regulators, a successful program must be appropriately resourced, employing an adequate number of staff with appropriate skill sets. It is important that the competencies of monitoring and inspection staff are equal to those of the firm's personnel regarding the relevant topic. Having a staff that is multidisciplinary and equipped with the proper skill sets to review and analyze the information obtained is critical. Generalists with substantial experience across the breadth of issues and firm relationships should complement their skills with those of experts in relevant quantitative specialties.

**Q.2.** *SEC as Systemic Risk Regulator*—Chairman Schapiro, the SEC's Consolidated Supervised Entity program, a program that existed without the benefit of statutory authorization, collapsed as its firms failed, were taken over, or shifted to regulation as bank holding companies.

How does the SEC's experience with the CSE program inform the model for regulation of systemic risk that you are advocating today?

**A.2.** Between 2004 and 2008, the SEC was recognized as the consolidated supervisor for the five large independent investment banks under its Consolidated Supervised Entity or "CSE" program. The CSE program was created as a way for U.S. global investment banks that lacked a consolidated holding company supervisor to voluntarily submit to consolidated regulation by the SEC. In connection with the establishment of the CSE program, the largest U.S. broker-dealer subsidiaries of these entities were permitted to utilize an alternate net capital computation (ANC).[1] Other large broker-dealers, whose holding companies are subject to consolidated supervision by banking authorities, were also permitted to use this ANC approach.[2]

Under the CSE regime, the holding company had to provide the Commission with information concerning its activities and exposures on a consolidated basis; submit its nonregulated affiliates to SEC examinations; compute on a monthly basis, risk-based consoli-

[1] In 2004, the SEC amended its net capital rule to permit certain broker-dealers subject to consolidated supervision to use their internal mathematical models to calculate net capital requirements for the market risks of certain positions and the credit risk for OTC derivatives-related positions rather than the prescribed charges in the net capital rule, subject to specified conditions. These models were thought to more accurately reflect the risks posed by these activities, but were expected to reduce the capital charges and therefore permit greater leverage by the broker-dealer subsidiaries. Accordingly, the SEC required that these broker-dealers have, at the time of their ANC approval, at least $5 billion in tentative net capital (*i.e.,* "net liquid assets"), and thereafter to provide an early warning notice to the SEC if that capital fell below $5 billion. This level was considered an effective minimum capital requirement.

[2] Currently six broker-dealers utilize the ANC regime and all are subject to consolidated supervision by banking authorities.

dated holding company capital in general accordance with the Basel Capital Accord, an internationally recognized method for computing regulatory capital at the holding company level; and provide the Commission with additional information regarding its capital and risk exposures, including market, credit and liquidity risks.

It is important to note that prior to the CSE regime, the SEC had no jurisdiction to regulate these holding companies. [3] Accordingly, these holding companies previously had not been subject to any consolidated capital requirements. This program was viewed as an effort to fill a significant gap in the U.S. regulatory structure. [4]

During the financial crisis many of these institutions lacked sufficient liquidity to operate effectively. During 2008, these CSE institutions failed, were acquired, or converted to bank holding companies which enabled them to access Government support. The CSE program was discontinued in September 2008. Some of the lessons learned are as follows:

*Capital Adequacy Rules Were Flawed and Assumptions Regarding Liquidity Risk Proved Overly Optimistic.* The applicable Basel capital adequacy standards depended heavily on the models developed by the financial institutions themselves. All models depend on assumptions. Assumptions about such matters as correlations, volatility, and market behavior developed during the years before the financial crisis were not necessarily applicable for the market conditions leading up to the crisis, nor during the crisis itself.

The capital adequacy rules did not sufficiently consider the possibility or impact of modeling failures or the limits of such models. Indeed, regulators worldwide are reconsidering how to address such issues in the context of strengthening the Basel regime. Going forward, risk managers and regulators must recognize the inherent limitations of these (and any) models and assumptions—and regularly challenge models and their underlying assumptions to consider more fully low probability, extreme events.

While capital adequacy is important, it was the related, but distinct, matter of liquidity that proved especially troublesome with respect to CSE holding companies. Prior to the crisis, the SEC recognized that liquidity and liquidity risk management were critically important for investment banks because of their reliance on private sources of short-term funding.

To address these liquidity concerns, the SEC imposed two requirements: First, a CSE holding company was expected to maintain funding procedures designed to ensure that it had sufficient liquidity to withstand the complete loss of all short term sources of unsecured funding for at least 1 year. In addition, with respect to secured funding, these procedures incorporated a stress test that estimated what a prudent lender would lend on an asset under stressed market conditions (a "haircut"). Second, each CSE holding company was expected to maintain a substantial "liquidity pool"

[3] The Gramm-Leach-Bliley Act had created a voluntary program for the oversight of certain investment bank holding companies (*i.e.,* those that did not have a U.S. insured depository institution affiliate). The firms participating in the CSE program did not qualify for that program or did not opt into that program. Only one firm (Lazard) has ever opted for this program.

[4] See, *e.g.,* Testimony by Erik Sirri, Director of the Division of Trading and Markets, Before the Senate Subcommittee on Securities, Insurance and Investment, Senate Banking Committee, March 18, 2009. *http://www.sec.gov/news/testimony/2009/ts031809es.htm.*

that was composed of unencumbered highly liquid and creditworthy assets that could be used by the holding company or moved to any subsidiary experiencing financial stress.

The SEC assumed that these institutions, even in stressed environments, would continue to be able to finance their high-quality assets in the secured funding markets (albeit perhaps on less favorable terms than normal). In times of stress, if the business were sound, there might be a number of possible outcomes: For example, the firm might simply suffer a loss in capital or profitability, receive new investment injections, or be acquired by another firm. If not, the sale of high quality assets would at least slow the path to bankruptcy or allow for self-liquidation.

As we now know, these assumptions proved much too optimistic. Some assets that were considered liquid prior to the crisis proved not to be so under duress, hampering their ability to be financed in the repo markets. Moreover, during the height of the crisis, it was very difficult for some firms to obtain secured funding even when using assets that had been considered highly liquid.

Thus, the financial institutions, the Basel regime, and the CSE regulatory approach did not sufficiently recognize the willingness of counterparties to simply stop doing business with well-capitalized institutions or to refuse to lend to CSE holding companies even against high-quality collateral. Runs could sometimes be stopped only with significant Government intervention, such as through institutions agreeing to become bank holding companies and obtaining access to Government liquidity facilities or through other forms of support.

*Consolidated Supervision Is Necessary but Not a Panacea.* Although large interconnected institutions should be supervised on a consolidated basis, policy makers should remain aware of the limits of such oversight and regulation. This is particularly the case for institutions with many subsidiaries engaging in different, often unregulated, businesses in multiple countries.

Before the crisis, there were many different types of large interconnected institutions subject to consolidated supervision by different regulators. During the crisis, many consolidated supervisors, including the SEC, saw large interconnected, supervised entities seek Government liquidity or direct assistance.

*Systemic Risk Management Requires Meaningful Functional Regulation, Active Enforcement, and Transparent Markets.* While a consolidated regulator of large interconnected firms is an essential component to identifying and addressing systemic risk, a number of other tools must also be employed. These include more effective capital requirements, strong enforcement, functional regulation, and transparent markets that enable investors and other counterparties to better understand the risks associated with particular investment decisions. Given the complexity of modern financial institutions, it is essential to have strong, consistent functional regulation of individual types of institutions, along with a broader view of the risks building within the financial system.

**Q.3.** *SEC's Endorsement of Treasury's Approach*—Chairman Schapiro, you chose to testify today on your own behalf. I suspect that if you had submitted your testimony for a Commission vote, you might have met some resistance since you endorse an approach that envisions the creation of a systemic risk regulator that will have authority over firms within the SEC's jurisdiction. Although cast as a second set of eyes to back up the front line financial regulators, the systemic risk regulator could complicate the SEC's job.

Are you concerned that the addition of a new regulatory body will water down your regulatory authority over firms that you oversee?

**A.3.** While a SRR should play a critical role in assessing emerging systemic risks by setting standards for liquidity, capital and risk management practices, in my view it is vital that its role be complemented by the creation of a strong and robust Council. I believe the Council should have authority to identify institutions, practices, and markets that create potential systemic risks, and also should be authorized to set policies for liquidity, capital and other risk management practices at firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness. The Council also would provide a forum for analyzing and recommending harmonization of certain standards at other significant financial institutions.

In most times, I would expect the Council and SRR to work with and through primary regulators of systemically important institutions. The primary regulators understand the markets, products and activities of their regulated entities. The SRR, however, can provide a second layer of review from a macroprudential perspective. If differences arise between the SRR/Council and the primary regulator regarding the capital or risk management standards of systemically important institutions, I strongly believe that the higher (more conservative) standard should govern. The systemic risk regulatory structure should serve as a "brake" on a systemically important institution's riskiness; it should never be an "accelerator."

In emergency situations, the SRR/Council may need to overrule a primary regulator (for example, to impose higher standards or to stop or limit potentially risky activities). However, to ensure that authority is checked and decisions are not arbitrary, the Council should be where general policy is set, and only then to implement a more rigorous policy than that of a primary regulator. This should reduce the ability of any single regulator to "compete" with other regulators by lowering standards, driving a race to the bottom.

**Q.4.** *SEC as Systemic Risk Regulator*—Chairman Schapiro, under the plan the Administration set forth, a so-called "Tier 1 Financial Holding Company" (Tier 1 FHC) and its subsidiaries would be subject to examination by the Federal Reserve. Thus, a broker-dealer subsidiary of a Tier 1 FHC would be subject to examination by the Fed and the SEC.

Should we be concerned that, rather than clarifying regulatory responsibility, this arrangement could blur lines of regulatory responsibility?

**A.4.** A similar arrangement exists today for broker-dealers subsidiaries within a Bank Holding Company. At its core, the mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Accordingly, rigorous financial responsibility requirements apply to all U.S. broker-dealers, which are designed to ensure that broker-dealers operate in a manner that permits them to meet all obligations to customers and counterparties. The first of these requirements is the net capital rule, which, among other things, requires the broker-dealer to maintain a level of liquid assets in excess of all unsubordinated liabilities to enable the firm to absorb business losses and, if necessary, finance an orderly self-liquidation. The second is the customer protection rule, which requires the firm to safeguard customer cash and securities by segregating these assets from its proprietary business activities. The third prong is comprised of recordkeeping and financial reporting requirements that require the broker-dealer to make and maintain records and file reports that detail its net capital positions and document the segregation of customer assets.

To ensure an equal playing field among the large and small, all broker-dealers should be subject to the same regulation, but additional review and holding company supervision can also take place. The SRR/Council could serve as a second set of eyes upon those larger institutions whose failure might put the system at risk, with the mandate of monitoring the entire financial system for systemwide risks and forestalling emergencies.

**Q.5.** *Too-Big-To-Fail*—Chairman Schapiro, your testimony correctly recognizes that one type of systemic risk is that we create a system that favors large institutions over their "smaller, more nimble competitors." Your testimony also suggests that a Financial Stability Oversight Council could prevent the formation of institutions that are too-big-to-fail.

How would this work in practice?

**A.5.** The Council, SRR, and primary regulators all should have a role in addressing the risks posed by large interconnected financial institutions. One of most important regulatory arbitrage risks is the potential perception that large interconnected financial institutions are too-big-to-fail and will therefore benefit from Government intervention in times of crisis. This perception can lead market participants to favor large interconnected firms over smaller firms of equivalent creditworthiness, fueling greater risk. To address these issues, policy makers should consider the following:

*Strengthen Regulation and Market Transparency.* Given the financial crisis and the Government's unprecedented response, it is clear that large, interconnected firms present unique and additional risks to the system. To minimize the systemic risks posed by these institutions, policy makers should consider using all regulatory tools available—including supplemental capital, transparency and activities restrictions—to reduce risks and ensure a level playing field for large and small institutions. A strong Council could provide a forum for examining regulatory standards across markets, ensuring that capital and liquidity standards are in place and being enforced and that those standards are adequate and appropriate for systemically important institutions and the activities they conduct. The Council and SRR would be primarily responsible for setting standards at the holding company level.

*Establish a Resolution Regime.* In times of crisis when a systemically important institution may be teetering on the brink of failure, policy makers have to immediately choose between two highly unappealing options: (1) providing Government assistance to a failing institution (or an acquirer of a failing institution), thereby allowing markets to continue functioning but creating moral hazard; or (2) not providing Government assistance but running the risk of market collapses and greater costs in the future. Markets recognize this dilemma and can fuel more systemic risk by "pricing in" the possibility of a Government backstop of large interconnected institutions. This can give such institutions an advantage over their smaller competitors and make them even larger and more interconnected.

A credible resolution regime can help address these risks by giving policy makers a third option: a controlled unwinding of a large, interconnected institution over time. Structured correctly, such a regime could force market participants to realize the full costs of their decisions and help reduce the "too-big-to-fail" dilemma. Structured poorly, such a regime could strengthen market expectations of Government support, thereby fueling "too-big-to-fail" risks.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM MARY L. SCHAPIRO**

**Q.1.** You discussed regulatory arbitrage in your written statement and emphasized the benefits of a Council to minimize such opportunities. Can you elaborate on this? Should standards be set by individual regulators, the Council, or both? Can a Council operate effectively in emergency situations?

**A.1.** Establishing a robust and multidisciplinary Financial Services Oversight Council (Council) would be an important step toward closing regulatory gaps. Because financial participants currently can use different vehicles or jurisdictions from which to engage in the same activity, participants can sometimes "choose" their regulatory framework. This choice can sometimes result in a race to the bottom among competing regulators and jurisdictions, lowering standards and increasing systemic risk.

A strong Council could provide a forum for examining and discussing regulatory standards across markets, ensuring that adequate and appropriate capital and liquidity standards for financial institutions in the marketplace and the activities they conduct are in place and being enforced. In addition, the Council would have the role of identifying risks across the system, harmonizing rules to minimize systemic risk, and helping to ensure that future regulatory gaps—and arbitrage opportunities—are minimized or avoided. In general, all regulatory tools available should be considered, including strong enforcement, additional measures to improve transparency, and appropriate activities restrictions. The Council should set policy if necessary to ensure that more rigorous standards than those of a primary regulator and/or the systemic risk regulator (SRR) are implemented. The Council should provide a different, impartial perspective relative to a single regulator having a daily oversight role.

In general, I would expect the Council and SRR to work with and through the primary regulators. The primary regulators understand the markets, products, and activities of their regulated entities. The SRR can provide a second layer of review over the activities, capital, and risk management procedures of systemically important institutions from a macroprudential perspective, considering risk to the system as a whole. If differences arise between the SRR/Council and the primary regulator regarding the capital or risk management standards of systemically important institutions, I strongly believe that the higher (more conservative) standard should govern.

In emergency situations, the SRR/Council may need to overrule a primary regulator (for example, to impose higher standards or to stop or limit potentially risky activities). However, to ensure that authority is checked and decisions are not arbitrary, general policy should be set by the Council, and only then to implement a more rigorous policy than that of a primary regulator.

The Council's responsibilities, lines of authority, and consultations with other regulators during both emergency and non-emergency situations should be explicitly delineated. Voting, quorum, and other governance requirements, including consultations with other regulators, should be carefully considered in advance for exigencies such as the ability to invoke resolution authority or overrule a primary regulator—as well as for designating systemically important institutions or setting policies as a matter of course.

**Q.2.** What factors should Congress consider as it weighs the benefits and drawbacks of expanding the Federal Reserve's authority to oversee the safety and soundness of systemically important payment, clearing, and settlement systems? Would it interfere with the SEC's authority over any of these systems?

**A.2.** While we believe it is appropriate for Congress to establish a single SRR to focus on macroprudential oversight and to identify systemic risk, it is important for Congress to consider the existing framework for the regulation and oversight of clearing agencies under the Exchange Act. Accordingly, we believe that any expansion of the Federal Reserve's authority should supplement rather than replace the existing regulatory framework for clearing agencies.

Confidence that the financial markets are both safe and fair is promoted by the risk management standards applicable to clearing agencies under Section 17A of the Exchange Act, including that clearing agencies must provide for the safeguarding of securities and funds and for the prompt and accurate clearance and settlement of securities transactions. The current risk management procedures for clearing agencies have shown remarkable robustness and resiliency both historically and through the recent period of financial stress. For example, no clearing agency incurred a loss following the Lehman bankruptcy last year. Furthermore, in the event of a participant default, one of a clearing agency's primary lines of defense is its substantial collateral pool, or clearing fund, that is comprised of substantial contributions from its participants. As a result, participants have a strong incentive to ensure the clearing agency maintains highly effective risk management policies and procedures.

In addition to the requirements regarding risk management, Section 17A also imposes a number of requirements to facilitate a national system for clearance and settlement of securities transactions. The regulation of the securities markets is inextricably tied to the regulation of the entities that provide clearance and settlement services. Clearance and settlement has an effect on almost every facet of the securities markets, including: characteristics of the products traded, trading partners, competition among trading venues, proxy and dividend distributions, and collaterization of ongoing transactions such as repurchase agreements and stock lending. In addition, regulation of many aspects of the securities market, such as the monitoring and regulation of "short selling," is accomplished through use of the clearance and settlement infrastructure. The standards that promote fairness and innovation in the securities markets have elements related to risk management, such as participant eligibility for clearing services, and could be compromised if another regulator could simply ignore the investor protections available under Section 17A or other laws. For these reasons, there should be a coordinated approach between the Council, functional regulators, and SRR in order to fully utilize the expertise and experience of all regulators and maintain the existing standards that are crucial to supporting the securities markets.

**Q.3.** What do you see as the key differences in viewpoints with respect to the role and authority of a Systemic Risk Council? For example, it seems like one key question is whether the Council or the Federal Reserve will set capital, liquidity, and risk management standards. Another key question seems to be who should be the Chair of the Council, the Secretary of the Treasury or a different Senate-appointed Chair. Please share your views on these issues.

**A.3.** Please see my response to your first question.

**Q.4.** What are the other unresolved aspects of establishing a framework for systemic risk regulation?

**A.4.** The Administration's white paper on Financial Regulatory Reform and recent legislation extensively address the additional supervisory, capital, leverage, and other requirements to which Tier 1 Financial Holding Companies (FHCs) would be subject. Consistent with the need to minimize regulatory arbitrage and close regulatory loopholes, attention is also due to firms that would not be considered Tier 1 FHCs and are not supervised as bank holding companies but nonetheless have a substantial presence in the securities markets or carry substantial customer assets. The failure of such "Tier 2" firms could have a disruptive or harmful impact on orderly and efficient markets and on customers, even if not necessarily at a global level. Moreover, it may be appropriate to impose graduated limits and capital charges, as well as increased supervisory attention, on these financial institutions as they grow.

**Q.5.** How should Tier 1 FHCs be identified? Which regulator(s) should have this responsibility?

**A.5.** The Council should have the authority to identify Tier 1 FHCs whose failure would pose a threat to the financial system due to their combination of size; leverage; interconnectedness; amount and nature of financial assets; nature of liabilities (such as reliance on short-term funding); importance as a source of credit for households, businesses, and Government; amount of cash, securities, or other types of customer assets held; and other factors the Council deems appropriate. One possible way to identify Tier 1 FHCs would be to use a process similar to that used to select participants in the Treasury Department and Federal Reserve's Supervisory Capital Assessment Program, or stress tests, conducted in 2009.

**Q.6.** One key part of the discussion at the hearing is whether the Federal Reserve, or any agency, can effectively operate with two or more goals or missions. Can the Federal Reserve effectively conduct monetary policy, macroprudential regulation, and consumer protection?

**A.6.** I believe the approach laid out above, where policy is set by a strong Council and implemented through functional regulators with a SRR overlay, would help address limitations associated with any individual regulators' mission or expertise.

**Q.7.** Under the Administration's plan, there would be heightened supervision and consolidation of all large, interconnected financial firms, including likely requiring more firms to become financial holding companies. Can you comment on whether this plan adequately addresses the "too-big-to-fail" problem? Is it problematic, as some say, to identify specific firms that are systemically significant, even if you provide disincentives to becoming so large, as the Administration's plan does?

**A.7.** Large financial institutions may enjoy a competitive advantage in the form of a lower cost of capital because the possibility of a Government backstop has been priced in. Accordingly, some have suggested that appropriate financial and risk management requirements be imposed on these large institutions to level the playing field for smaller competitors and to provide additional protection against their failure. I agree with the effort to establish a mechanism for macroprudential oversight and consolidated supervision of systemically important firms. Moreover, to minimize the systemic risks posed by these institutions, policy makers should consider using all regulatory tools available—including supplemental capital, transparency, and activities restrictions—to reduce risks and ensure a level playing field for large and small institutions.

A credible resolution regime can also help address these risks by giving policy makers the option of a controlled unwinding of a large, interconnected institution over time.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM MARY L. SCHAPIRO

**Q.1.** Many proposals call for a risk regulator that is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the risk regulator will set rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules in different ways. Under such a risk regulator, how would you make sure the rules were being enforced the same across the board?

**A.1.** Any risk regulator's role should be in conjunction with a strong Financial Services Oversight Council (Council). The Council would promote greater uniformity by providing a forum for examining and discussing regulatory standards across markets, ensuring that capital and liquidity standards are in place and being enforced, and that those standards are adequate and appropriate for systemically important institutions and the activities they conduct. In addition, the Council would have the role of identifying risks across the system, harmonizing rules to minimize systemic risk, and helping to ensure that future regulatory gaps—and arbitrage opportunities—are minimized or avoided. The Council would set policy if necessary to ensure that more rigorous standards than those of a primary regulator and/or the systemic risk regulator (SRR) are implemented. Such an approach would provide the best structure to ensure clear accountability for systemic risk, enable a strong, nimble response should adverse circumstances arise, and benefit from the broad and differing perspectives needed to best identify developing risks and minimize unintended consequences.

**Q.2.** Before we can regulate systemic risk, we have to know what it is. But no one seems to have a definition. How do you define systemic risk?

**A.2.** In my view, systemic risk is the concentration of risk in a single firm or a collective accumulation of risk across firms that creates a risk of sudden, near-term systemic seizures in markets or cascading failures of other entities. In addressing systemic risk it is important that we are careful that our efforts to protect the system from near-term systemic seizures do not inadvertently result in a long-term systemic imbalance that unintentionally favors large systemically important institutions over smaller firms of equivalent creditworthiness, fueling greater risk.

**Q.3.** Assuming a regulator could spot systemic risk, what exactly is the regulator supposed to do about it? What powers would they need to have?

**A.3.** A systemic risk regulator should be empowered, among other things, with broad information-gathering authority to obtain adequate reporting from firms that are or may pose a risk to the financial system and from other regulators. Using the information obtained, the systemic risk regulator would identify emerging risks—whether market-oriented, infrastructure-related, or entity-specific. For example, concentrations in particular businesses or asset classes and off-balance sheet or other activities that may not be readily transparent to the public or primary regulators should be of particular concern.

Given the breadth of the task, however, the Council, SRR, and primary regulators all have a role in identifying and addressing such risks. The Council and the SRR would need to rely heavily on primary regulators to implement policies. In that regard, the Council should play a key role in facilitating and emphasizing coordination among the SRR and primary regulators.

Moreover, while a consolidated regulator of large interconnected firms is an essential component to identifying and addressing systemic risk, a number of other tools must also be employed. These include more effective capital requirements, strong enforcement, and transparent markets that enable investors and other counterparties to better understand risks, established and maintained in coordination with primary regulators. Given the complexity of modern financial institutions, it is essential to have strong, consistent functional regulation of individual types of institutions, along with a broader view of the risks building within the financial system.

**Q.4.** How do you propose we identify firms that pose systemic risks?

**A.4.** The Council should have the authority to identify firms whose failure would pose a threat to the financial system due to their combination of size; leverage; interconnectedness; amount and nature of financial assets; nature of liabilities (such as reliance on short-term funding); importance as a source of credit for households, businesses, and Government; amount of cash, securities, or other types of customer assets held; and other factors the Council deems appropriate. One possible way to identify these firms would be to use a process similar to that used to select participants in the Treasury Department and Federal Reserve's Supervisory Capital Assessment Program, or stress tests, conducted earlier in 2009.

**Q.5.** All of the largest financial institutions have international ties, and money can flow across borders easily. AIG is probably the best known example of how problems can cross borders. How do we deal with the risks created in our country by actions somewhere else, as well as the impact of actions in the U.S. on foreign firms?

**A.5.** Globally active financial services firms may be geographically dispersed, but as we saw during this financial crisis, the holding company can become crippled by the failure of any one of its many material subsidiaries. Our experience has confirmed the need for cross-border coordination and dialogue, as well as for sound regulatory regimes for principal subsidiaries of international holding companies. These regulatory regimes should of course include capital and liquidity standards that are adequate, appropriate, and enforced for the type of financial institutions affected, as well as measures to address operational and reputational risks. The global nature of financial conglomerates such as AIG makes capital and liquidity standards appropriate topics for international coordination and cooperation. In general, the financial crisis has highlighted the need for regulators to work more closely together to better understand the risks posed by international financial companies and global market risks.

**Q.6.** Any risk regulator would have access to valuable information about the business of many firms. There would be a lot of people who would pay good money to get that information. How do we protect that information from being used improperly, such as theft or an employee leaving the regulator and using his knowledge to make money?

**A.6.** This same issue exists in our current regulatory regime and there is an established framework of regulation to safeguard against the misuse of confidential information. It is a criminal violation to disclose confidential information generally. See 18 U.S.C.

§1905, Disclosure of confidential information generally, which provides that any officer or employee of the United States or any of its department or agency who, in the course of his employment or official duties, discloses confidential information (unless authorized by law) will be subject to fines, imprisonment, or both and will be removed from office or employment.

There also are express standards of ethical conduct for employees or executives of any executive agency of the United States (such as the Securities and Exchange Commission) that provide, among other things, that an employee shall not engage in financial transactions using nonpublic Government information or allow the improper use of such information to further any private interest. See 5 CFR Section 2635.101(b)(3); see also 5 CFR Section 2635.703(a), which states that "[a]n employee shall not engage in a financial transaction using nonpublic information, nor allow the improper use of nonpublic information to further his own private interest or that of another, whether through advice or recommendation, or by knowing unauthorized disclosure."

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARY L. SCHAPIRO**

**Q.1.** Thank you for responding back to my letter that was signed by Senators Bunning, Martinez, Vitter, and Enzi about the need to make sure that any decision on short selling will be made based on empirical data. Has the SEC Office of Economic Analysis undertaken any independent analysis to determine if there would be a net benefit from imposing an additional short-selling restriction so that any final decision will be able to withstand scrutiny and cost-benefit analysis?

**A.1.** The Commission's Office of Economic Analysis (OEA), now part of the newly created Division of Risk, Strategy, and Financial Innovation, has performed independent analysis of the uptick rule and various other types of short sale restrictions. For example, OEA analysis includes (1) a major empirical study based on a pilot rule change prior to the elimination of Rule 10a-1 in 2007; (2) subsequent analyses to determine how various forms of uptick rules would have operated during the financial crisis; and (3) numerous studies of how Regulation SHO and its subsequent amendments have impacted delivery failures. OEA also has reviewed and analyzed many other publicly available empirical studies of short sale restrictions, including studies conducted both before and after the recent financial crisis. Collectively, these studies provide a wealth of empirical evidence relevant to understanding the costs and benefits of short sale regulation. In addition, the public has had many opportunities to present additional commentary, analysis, and empirical evidence bearing on short sale restrictions as a part of the rule-making process. OEA has assisted the Commission in reviewing studies and evidence raised through the public comment process.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM MARY L. SCHAPIRO**

**Q.1.** Ms. Schapiro, in recent months, you stated that the SEC is undertaking a comprehensive reexamination of rule 12b-1 fees. Can you please explain why, when the SEC has so many other important issues facing it, you are directing the SEC's resources to a review of these fees which exist to help millions of small investors have access to ongoing professional financial advice and service?

**A.1.** I have directed the staff to undertake a comprehensive reexamination of rule 12b-1 to help the Commission better understand the impact the rule has on investors and funds and to make recommendations to the Commission regarding the rule. Rule 12b-1, which permits funds to use their assets to pay for distribution costs, was adopted 30 years ago and has not been substantively revised since that time. As a result, certain provisions of the rule likely are outdated and no longer relevant to the way the rule is used today.

The amount of 12b-1 fees that shareholders pay through mutual funds has risen from a few million dollars per year in the early 1980s to over $13 billion in 2008. The expanded use and amount of the fees paid pursuant to rule 12b-1 have been a source of concern and controversy for many years. As you note, supporters of the rule argue that 12b-1 fees help small investors to access ongoing professional financial advice and services, and help spur innovation and fund growth. Others, however, have argued that the rule has, among other concerns, led to complex fee structures that make it difficult for investors to evaluate and compare overall costs and services.

The results of the staff's reexamination of rule 12b-1 will better inform the Commission as it considers potential updating and reform of this rule that has a substantial impact on fund investors.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DANIEL K. TARULLO**

**Q.1.** *AIG*—Governor Tarullo, I am very concerned that the Fed currently has too many responsibilities. The Fed's bail out of AIG has put the Fed in the position of having to unwind one of the world's largest and most complex financial institutions. Resolving AIG without imposing losses on the U.S. taxpayer is proving to be a time-consuming and difficult task. It could even potentially distract the Fed from its core mission of monetary policy.

Approximately how many hours have you personally dedicated to overseeing the Fed's investments in AIG?

How does this compare with the number of hours you have spent on monetary policy issues?

What assurance can you provide that the Fed is devoting enough time and attention to both AIG and monetary policy?

**A.1.** I joined the Board at the end of January 2009 and thus was not involved in matters involving the American International Group, Inc. (AIG) before that date. While we do not have records of the exact number of hours I have spent addressing AIG matters since I joined the Board, these matters do not occupy a significant part of my ongoing workload and do not detract from my other responsibilities as a member of the Board, including the conduct of monetary policy.

The oversight of the Federal financial assistance provided to AIG is shared by the Federal Reserve, which has provided several credit facilities designed to stabilize AIG, and the Treasury Department, which holds equity interests in the company. The day-to-day oversight of the Federal Reserve credit facilities is carried out by a team ofstaff at the Federal Reserve Bank of New York and the Board of Governors, assisted by expert advisers we have retained. In our role as a creditor of AIG, the Federal Reserve oversight staff makes sure that we are adequately informed on such matters as funding, cash flows, liquidity, earnings, risk management, and progress in pursuing the company's divestiture plan, so that we can protect the interests of the System and the taxpayers in repayment of the credit extended. With respect to the credit facilities extended to special purpose entities that purchased assets connected with AIG operations, the staff's oversight activities consist primarily of monitoring the portfolio operations of each of the entities, which are managed by a third-party investment manager. The Federal Reserve staff involved in the ongoing oversight of AIG periodically report to the Board of Governors about material developments regarding the administration of these credit facilities.

The Federal Reserve oversight staff for AIG works closely with the Treasury staff who oversee and manage the Treasury's relationship with AIG. As the holder of significant equity interests in the company, Treasury plays an important role in stabilizing AIG's financial condition, overseeing the execution of its divestiture plan, and protecting the taxpayers' interests.

With respect to time expended by the Reserve Bank members of the Federal Open Market Committee, the President of the New York Reserve Bank devotes significant attention to AIG. However, as noted above, day-to-day responsibility for overseeing the Bank's interests as lender to AIG has been delegated to a team of senior Bank managers. The President regularly consults with the AIG team—in particular he receives a daily morning briefing on AIG as well as other significant Bank activities, receives updates throughout the day on an *ad hoc* basis circumstances warrant, and occasionally intervenes personally on particular issues. The President believes that he is able to adequately balance the time and resources he allocates to AIG with the other Bank activities that warrant his personal attention, including his responsibilities as a voting member of the FOMC.

**Q.2.** *Safety and Soundness Regulation*—Governor Tarullo, in your testimony you state that there are synergies between monetary policy and systemic risk regulation. In order to capture these synergies, you argue that the Fed should become a systemic risk regulator. Yesterday, Chairman Bernanke testified that he believed there are synergies between prudential bank regulation and consumer protection. This argues in favor of establishing one consolidated bank regulator.

In your judgment, is it on the whole better to have prudential supervision and consumer protection consolidated in one agency, or separated into two different agencies?

**A.2.** There are important connections and complementarities between consumer protection and prudential supervision. For example, sound underwriting benefits consumers as well as the relevant financial institution, and strong consumer protections can add certainty to the markets and reduce risks to the institutions. Moreover, the most effective and efficient consumer protection requires the in-depth understanding of bank practices that is gained through the prudential supervisory process. Indeed, the Board's separate divisions for consumer protection and prudential supervision work closely in developing examination policy and industry gnidance. Both types of supervision benefit from this close coordination, which allows for a broader perspective on the quality of management and the risks facing a financial organization. Thus, placing consumer protection rule writing, examination, and enforcement activities in a separate organization that does not have prudential supervisory responsibilities would have costs, as well as benefits.

Achieving the synergies between prudential supervision and consumer protection does not require that responsibility for both functions and for all banking organizations to be concentrated in a single, consolidated bank regulator. Under the current framework for bank supervision, the Board has prudential supervisory responsibilities for a substantial cross-section of banking organizations in the United States, as well as rule-writing, examination, and enforcement authority for consumer protection. Likewise, the other Federal banking agencies all have both prudential supervisory authority for certain types of banking organizations and consumer protection examination and enforcement responsibilities for these organizations.

Moreover, as I indicated in my July 23rd testimony to the Committee, the United States needs a comprehensive agenda to contain systemic risk and address the problem of "too-big-to-fail" financial institutions. We should seek to marshal and build on the individual and collective expertise and resources of all financial supervisors in the effort to contain systemic risks within the financial system, rather than rely on a single "systemic risk regulator." This means new or enhanced responsibilities for a number of Federal agencies and departments, including the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Federal Deposit Insurance Corporation.

One important aspect of such an agenda is ensuring that all systemically important financial institutions—and not just those that own a bank—are subject to a robust framework for supervision on a consolidated or groupwide basis, thereby closing an important gap in the current regulatory framework. The Federal Reserve already serves as the consolidated supervisor of all bank holding companies, including a number of the largest and most complex banking organizations and a number of very large financial firms—such as Goldman Sachs, Morgan Stanley, and American Express—that became a bank holding company during the financial crisis. This expertise, as well as the information and perspective that the Federal Reserve has as a result of its central bank responsibilities, makes the Federal Reserve well suited to serve as consolidated supervisor for all systemically important financial firms.

As Chairman Bernanke recently noted, there are substantial synergies between the Federal Reserve's role as prudential supervisor and its other central bank responsibilities. Price stability and financial stability are closely related policy goals. The benefits of maintaining a Federal Reserve role in supervision have been particularly evident in the recent financial crisis. Over the past 2 years, supervisory expertise and information have helped the Federal Reserve to better understand the emerging pressures on financial firms and to use monetary policy and other tools to respond to those pressures. This understanding contributed to more timely and decisive monetary policy actions and proved invaluable in helping us to address potential systemic risks involving specific financial institutions and markets. More broadly, our supervisors' knowledge of interbank lending markets and other sources of bank funding contributed to the development of new tools to address financial stress.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM VINCENT R. REINHART**

**Q.1.a.** *Removing Bank Regulation From the Fed*—Dr. Reinhart, Governor Tarullo claims that there are synergies between systemic risk regulation and monetary policy.

As the former Director of the Division of Monetary Affairs at the Fed, do you believe that the Fed's ability to conduct monetary policy would be compromised if the Fed no longer regulated any financial institutions?

**A.1.a.** Absolutely not. The Fed's monetary policy responsibility requires a high-level understanding of the aggregate economy. Fed officials need an expertise in the workings of markets, industries, and sectoral behavior. They can get an aggregate understanding without being a supervisor. As for markets, no one wants to strip the Fed of its responsibility of managing the Fedwire and book-entry systems—the backbone to how funds and Treasury securities are transferred. As long as it provides those fundamental market utilities, the Fed will always have a window into markets and large firms, independent of its supervisory responsibilities. Fed officials frequently boast that their lending involves little risk because it is highly collateralized. If so, why do they need the information that comes from being the regulator of those firms? The Fed should focus on its core responsibility and work with the Congress to protect the information flows it deems essential.

**Q.1.b.** Would banking regulation improve if it was consolidated under one regulator?

**A.1.b.** Absolutely yes. Financial firms are too complicated to supervise or for markets to discipline. One reason is that they can search among multiple regulators for the most conducive (*i.e.,* lax) environment. Eliminate regulatory arbitrage by consolidating regulators.

**Q.2.** *Politicization of the Fed*—Dr. Reinhart, Professor Meltzer asserts in his testimony that the Administration's proposal to make the Fed responsible for systemic risk would ultimately sacrifice the independence of the Fed. As the primary Federal regulator, the

Fed's views would have great sway over whether a firm facing insolvency is rescued. Professor Meltzer points out that banks, future Administrations, and Congress will therefore seek to exert political influence over the Fed's decisions on which firms receive bail outs.

Do you agree with Professor Meltzer that making the Fed responsible for systemic risk regulation may cause the Fed to become politicized?

**A.2.** Monetary policy is abstract and about the national economy. Aiding a failing firm is concrete and about specific States and districts. All politics is local. If the Fed is responsible for systemic risk, it will be enmeshed in politics and its core responsibility will suffer.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM VINCENT R. REINHART**

**Q.1.** I doubt we can create a regulator that will be able to see and stop systemic risk. It seems to me a more practical and effective way to limit the damage firms can do is to limit their size and exposure to other firms. That also has the benefit of allowing the free markets to operate, but within reasonable limits. Do you agree with that?

**A.1.** Financial firms have gotten too complicated and too interconnected. This is related to, but not completely explained by, the size of a firm. In March 2008, for instance and much to my regret, financial authorities were unwilling to let market forces determine the fate of the mid-sized investment bank, Bear Stearns, because of concerns about its interconnectedness. My preferred solution is to combat complexity directly by enforcing strict consolidation of balance sheets and requiring different activities within a holding company to be chartered and capitalized separately. If a firm's balance sheet is transparent, then the market can exert meaningful discipline.

**Q.2.** Many proposals call for a risk regulator that is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the risk regulator will set rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules different ways. Under such a risk regulator, how would we make sure the rules were being enforced the same across the board?

**A.2.** Management by committee never works well. Introducing layers of supervision invites turf wars among the regulators, the search for regulatory gaps among the regulated, and mutual finger-pointing after the fact of failure.

**Q.3.** Before we can regulate systemic risk, we have to know what it is. But no one seems to have a definition. How do you define systemic risk?

**A.3.** Systemic risk refers to the possibility that there will be a widespread withdrawal from risk taking that does not discriminate across borrowers.

**Q.4.** Assuming a regulator could spot systemic risk, what exactly is the regulator supposed to do about it? What powers would they need to have?

**A.4.** Systemic risk is a contagion. The most effective response is to isolate the source. Before the fact, regulated entities should be required to keep a simple balance-sheet structure that limits interconnections. This reduces the risk of contagion. In the event, weak firms should be allowed to fail. If there are activities of the firm that pose system risk, they should be isolated and protected—after sufficient haircuts—and the rest of the firm left to fail.

**Q.5.** How would we identify firms that pose systemic risks?

**A.5.** A systemic threat is posed by any firm with large gross exposures, relative to its capital, to many different firms with no effective netting regime.

**Q.6.** All of the largest financial institutions have international ties, and money can flow across borders easily. AIG is probably the best known example of how problems can cross borders. How do we deal with the risks created in our country by actions somewhere else, as well as the impact of actions in the U.S. on foreign firms?

**A.6.** We can best protect our national interest by requiring that any firm operating in the United States have a transparent balance sheet and sufficient capital for each of its independent lines of business.

**Q.7.** As you probably have heard, many are calling for an audit of the Fed. Chairman Bernanke and others are opposed to that idea because they fear it will lead to Congressional interference with monetary policy. What can be done to improve transparency at the Fed? What should not be done? Is there any information on Fed discussions and the data that goes into them that would compromise the Fed's independence or ability to do its job if made public?

**A.7.** There are limits to transparency. A requirement that the Fed disclose more information sooner would probably push decision making more outside organized meetings, to the detriment of openness. There are two areas where the Fed could volunteer improvement. First, it could make a numeric summary of its staff forecast public with its minutes. The forecast is influential among FOMC participants. If they find it useful, would not the public? Second, the transcripts could be released sooner than the current 5-year lag, and probably substantially so.

**Q.8.** Do you have any suggestions for ways to improve the Fed's ability to carry out its core mission of monetary policy? Do you have any other comments about the Fed generally?

**A.8.** The Fed would be far better off if it focused on its core responsibility of monetary policy and hardened the wall of independence around it. Shed bank supervision, which it did not do well. Collect and share more data to compensate for the lack of supervision. Articulate a long-run inflation goal to anchor the public's understanding. The Fed's unwillingness to engage the Congress in a meaningful dialogue about the appropriate role of the central bank is a mistake.

## RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM PAUL SCHOTT STEVENS

**Q.1.** *Creating a New Systemic Regulator*—Mr. Stevens, your testimony pointed out the importance of clearly defining the relationship between any new systemic regulator and existing primary financial regulators.

What are the potential consequences of failing to draw clear lines?

**A.1.** Failure to clearly delineate the relationship between any systemic risk regulator and the existing primary financial regulators could have several adverse consequences, particularly if the systemic risk regulator is not constituted as a council of existing primary regulators. It would increase the chances that the systemic risk regulator and one or more primary regulators might find themselves working at cross purposes with respect to a given issue. If each believes that it has responsibility over a particular area, each could adopt regulations that are inconsistent, particularly if the regulators have distinct regulatory philosophies and different types of expertise. If the respective responsibilities of the systemic risk regulator and the primary regulators are not well-defined, there will be no clear avenue for resolving these sorts of conflicts. As a result, there could be delays in addressing the issue at hand.

Alternatively, the absence of clear lines could result in the systemic risk regulator and primary regulators duplicating each other's efforts, which would be inefficient and potentially create additional regulatory burdens for financial institutions. Or, the systemic risk regulator and relevant primary regulator may each mistakenly believe that the other is responsible for a particular matter, and the identification and resolution of issues could fall through the cracks.

A related point is the need to place explicit limits on the authority granted to the systemic risk regulator and to identify areas in which the systemic risk regulator and the primary regulators should work together. I believe it would be most unfortunate if the systemic risk regulator were to marginalize the primary regulator, thus potentially leading to the loss of specialized expertise that the primary regulator is in the best position to offer.

**Q.2.** *Tier 1 Financial Holding Companies*—Mr. Stevens, as you noted, the Administration's proposal would vest the Federal Reserve with the ultimate authority to designate a firm as a Tier 1 Financial Holding Company (Tier 1 FHC). A Tier 1 FHC is defined as a firm the failure of which would pose a threat to financial stability due to its size, leverage, and interconnectedness. Some of your larger members could potentially be swept up by that definition.

How do you anticipate that could change the way in which large mutual funds are regulated and could the designation of a large fund complex as a Tier 1 FHC create an uneven playing field for smaller firms without that designation?

**A.2.** As a threshold matter, it is useful to note the potential range of financial firms that could be designated as Tier 1 Financial Holding Companies (Tier 1 FHCs). In its white paper on financial services regulatory reform, and in the "Findings and Purposes" section of its draft legislation, the Administration describes a Tier 1 FHC as a firm the failure of which would pose a threat to financial stability due to its size, degree of leverage, and interconnectedness. Elsewhere in the draft legislation is a standard that governs Tier 1 FHC designations, and it is much more expansive. In particular, the Federal Reserve need not find all three factors to be present in order to determine that a firm should be designated a Tier 1 FHC—rather, the legislation would require that the Federal Reserve consider these and other enumerated factors, in addition to any other factors that the agency in its discretion deems appropriate.

The degree of discretion that the Administration seeks to vest in the Federal Reserve is further illustrated by the Administration's proposal to authorize that agency to require certain financial companies to submit "such information as [the Federal Reserve] may reasonably require" for purposes of making Tier 1 FHC designations. Under the draft legislation, this authority would extend to any financial company having (1) $10 billion or more in assets, (2) $100 billion or more in assets under management, or (3) $2 billion or more in gross annual revenue. These thresholds are low enough to capture potentially a wide array of companies in the fund industry.

Under such an open-ended framework, it is certainly possible that a large mutual fund (typically organized as a corporation or business trust under state law) or a family of such funds collectively could be designated a Tier 1 FHC. The same might be true for a mutual fund investment adviser and its affiliated companies. Perhaps most likely, a mutual fund adviser that is part of an integrated financial services firm could be swept into the Tier 1 FHC regime. These scenarios are discussed below.

*Mutual funds*

Designating a large mutual fund or family of funds as a Tier 1 FHC would not, in my view, be likely to serve the stated purposes of the Administration's proposal. Mutual funds are already subject to comprehensive regulation under the Federal securities laws including, in particular, the Investment Company Act of 1940 (ICA). Perhaps most relevant for this purpose are the ICA's strict limitations on leverage to which mutual funds must adhere. Other core areas of fund regulation, including daily valuation of fund shares, separate custody of fund assets, affiliated transaction prohibitions, diversification requirements, and extensive disclosure and transparency requirements, are part of an extensive regulatory framework that has protected fund investors and proven resilient in difficult market conditions.

Importantly, the Federal Reserve has long viewed a mutual fund as being controlled by its independent board and not by its investment adviser or by a company that provides the fund with administrative, brokerage, and other services. Consistent with this longstanding view, the Federal Reserve would presumably need to conclude that the relevant risk characteristics of a mutual fund or fund family themselves warrant designating the fund or fund family as a Tier 1 FHC, and it would not take into account the activities of the fund adviser and/or the adviser's affiliates in making this determination. As discussed above, designating a fund or fund family as a Tier 1 FHC would appear unnecessary given the comprehensive ICA regulatory scheme, including its strict limits on leverage.

Under the Administration's proposal, Tier 1 FHC status might be applied to certain kinds of funds such as money market funds, which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost. These funds have been comprehensively regulated by the Securities and Exchange Commission (SEC) not only under the ICA provisions outlined above, but also through a specialized and highly prescriptive rule, Rule 2a-7, for 30 years. For the reasons described below, any concerns that a large money market fund or family of such funds could present the potential for systemic risk should be addressed by SEC reforms and other pending initiatives, and not by designating such fund(s) as a Tier 1 FHC.

In March, ICI's Money Market Working Group issued a comprehensive report outlining a range of measures to strengthen the liquidity and credit quality of money market funds and ensure that money market funds will be better positioned to sustain prolonged and extreme redemption pressures. [1] Consistent with the Working Group's recommendations, the Administration, in its white paper, specifically directed the SEC to move forward with plans to strengthen the money market fund regulatory framework to reduce the credit and liquidity risk profile of individual money market funds and to make the money market fund industry as a whole less susceptible to runs. In so doing, the Administration recognized that the SEC, as the primary regulator for money market funds, is uniquely qualified to evaluate and implement potential changes to the existing scheme of money market fund regulation. The SEC already has proposed such amendments, many of which are similar to the Working Group's recommendations, and is currently reviewing the comments it has received from ICI and others on the proposal. [2] In addition, the President's Working Group on Financial Markets is considering whether any other reforms are needed to further strengthen the resiliency of money market funds to certain short-term market risks.

Finally, whether the designation of a large fund or fund family as a Tier 1 FHC could create an uneven playing field for smaller funds without that designation is difficult to say. It is conceivable that investors might perceive such a designation as providing some kind of assurance or advantage and, thus, that a Tier 1 designation could have a positive influence on their investment decisions, especially in times of market stress. But it seems more likely that a Tier 1 FHC designation—and its potential effects on how funds are regulated—would put those funds at a competitive disadvantage as compared to their peers that are not so designated.

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[1] See "Report of the Money Market Working Group", Investment Company Institute (March 17, 2009), available at *http://www.ici.org/pdf/ppr_09_mmwg.pdf.*

[2] See "Money Market Fund Reform", SEC Release No. IC-28807 (June 30, 2009), 74 FR 32688 (July 8, 2009), available on the SEC's Web site at *http://sec.gov/rules/proposed/2009/ic-28807.pdf.*

*Investment Advisers*

Bringing a mutual fund investment adviser—most likely, one that is part of an integrated financial services firm—within the proposed supervisory and regulatory scheme for Tier 1 FHCs would impose an additional layer of substantive regulation on the adviser that would be fundamentally different from, and could be at odds with, the regulatory schemes to which fund advisers have long been subject.

Generally speaking, a Tier 1 FHC and its subsidiaries—regardless of whether those subsidiaries are already regulated by a "functional" regulator such as the SEC—would be subject to supervisory and regulatory authority of the Federal Reserve. Such supervision is intended to be "macroprudential" in focus, combining "enhanced forms" of the Federal Reserve's normal supervisory tools that are focused on safety and soundness with rigorous assessments of how the firm's overall activities and risk exposures potentially impact other Tier 1 firms, critical markets, and the broader financial system. A firm designated as a Tier 1 FHC would need to meet strict prudential standards, including risk-based capital standards, leverage limits, liquidity requirements, and overall risk management requirements. Following a transition period, the firm also would have to conform to the restrictions on nonfinancial activities in the Bank Holding Company Act, even if the firm did not control an insured depository institution.

In a sharp departure from current law, the Federal Reserve would be given authority to impose and enforce prudential requirements on a fund adviser, upon consultation in some cases with the SEC. This would be true regardless of whether the adviser is named a Tier 1 FHC in its own right or is part of an integrated financial services firm that is designated as a Tier 1 FHC. In either case, it is not clear how prudential requirements such as capital standards, which make considerable sense in ensuring the safety and soundness of an insured depository institution and its holding company, would be applied to investment advisers. There would be other ways in which prudential regulation by the Federal Reserve may conflict with the regulatory requirements to which investment advisers already are subject, and it is unclear at this point how such differences in regulatory requirements would be reconciled.

Lastly, it is important to recognize that, unlike the SEC, the Federal Reserve does not have an investor protection mandate. Instead, its bottom-line objective is to promote the safety and soundness of financial institutions. In pursuing their respective missions, the two agencies follow distinct regulatory approaches, they have different regulatory tools at their disposal, and each has its particular areas of expertise. The difficulties likely to result from superimposing Federal Reserve supervisory and regulatory authority onto comprehensive SEC regulation of mutual fund advisers should not be underestimated.

**Q.3.** *Independent Board Versus Independent Council*—Mr. Stevens, you argue that the creation of an independent board, as opposed to a council of existing regulators, could lead to incentives to justify its existence by finding systemic risks even where they do not exist.

What aspects of the Council's design would prevent its staff from falling prey to the same pressure to justify the Council's existence?

**A.3.** I believe that several aspects of the design of a Systemic Risk Council (as I have described it in my written testimony) would make it highly unlikely that the Council or its staff would feel pressured to find systemic risks merely to justify the Council's existence.

As the leaders of the core financial regulatory agencies, all standing members of the Council would already have critical "day jobs," ones that make them ultimately responsible for the regulation of financial firms, activities, and markets within their spheres of expertise. It is precisely these roles—as Secretary of the Treasury or as Chairman of the SEC, for example—that would well position the Council members to distinguish between regulatory matters best handled by the appropriate primary regulator(s) and those matters that cut across regulatory lines and present the potential for harm that could spread throughout the financial system. In these latter cases, the Council would be required to make a formal determination that the matter is of such nature and import as to require the Council's involvement, both in developing a series of responses to the identified risks and in directing the appropriate primary regulator(s) to implement those responses. I do not believe that the Council members would come to such a conclusion lightly.

Moreover, the Council would not just be tasked with the prevention and mitigation of systemic risk—it would also be the body responsible for policy coordination and information sharing across the various federal financial regulators. The time and energies of the Council and its independent staff, and in particular the knowledge gleaned from their continuous monitoring of conditions and developments in the financial markets, would be leveraged for both purposes. This is significant because not all of the issues and risks that they identify will involve threats to overall financial stability. Through the collaborative Council process, these "lesser" issues and risks can get the attention that they deserve, presumably by the appropriate primary regulator(s).

Finally, as regards the staff, I have proposed that a small but diverse group of highly experienced individuals should be sufficient to support the work of the Council. Many of these individuals should be seconded from the financial regulatory agencies represented on the Council and thus, like the Council members themselves, be well positioned to identify risks that are truly systemic in nature. And the staff, while independent, will follow an agenda that is determined by the Council. All of these factors, in my view, would appropriately focus the staff's efforts.

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## RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ALICE M. RIVLIN

**Q.1.** *Super Regulators*—Ms. Rivlin, you state in your testimony that it would be "a mistake to give the Federal Reserve responsibility for consolidated prudential regulation" of systemically important institutions as the Obama administration has proposed. You note that if the Fed acquires this additional responsibility it will need leaders with regulatory skills—lawyers, not economists like Volcker, Greenspan, and Bernanke.

Is it realistic to expect that any one person can be an expert in all of the areas falling under the Fed's jurisdiction?

As a former Vice-Chair of the Fed, do you think that the Fed was an effective bank regulator in the run up to this crisis?

**A.1.** Answer not received by time of publication.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ALICE M. RIVLIN**

**Q.1.** I doubt we can create a regulator that will be able to see and stop systemic risk. It seems to me a more practical and effective way to limit the damage firms can do is to limit their size and exposure to other firms. That also has the benefit of allowing the free markets to operate, but within reasonable limits. Do you agree with that?

**A.1.** Answer not received by time of publication.

**Q.2.** Many proposals call for a risk regulator that is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the risk regulator will set rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules different ways. Under such a risk regulator, how would we make sure the rules were being enforced the same across the board?

**A.2.** Answer not received by time of publication.

**Q.3.** Before we can regulate systemic risk, we have to know what it is. But no one seems to have a definition. How do you define systemic risk?

**A.3.** Answer not received by time of publication.

**Q.4.** Assuming a regulator could spot systemic risk, what exactly is the regulator supposed to do about it? What powers would they need to have?

**A.4.** Answer not received by time of publication.

**Q.5.** How would we identify firms that pose systemic risks?

**A.5.** Answer not received by time of publication.

**Q.6.** All of the largest financial institutions have international ties, and money can flow across borders easily. AIG is probably the best known example of how problems can cross borders. How do we deal with the risks created in our country by actions somewhere else, as well as the impact of actions in the U.S. on foreign firms?

**A.6.** Answer not received by time of publication.

**Q.7.** As you probably have heard, many are calling for an audit of the Fed. Chairman Bernanke and others are opposed to that idea because they fear it will lead to Congressional interference with monetary policy. What can be done to improve transparency at the Fed? What should not be done? Is there any information on Fed discussions and the data that goes into them that would compromise the Fed's independence or ability to do its job if made public?

**A.7.** Answer not received by time of publication.

**Q.8.** Do you have any suggestions for ways to improve the Fed's ability to carry out its core mission of monetary policy? Do you have any other comments about the Fed generally?

**A.8.** Answer not received by time of publication.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ALLAN H. MELTZER**

**Q.1.** *Lessons of Fed History*—Professor Meltzer, you are in the process of completing your book on the History of the Federal Reserve. I understand that you have been working on this project for more than a decade. This research gives you a unique perspective about the strengths and weaknesses of the Fed.

In your examination of its history, has the Fed demonstrated that it is inherently better at identifying systemic risks than any other regulator?

**A.1.** No. If anyone could forecast crises, they would either be very rich or they could prevent them. We need to choose policies that reduce the risk of crises. My answers to some of Senator Bunning's questions suggest some ways of reducing failures and the public's cost of failures.

**Q.2.** What are the problems that are likely to occur if the Fed is given authority to regulate systemic risk?

**A.2.** The Fed will not be able to do much because we do not know how to forecast systemic risks. The Fed will be more engaged in political decisions than is consistent with independence.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ALLAN H. MELTZER**

**Q.1.** I doubt we can create a regulator that will be able to see and stop systemic risk. It seems to me a more practical and effective way to limit the damage firms can do is to limit their size and exposure to other firms. That also has the benefit of allowing the free markets to operate, but within reasonable limits. Do you agree with that?

**A.1.** Yes, very much. I propose to limit size by making banks increase their reserves (capital) more than in proportion to the increase in the size of assets. That shifts the cost from the public to the stockholders, changes bankers' incentives, and protects the public. That should accompany an end to "too-big-to-fail" and a lender of last resort rule that Congress and the Federal Reserve agree to follow.

**Q.2.** Many proposals call for a risk regulator that is separate from the normal safety and soundness regulator of banks and other firms. The idea is that the risk regulator will set rules that the other regulators will enforce. That sounds a lot like the current system we have today, where different regulators read and enforce the same rules different ways. Under such a risk regulator, how would we make sure the rules were being enforced the same across the board?

**A.2.** Again, you are right. The central point of difference between a risk regulator and increased bank capital lies in who bears the residual risk. You and I want it to be management and stockholders. Those favoring a risk regulator leave the public bearing the risk.

**Q.3.** Before we can regulate systemic risk, we have to know what it is. But no one seems to have a definition. How do you define systemic risk?

**A.3.** I don't think there is an all-purpose definition. I do not need to define it because I do not want a risk regulator to decide. If costs are borne by the banks, they will have an incentive to be more prudent. We cannot prevent all failures because banks lend long and borrow short. We can prevent failures from becoming crises.

The lender of last resort should lend only to those that have quality collateral. That puts the incentives where they should be.

**Q.4.** Assuming a regulator could spot systemic risk, what exactly is the regulator supposed to do about it? What powers would they need to have?

**A.4.** See above. I can't see how we can get a definition. If the opportunity arises every member of congress would claim that a large failure in their district is systemic. And their constituents would expect that.

**Q.5.** How would we identify firms that pose systemic risks?

**A.5.** I would not. I would make them hold capital to safeguard the rest of us.

**Q.6.** All of the largest financial institutions have international ties, and money can flow across borders easily. AIG is probably the best known example of how problems can cross borders. How do we deal with the risks created in our country by actions somewhere else, as well as the impact of actions in the U.S. on foreign firms?

**A.6.** Yes, a big problem. We allow failures of the companies we charter. If foreign governments want to rescue the subs in their jurisdiction, why is that a problem for us?

**Q.7.** As you probably have heard, many are calling for an audit of the Fed. Chairman Bernanke and others are opposed to that idea because they fear it will lead to Congressional interference with monetary policy. What can be done to improve transparency at the Fed? What should not be done? Is there any information on Fed discussions and the data that goes into them that would compromise the Fed's independence or ability to do its job if made public?

**A.7.** Independence of central banks began under the gold standard. Fed actions were restricted and no one expected long-term inflation. These restrictions have gone away. We need new restrictions that Congress can monitor. That means we must adopt a quasi-rule that allows limited discretion. The Fed should announce its inflation and unemployment targets. If it misses the target substantially, it should offer an explanation and a resignation. The President can accept the explanation or the resignation. My proposal relates responsibility to authority. Several countries have adopted variants of it.

Congressman Paul's proposal is too much concerned with procedure. More important is outcome—inflation and unemployment. From about 1985 to 2003, we had low inflation and good growth. The Fed must be made to repeat or improve on that performance.

**Q.8.** Do you have any suggestions for ways to improve the Fed's ability to carry out its core mission of monetary policy? Do you have any other comments about the Fed generally?

**A.8.** See the previous question. We need to limit discretion without putting the Fed in a straight jacket. We need to end "too-big-to-fail." We need to agree on lender of last resort policy. We need better—more effective—Congressional oversight.